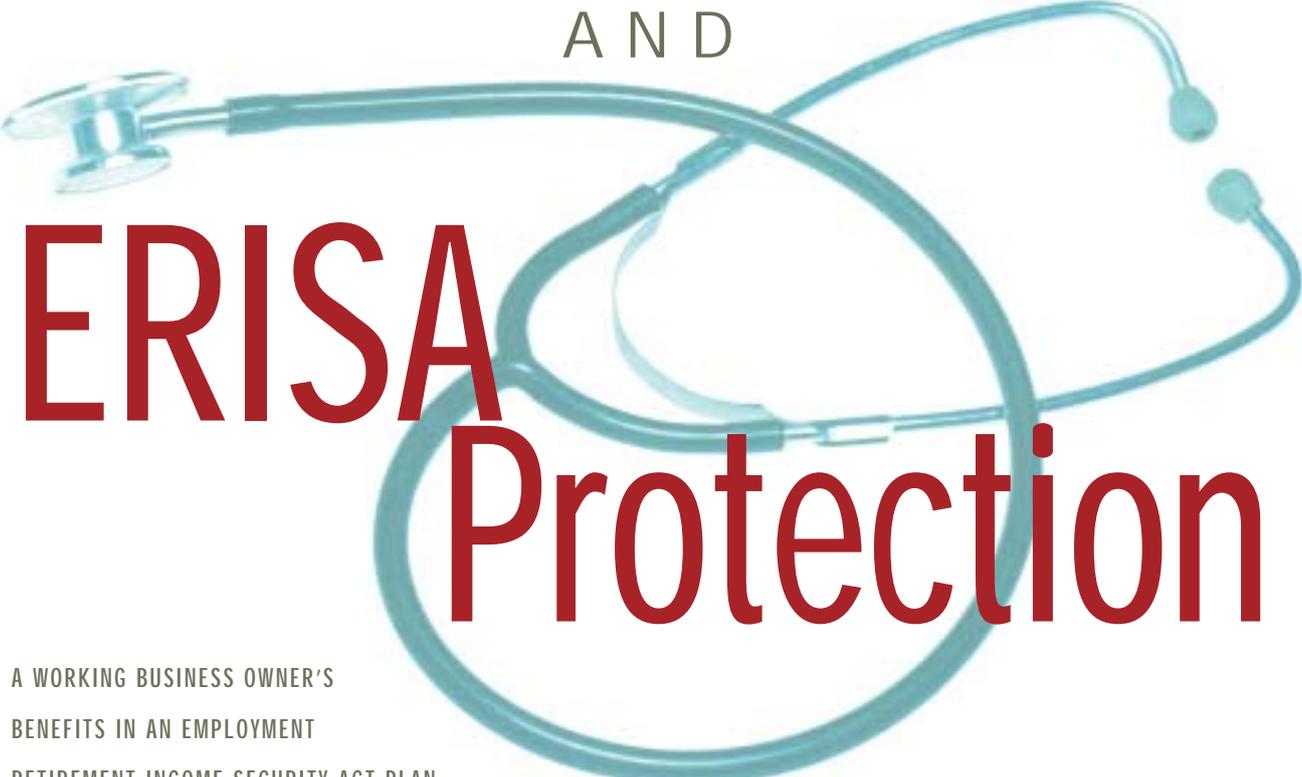


SMALL BUSINESS OWNERS  
AND



ERISA  
Protection

A WORKING BUSINESS OWNER'S  
BENEFITS IN AN EMPLOYMENT  
RETIREMENT INCOME SECURITY ACT PLAN  
ARE PROTECTED FROM CREDITORS IF THE PLAN ALSO COVERS OTHER BUSINESS EMPLOYEES, THE SUPREME COURT RULES.

BY MILT ZALL, CIA

The U.S. Supreme Court recently decided a case arising from the bankruptcy of the owner-employee of a corporation that sponsored an employee retirement plan in which the owner participated. The court was asked to decide whether the working owner of a business (here, the sole shareholder of the corporate employer) is precluded from being a plan “participant” under the provisions of the Employee Retirement Income Security Act of 1974 (ERISA) in a retirement plan that is established in accordance with ERISA.

This case presents the question of whether a working owner (such as a sole shareholder, sole proprietor, or partner who renders services to a business) may be a participant in an ERISA plan and enjoy the same protections that other plan participants enjoy. A lower court, the U.S. Court of Appeals for the Sixth Circuit, had ruled that working owners could not be ERISA-plan participants.

