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Can the Small Business Owner Survive *Patterson* (An Update)?

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Chaos has been wrought by the lower courts since Patterson was decided. Great care must be taken in advising a client about his or her plan's protection, especially if the client is the sole shareholder of even the most IRC compliant plan.

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Two and a half years ago, this author wrote a three-part article (the "Article") that appeared in this publication entitled "Are Qualified Plans Exempt in Bankruptcy? *Patterson* and its Aftermath."[1] The Article examined the history and the current status of whether a qualified plan balance was exempt in bankruptcy. This article will not attempt to revisit the history leading up to *Patterson*[2] or even *Patterson* itself. A reading (or re-reading) of the Article will provide the reader with more than he or she probably ever wants to know regarding the history and the case.

The Article studied some of the cases both leading up to and following *Patterson*, and noted an alarming trend of cases in which sole shareholder plans were held not to have the protection of *Patterson* because they were not ERISA qualified. Further, in those states that have opted out of the federal Bankruptcy exemptions under section 522(b)(1) of the Bankruptcy Code (Code), several courts were beginning to take the position that the federal bankruptcy courts should undertake the inquiry of whether a plan was tax qualified under the Internal Revenue Code (IRC), as most of the states who have an independent pension exemption tie such exemption to qualification under the IRC. This article will update the case law since the end of 1997 when the Article was written and attempt to provide some answers and guidance in a very troubling area. First, those cases outside the state of Florida will be examined and then those inside Florida.

The Non-Florida Cases

A citation search of *Patterson* since 1997 will yield no less than 100 cases. Some of these cases have nothing to do with pensions and instead focus on the *Patterson* approach to statutory interpretation and plain language. Several cases do, however, address the core issue of *Patterson*. This article will not undertake the exhaustive citation patterns of the previous Article, but instead will focus on about a dozen or so cases that have been "typical" in the area.

Most of the published cases do not address the "normal" situation in which a

debtor claims his or her plan balance to be exempt. In most instances, debtors are merely employees of an entity, and under *Patterson* those plan balances are exempt. Virtually all of these "normal" cases are probably simply agreed to because of *Patterson*, and, thus, no opinion is offered regarding the issue as there is no real controversy.

The cases that have been published generally involve small business owners, i.e., those having only themselves or a "few" other employees. In these cases, the small business owners have claimed that their plan balances are exempt.

The bankruptcy court in New Hampshire in *In re Gaudette*[3] examined a plan that was established solely for the benefit of the debtor. The court held that since ERISA does not include sole shareholders as employees, *Patterson* did not protect the debtor's balance as *Patterson* protects only pensioners of ERISA qualified plans.[4] The court in *Gaudette* relied on a case that has been viewed as somewhat misguided. The court, relying on *Kwatcher*,[5] stated the "employee and employer are meant to be separate animals under Part 1 of ERISA and the twain shall never meet." The court in *Gaudette* stated that it quoted the previous passage because it spoke "loud and clear to the instant case."[6] The court, in agreeing with *Kwatcher*, stated finally that once the person is classified as the employer (the sole shareholder) payments to that person from the plan violate ERISA because the sole shareholder is the employer. Finally, the court stated that under *Kwatcher*, a sole shareholder cannot be both employee and employer (apparently ignoring centuries of cases holding otherwise), and thus held the plan balance to be part of the bankruptcy estate.

The *Gaudette* decision is troubling in two respects. First, like many other cases, the court held that the sole shareholder's plan balance is not exempt because it is not an ERISA plan. The *Gaudette* court, however, relied on *Kwatcher*, a case that has been criticized as overstepping the boundaries of reason.

