Are You Sure Your ERISA Plan is a “Safe Vehicle” which is Protected from Judgment Creditors?

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Most lawyers, and their clients (including physicians) have historically viewed assets in a retirement plan as “safe” from all but the most highly protected creditors (IRS, ex-spouse, etc.). In a very recent case from California, (In the Matter of Lloyd Myles Rucker), the Ninth Circuit Court of Appeals denied a debtor facing a substantial business judgment in excess of $6,000,000.00 utilization of an exemption that had previously been seen as a sacred cow, handing asset protection strategists a glaring defeat. While apparently distinctive to California, the holding rests upon rationale that could have much more widespread application.

Quoting directly from the Appeals' Court opinion, the Court set forth the factual and legal grounds for its decision:

> “Facing a civil judgment debt of more than $6.5 million, Lloyd Myles Rucker declared bankruptcy and tried to exempt his assets as belonging to private retirement plans under California Civil Procedure Code (“CPC”) § 704.115. Rucker had previously placed the assets in pension and 401(k) plans funded by his wholly owned corporations. The bankruptcy court denied the exemption on the explicit ground that Rucker’s retirement plans were not designed and used primarily for retirement purposes. The district court saw it otherwise and reversed this judgment. We conclude, after considering the totality of the circumstances, that the bankruptcy court’s prior decision was not clear error, and we therefore reverse the district court.”

It is noteworthy that the Court made certain factual findings which may provide some limited relief. The Court stated “From 2001 to 2005 Rucker aggressively funded the Plans both personally and through his Controlled Corporations. In most of these years Rucker willfully caused the Plans to be “overfunded,” in that contributions to them exceeded the annual limits imposed by the Internal Revenue Code. *See* 26 U.S.C. § 401(a)(16) (stating that retirement plans must adhere to contribution limits to earn favorable tax treatment). The overfunding amount was about 20 percent of the total value of the Plans. Also,

contributions to the Plans by the Controlled Corporations were markedly substantial in relation to the salaries the corporations paid to Rucker, in some instances exceeding his salary."

While the overfunding of the Plans, and the relationship of the contributions to the salary of the employee benefiting from the contribution would seem fair game for comment if the analysis were one focusing on the tax deductibility of the contributions made, and perhaps, the continued status of the Plans as "qualified plans", concluding that such overfunding amounts are to be treated as nullifying the "safety zone" historically provided for qualified plan balances will, in all likelihood, convey a chilling effect on the overall establishment and maintenance of qualified plans.

Perhaps some solace can be taken from the Court's focus on other egregious behavior engaged in by Mr. Rucker in the instant case, and that plan account holders may be able to draw distinctions as they compare their own conduct to that of Mr. Rucker. To this end, the Court specifically stated:

> "The bankruptcy court found that Rucker "repeatedly failed to accurately disclose" to the IRS contributions made by the Controlled Corporations. Between 2002 and 2004 Rucker contributed $160,000 more to the 401(k) Plans than he disclosed to the IRS, and in 2003 alone he contributed about $150,000 more to the Pension Plan than he first reported. The record also shows that in 2003 Rucker directed a wholly owned offshore corporation to contribute $120,000 to his Plans via a foreign bank account, even though the offshore corporation was not a plan sponsor permitted to contribute to the Plans."

While Rucker's conduct may not have won him any IRS taxpayer compliance awards, the relevant California statute providing the exemption from creditors for retirement accounts provided that it exempts "all amounts held, controlled, or in process of distribution by a private retirement plan." This language is substantially similar to the parallel exemption provisions in the statutes of most all States.

The impacted creditor, however, analyzing the statute in a somewhat novel way, claimed that the plan balances were not exempt, "…because they were not designed or used primarily for retirement purposes". This finding rested, in large part, on the overfunding of the Plans, although the Court did not find Mr. Rucker a credible person, generally. Based upon its analysis, the Court found that Mr. Rucker had, as a motive for accumulating assets inside the Plans, the primary intent to shield his assets from creditors.

Accepting that Mr. Rucker's intent may have been driven by more than a single factor, the Appellate Court found itself squarely faced with this "dual motive" analysis. Without discussing the absence of any specific statutory requirement in the quoted exemption provision concerning a need for the Court to make a finding that there existed no motive other than retirement utilization, the Court stated "…The evidence taken together squarely raises the issue of whether a person who funds a retirement plan both for retirement purposes in part and to shelter assets and avoid paying debts in part has acted primarily for retirement purposes". Citing several cases in which retirement plans had previously been held non-exempt under the California statute as a result of the debtor's pre-bankruptcy abuse of the Plan structure through repeated loans and distributions, the Court concedes, in the conduct of its analysis, that "…We are not aware of any California or federal court in a

published opinion denying an exemption under CPC § 704.115 in circumstances where the debtor made no significant withdrawals or loans from the plan". Not satisfied with the outcome of its search of prior precedent, however, the Court goes on to state "…At the same time, however, we are also aware of no precedent stating that the lack of withdrawals or loans in itself conclusively establishes a primary retirement purpose."

In its novel holding, the Court states "…In summary, when a court evaluates the totality of the circumstances to determine whether a private retirement plan is designed and used primarily for retirement purposes under CPC § 704.115, "[a]ll factors are relevant," and a court is not limited to considering only those factors previously considered by other California and federal courts. *Bloom*, 839 F.2d at 1379-80. Courts may also consider, as the bankruptcy court did here, whether the debtor overfunded the plan or violated other IRS rules in contributing to the plan; the contribution amount by a corporation relative to the debtor's wages from that corporation; and the debtor's credibility and subjective intent. None of these additional factors is required or dispositive."

Most eerily, the specific language quoted just above could easily be read to open a brand new line of analysis when attempting to attack a claimed exemption for Plan assets—that is, "...whether the debtor…violated other IRS rules in contributing to the Plan…". This new strand will, no doubt, cause significant angst for physician clients, who frequently have very substantial assets in their qualified plans, and who are unduly are risk from the ravages of judgment creditors. If nothing else, it should prompt extreme care and caution in assuring that the plans diligently comply with all IRS rules and regulations, lest the failure to do so be construed by a Court as removing what has historically been a safe place to house assets, generally immune from creditor attack.

If you have any questions regarding this topic, please contact a member of the Foster Swift Health Care Practice Group.