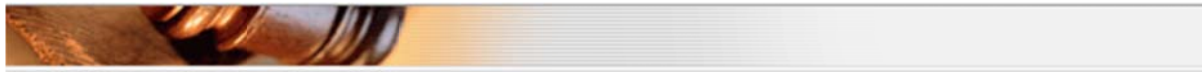
CORPORATE ASSISTANCE
Compliance Management for Business Owners



Protecting Your "Non-Qualified" Plan Assets Against Veil Piercing

In a previous article, we showed how employees can use veil piercing in "ERISA qualified" plan claims to hold business owners personally liable for plan nonperformance.

In this issue, we discuss the treatment "non-qualified" retirement or deferred compensation plans are likely to receive in a veil piercing scenario. There are several important lessons for business owners:

- Non-qualified plans are attractive options for executive employees because they don't have contribution limits and participation requirements like qualified plans.
- Many business owners who are also employees use non-qualified plans as a way to give themselves tax-advantaged compensation.
- If a corporate veil is pierced, non-qualified plan assets can be successfully attached in a court judgment. Business owners should clearly understand which of their financial plans are "ERISA qualified" and which are not.
- Business owners of companies that use non-qualified plans should take extra care to ensure they are maintaining proper corporate governance.

Background

A "non-qualified" plan is an employer-sponsored retirement or other deferred compensation plan that does not meet the tax qualification requirements under Internal Revenue Code Sec. 401 (i.e. qualified plan requirements). Companies use non-qualified plans as a method to attract and retain key employees. They are often used to supplement a qualified plan (e.g. 401(k)) and provide greater benefits to executive employees.

Non-qualified plans are attractive for highly compensated individuals, because they do not have the contribution limits and participation requirements associated with ERISA qualified plans.

A non-qualified plan allows an employee to defer the receipt of taxable wages or bonuses until some future year when (hopefully) the employee is in a lower tax bracket, thereby paying less in taxes when the compensation is received. Particularly in privately held companies, these plans give business owner/employees a proven, tax-efficient way to take compensation and build wealth. Examples of non-qualified plans include:

- Supplemental Executive Retirement Plans (SERPs)
- Deferred Bonus Plans
- Stock Option /"Shadow" Stock Plans
- Key Employee or Group-Term Life Insurance Plans

The National Center for Employee Ownership (NCEO) is a nonprofit organization that tracks business ownership by employees. Based on their statistics, there were roughly 40 million US participants in non-qualified plans as of 2003, with hundreds of billions in plan assets.

The ERISA Qualification Question

There is a wide variety of retirement and deferred compensation plans on the market. These plans differ in purpose, structure, requirements, and performance. In a legal dispute, one of the first issues a court will address is whether the plan in question is "ERISA qualified".

The answer to this issue is not always obvious. There are numerous examples of cases where courts ruled counter to the defendant's expectations, or where an appeals court reversed the finding of a lower court regarding ERISA qualification.

As we discussed last month, if your plan is found to be ERISA qualified, it is protected even in the event of a veil piercing. The non-alienation protections in ERISA constitute some of the strongest asset protection available under the law.

Business owners need to clearly understand the treatment their specific financial plans can expect with regards to ERISA qualification. Check with your financial advisor if you have any questions on this point.

The Case of Lowenschuss v. Selnick

In 1981, Beverly Selnick filed for divorce from Fred Lowenschuss in the state of Pennsylvania. Ten years later, the divorce court issued a decree that awarded Beverly an ownership interest in 38.7% of the assets of Fred Lowenschuss' pension plan. However, instead of transferring to Beverly her share of the plan assets, Fred transferred over $8 million of plan assets out of Pennsylvania to avoid the jurisdiction of the Pennsylvania courts.

Fred relocated to Nevada and in 1992 filed a Chapter 11 bankruptcy petition. On his petition, Fred claimed the plan assets were excluded from the bankruptcy estate because it was an ERISA qualified plan. Fred knew that if he could get ERISA treatment, Beverly's court judgment and any other creditor claims would not be able to gain access to the plan assets.

On appeal, the court ruled that Fred's pension plan was not ERISA qualified, and the assets were thereby included in his estate. The court also granted Beverly's motion to appoint a trustee to manage the plan assets. In the end, Beverly got her share of the plan assets, notwithstanding Fred's efforts to evade her.

What This Means To You

What can we learn from the travails of Beverly Selnick and Fred Lowenschuss, and how does it apply to your corporate veil? Although the legal setting was bankruptcy, the same principles and rules would apply to a veil piercing scenario. Let's start with what we know:

- When you create a business entity, a corporate veil separates your business assets from your personal assets. The veil is a shield that protects assets on either side from liabilities on the other side.
- When your corporate veil is pierced, the shield vanishes. Personal liabilities can impact your business assets, and your personal assets are exposed to business liabilities.

The bankruptcy court showed us that non-qualified plan assets are considered part of your personal estate. As a result, they are exposed to liabilities that are directed against you personally. Or, in other words, that successful veil piercing claims against your business can latch onto your non-qualified plan assets.

What You Can Do

Simple – keep the rules of corporate governance. If your veil is strong, business liability claims are stopped at the "veil's edge".

As part of our ongoing efforts to help you govern your business entities, we are continually researching the causes and legal arguments related to veil piercing. Veil piercing threats come from both statutory law (laws created by Congress and state legislatures) and common law (legal precedents that come as a result of court rulings).

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