The second, most troubling, part of *Gaudette* is the court's statement that once the sole shareholder is established as an employer, he or she is not treated as an employee under ERISA. Thus, a potential logical conclusion from *Gaudette* is that in a plan (that is ERISA qualified) with many employees, the employees' plan balances are exempt, but the sole shareholder's balance (because he or she is the "employer") is not exempt. This interpretation is especially troubling and repugnant to the spirit of *Patterson*. The term "ERISA qualified" refers to a plan as a whole, not to an individual's plan balance. The *Gaudette* decision opens the door to the argument that sole shareholders who establish plans for themselves and employees are not entitled to the same exemption as the employees, even in the event of impeccable compliance with both the IRC and ERISA. Query as to why any sole shareholder would even bother to establish a plan given this framework.

In *In re Kuraishi*,[7] the court held that the debtor's KEOGH plan was not exempt. In *Kuraishi*, the debtor participated in three plans. The trustee withdrew its objection to the two plans that were ERISA qualified plans and allowed those plans to be classified as exempt. The KEOGH plan, in which the debtor was the only participant, however, was held not subject to ERISA. The debtor argued that the KEOGH plan was still exempt because the plan document contained a valid anti-alienation provision making it spendthrift and, thus, exempting the funds under section 541(c)(2) of the Code. The court held that inasmuch as the debtor himself (as trustee) could access the plan funds, the plan was not a spendthrift trust with a valid restriction on transfer under California law and the plan funds were included in the bankruptcy estate.

The court in *Kuraishi* went out of its way to distinguish its facts from *In re Moses*,[8] in which the Ninth Circuit held a plan balance to be exempt. In *Moses*, the

court held that under facts similar to those in *Kuraishi*, the debtor's plan balance was exempt. In *Moses*, however, the debtor was not the sole shareholder or sole trustee of the plan. The court held that since the debtor could not make decisions relative to the plan on his own, the plan's anti-alienation provision did qualify as an applicable restriction on transfer under section 541(c)(2) of the Code and rendered the plan balance exempt. Query whether the appointment of a corporate co-trustee in *Kuraishi* would have rendered the plan balance exempt.

In *In re CRS Steam, Inc.*,[9] the bankruptcy court held that a Simplified Employee Pension (SEP) was included in the bankruptcy estate even though the debtor's SEP contained an anti-alienation provision. In *CRS Steam, Inc.*, the debtor created the plan and was the sole owner, participant, etc., of the plan. As such, the plan did not qualify as an ERISA plan. Further, although the court recognized (contrary to the presumption of some courts under California law) that spendthrift provisions are generally enforceable under Massachusetts law, it stated that a party "may not create a trust for his own benefit, transfer property into it, and have a spendthrift clause protect the property from his creditors."

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Two interesting cases regarding IRAs were decided in bankruptcy court in the eastern district of Michigan. In the first case, *In re Zott*,[10] Judge Shapero held that the debtor's IRA was not exempt under Michigan law. The court, in a very lengthy opinion, openly disagreed with the Eleventh Circuit's decision in *Meehan*, which held that an IRA did not have to contain anti-alienation language to be exempt.[11] The court in *Zott* held that since the debtors had the ability to control the disposition of the IRA, there could not be any real restriction on its transfer and that the Michigan statute exempting IRAs was not applicable non-bankruptcy law for purposes of establishing the exemption.[12]

A year later, a similar decision by Judge Shapero was appealed to the district court. In *In re Hermes*,[13] Judge Duggan held that, in fact, an IRA was similar to a stock bonus, pension, or profit sharing plan and qualified for exemption to the extent reasonably necessary for the support of the debtor. The *Hermes* court specifically acknowledged and agreed with the holding in *Meehan* and specifically overruled Judge Shapero. Judge Duggan stated "[t]he failure to treat IRA's as similar plans, and thus exempt, would be to penalize individuals who are not in a position to participate in a pension or profit-sharing plan, e.g. self-employed individuals."[14]

Perhaps the single most troubling case is the very recent decision *In re Goldschein*.[15] The *Goldschein* decision is exactly what the reader of *Gaudette* would fear. In *Goldschein*, the debtor was the trustee, officer, and principal of the company. The trustee argued that although the plan had received a favorable determination letter from the IRS, and "apparently" had other employees, the principal's plan balance was still not exempt.

