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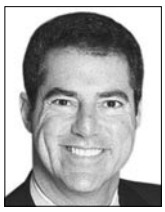
Expert Analysis

SECOND CIRCUIT REVIEW

Unpaid Employer Contributions Not Plan Assets Under ERISA



By **Martin Flumenbaum** And **Brad S. Karp**

This month we discuss *In re Halpin*,[1] in which the U.S. Court of Appeals for the Second Circuit held for the first time that an employer's unpaid contributions to an employee benefit plan do not qualify as "assets" of the plan under ERISA, absent provisions to the contrary in relevant plan documents. In its decision, written by Circuit Judge Barrington D. Parker and joined by Circuit Judge Debra Ann Livingston and District Judge Denny Chin (sitting by designation), the court affirmed the judgments of the Bankruptcy Court and District Court for the Northern District of New York, denying a motion to deem an employer's unpaid contributions to an employee benefit plan nondischargeable in bankruptcy. The decision resolves an unsettled question of law, situated at the intersection of ERISA and bankruptcy law.

Background and History

William C. Halpin, Jr. was the president and sole shareholder of Halpin Mechanical & Electrical Inc. (HM&E), an electrical contracting business. HM&E entered into agreements with a union requiring HM&E and its employees to contribute to various ERISA pension and benefit funds (the "Funds"). Over time, HM&E failed to make the required employer contributions to the Funds. Eventually, Mr. Halpin and HM&E filed for protection under Chapter 7 of the U.S. Bankruptcy Code, seeking the discharge of debts, including unpaid contributions.

During the bankruptcy proceedings, the trustees for the Funds asserted that the unpaid employer contributions were plan assets under the Employee Retirement Income Security Act (ERISA), and that Mr. Halpin exercised sufficient authority over them to make him a fiduciary. Thus, the trustees argued that Mr. Halpin's failure to make the required contributions to the Funds constituted a breach of fiduciary duty and subjected him to personal liability for any losses sustained by the plan by reason of his conduct.[2] Moreover, the trustees contended that Mr. Halpin's liability would not be dischargeable in bankruptcy, because §523(a)(4) of the Bankruptcy Code bars the discharge of an individual from any debt arising from "fraud or defalcation while acting in a fiduciary capacity." As a result, the trustees moved the Bankruptcy Court to deem the debt arising from unpaid employer contributions nondischargeable. In response, Mr. Halpin argued that unpaid contributions are not plan assets, that he was not a fiduciary and not personally liable, and that there was no debt to discharge.

> The Second Circuit held that unpaid employer contributions are not plan assets and are not held in trust for the beneficiaries of the Funds.

Court Decisions

The Bankruptcy Court for the Northern District of New York denied the trustees' motion to deem the debt arising from unpaid contributions non-dischargeable. The District Court affirmed, finding that plan documents did not give the Funds a property interest in unpaid contributions, so the unpaid contributions were contractually due payments and not plan assets. Because the unpaid contributions were not plan assets, the District Court reasoned that Mr. Halpin was not a plan fiduciary over those assets and thus could not be held personally liable for any loss sustained by those assets by reason of his conduct.

Second Circuit Decision

Whether unpaid employer contributions to a retirement plan constitute plan assets under ERISA is a question of law, so the Second Circuit applied a de novo standard of review. ERISA defines a plan "fiduciary" as one who "exercises any discretionary authority or discretionary control respecting management of such plan or exercises any authority or control respecting management or disposition of its assets…or… has any discretionary authority or discretionary responsibility in the administration of such plan."[3] Thus, the Court held that establishing non-dischargeability requires a threshold showing that "(1) the unpaid contributions were plan assets and (2) Halpin exercised a level of control over those assets sufficient to make him a fiduciary." Finding that the first prong of the test was

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not satisfied, the court did not reach the second prong.[4]

"Assets" are not defined under ERISA. In the absence of explicit statutory direction, the court examined pronouncements of the Department of Labor (the "department"), the agency charged with administering and enforcing Title I of ERISA. Although the department had not issued a formal rule governing when employer contributions become plan assets, it had informally advised that "the assets of a plan generally are to be identified on the basis of ordinary notions of property rights under non-ERISA law."[5] The department explained that "assets" include property over which the plan has a beneficial ownership interest. Accordingly, the department had informally taken the position that "employer contributions become an asset of the plan only when the contribution has been made," rather than when the contribution becomes due under the plan. When an employer fails to make a required contribution, the plan has a claim against the employer for the unpaid contribution, and that claim is a plan asset.[6]

Finding the department's interpretation persuasive and according it some deference, the court proceeded independently to analyze the issue. In the absence of a statutory definition of "asset," the court examined the concept as understood under the common law of property and trusts. Under "ordinary notions of property law," if a debtor fails to pay a creditor, the creditor does not become vested with a property interest in the debtor's assets. Rather, the creditor has a "chose in action," an assignable contractual right, against the creditor to recover the monies due.

A chose in action and a debt are two sides of the same coin: A chose in action is a creditor's contractual right to get paid; a debt is a debtor's contractual obligation to pay. The court noted that it is well settled under trust law that debtor and creditor do not stand in a fiduciary relationship. Rather, a creditor has a contract claim against a debtor. A trust does not arise as to assets until "they are either set aside by the employer for the employees' purposes or paid over to another person for those purposes."[7]

Applying these principles, the court held that unpaid employer contributions are not plan assets and are not held in trust for the beneficiaries of the Funds. The trustees and HM&E could have contractually provided for another result, but the court found no evidence in the plan documents that they had done so.