The facts of this case are fairly straightforward. Dr. Raymond B. Yates was a practicing physician and the sole shareholder and president of a professional corporation known as Raymond B. Yates, M.D., and P.C. The corporation maintained the Raymond B. Yates, M.D., P.C. Profit Sharing Plan (the plan), for which Dr. Yates was the plan administrator and trustee. As of June 30, 1996, four persons were designated as plan participants, including Dr. Yates, his wife, and two employees. From its inception, the plan always had at least one participant other than Dr. Yates or his wife.

The plan was established in accordance with Section 401 of the Internal Revenue Code and contained an “Anti-alienation” provision as required by the Internal Revenue Code and ERISA. That provision, known as the “Spendthrift Clause,” provided that: Except for plan loans to participants (as permitted by Article 12 of the plan

document) and the assignments provided therefore, no benefit or interest available hereunder would be subject to assignment or alienation, either voluntarily or involuntarily. This provision is intended to protect plan assets from the claims of creditors and is a very important provision in the eyes of an owner-employee. It ensures the owner-employee that no matter what good or bad luck the business may encounter, at least money deposited into the company pension plan is “safe.”

In an earlier case, *Patterson v. Shumate* [504 US 753 (1992)], the Supreme Court held that retirement benefits of a plan participant (who has filed for bankruptcy protection) in an “ERISA-qualified” plan are protected from that debtor’s creditors. The Supreme Court, however, didn’t define “ERISA-qualified” in its decision. Defining the term has been left up to the lower courts, and the definition has continued to be refined.

Many federal circuit courts of appeal have previously ruled that a plan in which the only participant is and always has been the sole owner of the business that sponsors the plan (or only the owner and his or her spouse) is not ERISA-qualified. The basis for this position is that, under the Department of Labor (DOL) regulations that govern ERISA plans, the owner and spouse aren’t employees, and if they are the only participants, then the plan isn’t an “employee benefits plan” for purposes of Title I of ERISA because it covers no employees. Further, since it isn’t an “employee benefits plan” under ERISA, the plan isn’t subject to the anti-alienation provision that is part of Title I.

A plan’s status as an “employee benefit plan” under ERISA Title I has been crucial in these cases because the ability to enforce the anti-alienation provision is required in order for the benefits to be protected from creditors under the Supreme Court holding in *Patterson v. Shumate*. That’s because Bankruptcy Code Section 541(c)(2) provides that the retirement benefits are excluded from the debtor’s bankruptcy estate only if they are subject to a “restriction on the transfer of a beneficial interest of the debtor in a trust that is enforceable under applicable non-bankruptcy law.” Under the *Patterson v. Shumate* decision, ERISA Section 206(d)(1) was held to be such a restriction.

George M. Morrison, a principal in the law firm of G.M. Morrison, PC, an employee benefits law firm that specializes in ERISA retirement plans, says, “The legal issue raised in Yates’ appeal to the Supreme Court is whether the protections of *Patterson v. Shumate* extend to a plan that benefits the shareholder of an incorporated

business. On this issue, the DOL regulations appear to be in conflict with the Supreme Court’s decision in *Nationwide Mutual Ins. Co. v. Darden*, in which the Court held that the term ‘employee’ for purposes of ERISA is to be determined under common law definitions. Under this approach, an employee of an incorporated entity is treated as a common law employee even if he or she wholly owns the corporation. Under this interpretation, the owners of a corporation would nevertheless be entitled to the protections of *Patterson v. Shumate*.”

## THE FACTS

In December 1989, Dr. Yates borrowed \$20,000 from the plan, pledging his vested account balance in the plan as security. The loan was repaid in its entirety in November 1996. On December 2, 1996, three weeks after the repayment, an involuntary bankruptcy petition was filed against Dr. Yates under Chapter 7 of the bankruptcy law. Several months later, William T. Hendon, the trustee in bankruptcy, commenced adversary proceedings against Dr. Yates in the U. S. Bankruptcy Court for the Eastern District of Tennessee. The bankruptcy court concluded that Dr. Yates’s interest in the plan was not excluded from his bankruptcy estate. The court reasoned that Dr. Yates, as the “self-employed owner of the professional corporation that sponsored the pension plan... cannot participate as an employee under ERISA, and he cannot use its provisions to enforce the restriction on the transfer of his beneficial interest in the plan.”

The U.S. District Court for the Eastern District of Tennessee affirmed the judgment of the bankruptcy court. The district court considered itself bound by prior Sixth Circuit decisions that had held that neither a sole proprietor nor a sole shareholder of a corporate employer could be a participant in an ERISA plan. The U.S. Court of Appeals for the Sixth Circuit affirmed the district court’s judgment. The court reasoned that the plan’s anti-alienation clause isn’t “enforceable under applicable non-bankruptcy law” because it “is not enforceable by Dr. Yates under ERISA.”