The court in *Goldschein* stated that when a plan is governed by the IRC (submitted for a determination letter), ERISA and the IRC both must be complied with to qualify for the protection of *Patterson*. The court stated that "it is apparent that where a tax qualification is involved, Congress intended the provisions of ERISA and the provisions of the Internal Revenue Code to work in consort .... in order to be entitled to the exclusion of benefits from the bankruptcy estate, the plan must comply with the provisions of both statutes."[16]

The trustee in *Goldschein* was able to advance an amazing argument that the plan was not qualified because it included Mrs. Goldschein in the plan and she did not really work there. The trustee also demonstrated that loans were taken out of the plan without proper documentation (including those as to security and amounts). The court then acknowledged the reasoning of the Fifth Circuit in *Sewell* (discussed below), which held that qualification under the IRC has nothing to do

with ERISA, but stated that *Sewell* could not have meant acts as bad as those committed in the instant case. Thus, with one very disturbing sweep of its pen, the court separated the debtor's balance from the rest of the plan, and held his plan balance to be non-exempt. Query whether another participant's balance in this now "ERISA disqualified plan" would have been exempt in front of the court in *Goldschein*.

Two of the more interesting court of appeals decisions rendered recently are *Watson* and, as discussed above, *Sewell*. In *In re Watson*,[17] the Ninth Circuit held that a physician who was the sole shareholder and sole participant in a plan could not exempt his balance in the plan in bankruptcy. Although the plan contained an anti-alienation provision and was tax qualified, the court found that Watson did not qualify as an employee under ERISA. The court found arguments that the restrictive ERISA definition of employees was unconstitutional unpersuasive.

In *In re Sewell*,[18] the Fifth Circuit may have taken a somewhat friendlier approach. *Sewell* concluded that, even if a plan was not qualified by its actions under the IRC, such non-compliance was not relevant to this particular ERISA qualified plan. The debtor was merely an employee of the employer and was not a trustee, administrator, or other fiduciary. The trustee also admitted that the plan did contain a valid anti-alienation clause. The Fifth Circuit noted that it was following the logic of *Baker* in addressing the issue of whether ERISA qualification mandated IRC qualification as well.[19]

Before citing *Sewell* as "debtor-friendly," pay careful attention to the final footnote in the decision. The court stated that tax qualification has nothing to do with ERISA as to the debtor's "non-transferable beneficial interest in an ERISA employee pension benefit plan" but noted that it was not creating a per se rule as to every ERISA retirement plan. Specifically of concern is the court's note that "we can conceive of a provision in an ERISA trust entitling the participant to invade the principal of a defined contribution plan for his own purposes—to take a loan that can be converted to a withdrawal for failure to repay, or to accelerate disbursement directly."[20] The court, however, stated that since the record did not suggest such facts, the court did not need to pursue the question. Even *Sewell*, which appears debtor friendly, will likely be read as an invitation to the bankruptcy courts to more thoroughly pick apart each and every provision of the plan document and to examine whether a plan is both ERISA and IRC qualified. These questions had previously and traditionally been the province of the Department of Labor and the IRS, respectively.

Of course, there have been numerous cases where plan balances have qualified under ERISA and those balances have been held to be exempt.[21] As illustrated above, however, numerous courts have apparently decided to establish new lines of case law, invalidating asserted plan balance exemptions for a variety of reasons.

For the professional who might want to have a plan to benefit only him or herself, it appears that the protection of Patterson is unavailable.

The Florida Cases

The cases discussed are separated into Florida and non-Florida cases for two reasons. First, as this author's practice is limited to Florida, the distinction makes sense from a personal level. Second, the Florida cases indicate in a microcosm the phenomenal "departure" from *Patterson* both inside and outside Florida.

Judge Paskay wrote the opinion in *In re Fernandez*.[22] Judge Paskay has been considered to be "anti-debtor" for some time and a decision rendered against the debtor was expected. In *Fernandez*, the debtor was an attorney whose professional association had adopted a defined benefit plan, a money purchase plan, and a profit sharing plan, all with favorable determination letters from the IRS. Although there was debate concerning whether there were in fact other participants in the plan, the

debtor argued that the plans were protected by *Patterson*. Judge Paskay stated that although *Patterson* decided that ERISA qualified plans were exempt, it left open the door to the question of whether the same was true if the plans were not operated in accordance with ERISA. Judge Paskay stated that it was "uniformly agreed" that although Fla. Statute §222,21 does not mention ERISA, "IRC qualified" means "ERISA qualified" as well. This author has no idea "who" uniformly agreed that IRC qualified means ERISA qualified as well since, as noted above, many courts have not agreed with this conclusion.

In *Fernandez*, Judge Paskay undertakes an exhaustive evaluation of each plan investment to determine whether they were prudent, and whether they were for the benefit of the participants or the plan (query how this is any different from a directed investment option in a plan document). Judge Paskay states that the violations are not egregious (as compared to another case) but still finds that the investments were made solely and exclusively for the benefit of the debtor, and, thus, violate ERISA.[23] Because the plans violated ERISA, two results occurred.

1. The plans having violated ERISA were not eligible for protection under *Patterson*.
2. Because, according to Judge Paskay, the IRC requires ERISA compliance, the debtor did not qualify for the independent Florida state exemption as well.

The *Fernandez* case for Florida pensioners is as dangerous as it gets. Judge Paskay's opinion basically allows a trustee to use non-qualification for ERISA as a way around Florida's statute, which is keyed to IRC qualification. A trustee could argue that even if a plan was in perfect IRC compliance but had no employees, it would not be eligible for the Florida exemption because it was not ERISA qualified. This author believes that Judge Paskay has missed the point of the Florida statute and misinterpreted the interplay of ERISA and the IRC.

In *In re Blais*,[24] Judge Nesbitt remanded a plan to the bankruptcy court for a determination of whether the plan in operation violated the IRC (and then presumably disqualified for the exemption). Further, in *In re Lawrence*,[25] Judge Utschig determined that a plan that allegedly had two participants actually only benefited the debtor. Judge Utschig reasoned that since only the debtor participated in the plan, the plan was not subject to ERISA. Further, since the plan was non-compliant in its filings of certain amendments, the court concluded the plan was not IRC qualified (as well as because the plan was not ERISA qualified, which the court reasoned is also a part of IRC compliance).

Planning For The Small Business Owner

What advice can be given to the small business owner who has asset protection concerns and asks whether he or she should start a qualified plan and whether this plan balance will be exempt?

Under *Patterson*, one would believe that as long as the plan has other employees, the plan would be exempt. Under the line of cases cited above, however, an argument can be made that the protection applies to everyone *except* the business owner (if he or she is the sole shareholder and held to be "the employer"). Further, for the professional who might want to have a plan to benefit only him or herself, it appears that the protection of *Patterson* is unavailable. In a state like Florida, Maryland, any state in the Fifth Circuit, or any state whose exemption is conditioned upon IRC compliance, it is also possible that, even if the client's plan is IRC "perfect," the failure to be ERISA qualified may mean that the client's plan is IRC "disqualified" for purposes of the state exemption.

Given the recent trend in case law, attorneys must be very careful in the advice given to clients regarding the protection of their plan balances. Although a plan benefits "employees," the sole shareholder may not benefit from such protection. If this is a potential result, the bankruptcy courts have probably given small business owners yet another reason (besides cost and economics) to simply not maintain a plan.

Should clients be advised to close down their plans and rollover the balance to an IRA or some other exempt form? Would a court view this transfer from a potentially perfectly compliant (IRC compliant) plan as transferring "tainted" assets and thereafter invade the IRA?