## THE APPEAL

The Supreme Court’s review was then sought to resolve a conflict among the courts of appeal as to whether a working owner (such as a sole shareholder like Dr. Yates, a sole proprietor, or a partner who renders services to a business) may be a participant in an ERISA plan that also covers other employees. Although the Sixth Circuit Court of Appeals held that working owners who own the entire

interest in a business aren't eligible to participate in ERISA plans, not all U.S. courts of appeal had previously concurred in this view. The issue is important because the question as to whether working owners may be participants in ERISA plans arises frequently and in a variety of contexts. This issue is of particular importance to doctors and other professionals who may find themselves at risk of catastrophic malpractice claims. In addition, as Dr. Yates's attorney, James Al Holifield, Jr., points out, "Very few working owners of incorporated businesses will establish a retirement plan that they themselves cannot contribute to if they're afraid that creditors will seize the plan's assets. What incentive do they have for establishing a plan?"

### THE U.S. GOVERNMENT INTERVENES

The U.S. government, though not a party to this case, filed a brief with the Supreme Court in support of Dr. Yates. The government argued that the court of appeals was wrong when it held that working owners who own the entire interest in a business aren't eligible to participate in ERISA plans.

The government contended that ERISA sought "to protect...the interests of participants in employee benefit plans and their beneficiaries." The government said the Sixth Circuit Court of Appeals' decision in this case was flat out wrong. Without analyzing the issue independently, that court followed circuit precedent and held that "a sole shareholder cannot qualify as a 'participant or beneficiary' in an ERISA pension plan." That holding, the government argued, disregarded the guidance provided by the U.S. Supreme Court in *Nationwide Mutual Insurance Co. v. Darden*, as well as the text of ERISA itself, was in conflict with an advisory opinion issued by the Department of Labor; and misinterpreted a DOL regulation.

### THE SUPREME COURT RULES

The Supreme Court, in a 9-0 decision, issued an opinion that if a plan covers one or more employees other than the business owner and his or her spouse, the working owner may participate on equal terms with other plan participants. This decision resolves a split in the federal courts on the question of whether a working business owner is a "participant" under ERISA.

A working owner, in common with other employees, qualifies for the protections ERISA affords plan participants and is governed by the rights and remedies ERISA specifies, the Court said. In so ruling, the Supreme Court rejected the position, taken by some lower courts in this case, that a business owner may rank only as an "employ-

er" and not also as an "employee" for purposes of ERISA-sheltered plan participation. The Supreme Court held that when a plan covers one or more employees other than the working owner and his or her spouse, then the working owner is an ERISA-protected participant and can participate "on equal terms" with other plan participants.

Finding ERISA's definitions of the terms "employee" and "participant" unclear, the Court examined other ERISA provisions that support the concept that an owner-employee can wear two hats (i.e., as an employer and an employee). The Court postulated that ERISA was intended to be consistent with existing Internal Revenue Code provisions, which allow sole proprietors and other working owners to be covered by tax-favored benefit plans. Emphasizing that the intent of ERISA was to provide a uniform federal law, the court concluded that a plan covering at least one nonowner employee should provide ERISA protection to all participants in the plan, not just the nonowner participants.

ERISA was enacted "to protect...the interests of participants in employee benefit plans and their beneficiaries," the Court said. This case primarily concerns the definition and coverage provisions of ERISA. The Supreme Court felt it didn't have to look outside ERISA itself to conclude with certainty that Congress intended working owners to qualify as plan participants. In addition, a U.S. Department of Labor ruling in 1999 said, "In our view, the statutory provisions of ERISA, taken as a whole, reveal a clear Congressional design to include 'working owners' within the definition of 'participant' for purposes of Title I of ERISA."

The Supreme Court ruled that Yates's plan contributions were protected from his creditors. "This ruling represents a victory for employers and employees alike," says James Al Holifield, Jr., because it establishes as the law of the land "that all money in an ERISA-qualified plan is protected from the grasp of creditors and serves to insure the financial solvency of ERISA plan participants upon retirement." The irony here is that while ordinary creditors are precluded by ERISA from attacking an ERISA plan's assets, the IRS can go after an ERISA plan's assets if the plan owes the IRS money. ■

*Milton Zall is president of Zall Enterprises, an editorial consulting firm based in Silver Spring, Md. He writes on taxes, investments, technology, the Internet, and HR/business issues. He is a Certified Internal Auditor and a Registered Investment Advisor. He can be reached at [milt.zall@verizon.net](mailto:milt.zall@verizon.net).*