The answers are probably as disturbing as the questions. Each attorney, however, needs to advise clients thoroughly and frankly regarding the trap doors that may lie ahead. In some instances, the appointment of a corporate co-trustee might help. In the sole shareholder business, however, short of taking in another owner, what answers provide certainty for those small business owners?

Conclusion

The Article undertook an exhaustive look at *Patterson*, so there is no need to again quote Justice Scalia's brilliant concurrence in the unanimous court decision. Ultimately, however, the chaos that has been wrought by the lower courts since *Patterson* will lead to yet another scolding from the Supreme Court. The Court did not leave open the question (as many courts have said) of "what is ERISA qualified." Instead, those lower courts have opened that door themselves. In the meantime, great care must be taken in advising clients about their plans' protection, especially if the client is the sole shareholder of even the most IRC compliant plan. ■

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[1] See Singer, "Are Qualified Plans Exempt in Bankruptcy? Patterson and Its Aftermath," 2 JOAP 19 (July/August 1997), 3 JOAP 29 (September/October 1997), and 3 JOAP 54 (November/December 1997).
[2] Patterson v. Shumate, 504 U.S. 753 (1992).
[3] 3 In re Gaudette, 240 Bkrptcy. Rptr. 649 (Bkrptcy D.N.H., 1999).
[4] 29 U.S.C. section 1002. This author disagrees with the narrow interpretation of *Patterson* and stated in the Article his belief that if the Court were afforded another opportunity, it would have found IRC Section 401(a)(13) to also qualify as applicable non-bankruptcy law for purposes of the Code, thus creating another grounds for exemption.
[5] Kwatcher v. Massachusetts Services Employee Pension Fund, 879 F.2d. 959 (CA-1, 1989).
[6] Note 3, *supra*.
[7] 237 Bkrptcy. Rptr. 172 (Bkrptcy. C.D. Cal., 1999).
[8] In re Max R. Moses, 167 F.3d 470 (CA-9, 1999).
[9] 217 Bkrptcy. Rptr. 365 (Bkrptcy. D. Mass., 1998).
[10] 225 Bkrptcy. Rptr. 160 (Bkrptcy. E.D. Mich., 1998).
[11] In re Meehan, 102 F.3d 1209 (CA-11, 1997). The court held that an IRA was still exempt because of a Georgia statute exempting the IRA from garnishment.
[12] Note 10, *supra*.
[13] 239 Bkrptcy. Rptr. 491 (Bkrptcy. E.D. Mich., 1999).
[14] *Id.*
[15] 244 Bkrptcy. Rptr. 595 (Bkrptcy. D.MD., 1999).
[16] *Id.*
[17] 161 F.3d. 593 (CA-9, 1999).
[18] 180 F.3d. 707 (CA-5, 1999).
[19] See In re Baker, 114 F.3d. 636 (CA-7, 1997).
[20] Note 18, *supra*.
[21] For example see In re Meinen, 228 Bkrptcy. Rptr. 368 (Bkrptcy. W.D. Pa., 1998) and In re Wiczer-Spaulding, 223 Bkrptcy. Rptr. 538 (Bkrptcy. D. Minn., 1998).
[22] 236 Bkrptcy. Rptr. 483 (Bkrptcy. M.D. Fla., 1999).
[23] See also *In re Groff*, 234 Bkrptcy. Rptr. 153 (Bkrptcy. M.D. Fla., 1999) in which Judge Paskay seemed "tempted" to invade an IRA that contained proceeds from a rollover from a prior SEP Plan (but ultimately held the plan balance to be exempt).
[24] 220 Bkrptcy. Rptr. 485 (Bkrptcy. S.D. Fla., 1997). This case is still pending and the author is involved as an expert in the case.
[25] 235 Bkrptcy. Rptr. 498 (Bkrptcy. S.D. Fla., 1999).