The court also found that sound public policy supported its holding that unpaid contributions are not plan assets. "The term 'assets,'" wrote the court, "is critical to virtually all commercial transactions, and has a reasonably well understood meaning that is imbedded in the common law of contracts, property and trusts." To give the term a new definition under ERISA law would disturb the coherence of the concept and rob real-world actors of a predictable source of laws on which they could rely in structuring their relationships.[8] Furthermore, if an employer's required contributions became an asset of the plan the moment they were due, then the employer would be holding an undifferentiated portion of assets in trust for some employees with a responsibility to dispose of them in their sole interest. This would create a fiduciary obligation in tension with the employer's other obligations, some fiduciary, to entities including the business as a whole, customers, shareholders, and other creditors. The court found it inconceivable that Congress intended such a result.

> Under the Second Circuit's approach, and unlike the Tenth Circuit's approach, debts arising from unpaid employer contributions can never become non-dischargeable under §523(a)(4) of the Bankruptcy Code—no matter the level of authority exercised by the employer over plan assets.

The trustees relied on the Second Circuit's decision in *United States v. LaBarbara* to support their position that employer contributions became plan assets the moment they became due. In *LaBarbara*, the head of a union was found to have accepted bribes to facilitate an employer's scheme to avoid making contributions required under an employee benefit plan. He was convicted of aiding and abetting the embezzlement of an employee benefit plan's assets. On appeal, he contended that the monies owed to the plan were not "assets" of the plan until paid; accordingly, he could not be convicted of aiding and abetting an embezzlement of plan assets.

In rejecting this argument, the Second Circuit held that "[o]nce wages are paid to [Union] members, [the employer] had contractual obligations to the Funds that constituted 'assets' of the Funds by any common definition. Certainly, an audit of the Funds would have had to include such fixed obligations as assets."[9]

The *Halpin* court determined that the above-quoted language did not compel a determination that unpaid employer contributions are plan assets. Distinguishing *LaBarbara*, the court stated:

> We did not find that the unpaid funds were plan assets; rather, we concluded that Strathmore's contractual obligation to the plan was a *chose in action*, and hence an asset. Under this reasoning, we held that LaBarbara's crime was aiding and abetting [the employer's] concealment of the union's *right to collect funds* from Strathmore, not the concealment of any actual funds. Consequently, we see no tension between *LaBarba-ra's* holding and our analysis here.[10]

Other Federal Courts

The Courts of Appeals for the Eighth, Ninth, Tenth, and Eleventh circuits have all held that, absent contractual language to the contrary, unpaid employer contributions are not assets of an employee benefit plan.[11] The Fourth Circuit had disagreed, but its decision was overturned by the Supreme Court due to the government's change of position in that case. In *United States v. Jackson*, the Fourth Circuit held that "employer contributions to ERISA pension funds became assets of the ERISA plans when they became due and payable."[12]

On writ of certiorari to the Supreme Court, the government changed its position. In light of the Department of Labor's pronouncements and the doctrinal and policy arguments discussed above, the Solicitor General stated in its brief that it now believed that unpaid contributions were not plan assets when they became due, but that the contractual right to recover them was a chose in action and a

plan asset. Because the government had focused on proving an embezzlement of the funds themselves, rather than the contractual right to them (which is possible, as in *LaBarbara*), the Solicitor General asked the Supreme Court to vacate the judgment of the Fourth Circuit and remand the case for further proceedings consistent with the position expressed in its brief. The Supreme Court obliged.[13]

Despite this general consensus, one case followed a track slightly different from the Second Circuit's. In *In re Luna*, the Tenth Circuit held that unpaid employer contributions were dischargeable in bankruptcy. In *In re Halpin*, the Second Circuit characterized this as the "same result" as it had reached. But a review of the Tenth Circuit opinion reveals that the decisions rest on different lines of reasoning.

As previously mentioned, to determine whether Mr. Halpin was a fiduciary over plan assets, the Second Circuit applied a twopronged test asking (1) whether the unpaid contributions were plan assets, and (2) whether Mr. Halpin exercised sufficient control over those assets to make him a fiduciary. The Second Circuit found that unpaid contributions are not plan assets, so it did not reach the second question. By contrast, the Tenth Circuit's decision, applying the same test, turned on the second question.

The Tenth Circuit held that unpaid contributions are not themselves plan assets, but the contractual right to them gives rise to a chose in action that is a plan asset. To this extent, the Tenth Circuit's holding is in agreement with the decisions of the Second Circuit in *LaBarbara* and *In re Hal-pin*.[14] But the same principle led to different analyses in the Second and Tenth circuits. Ultimately, the Tenth Circuit's decision that the debt arising from unpaid employer contributions was dischargeable in bankruptcy turned on the conclusion that the defendant did not exercise sufficient authority over plan assets to make him a fiduciary, not on the holding that unpaid contributions are not plan assets.[15]

Conclusion

In re Halpin resolves an open question in the Second Circuit. It brings Second Circuit law into conformity with that of the Eighth, Ninth, Tenth, and Eleventh circuits, as well as with the positions of the Department of Labor and the Solicitor General of the United States.

Under the Second Circuit's approach, and unlike the Tenth Circuit's approach, debts arising from unpaid employer contributions can never become non-dis-chargeable under §523(a)(4) of the Bankruptcy Code—no matter the level of authority exercised by the employer over plan assets. It remains to be seen which approach other circuit courts of appeals will follow when faced with this issue, and whether their decisions will generate a circuit split sufficiently substantial to draw Supreme Court review.

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1. Docket No. 07-3206-bk (L), 07-3234-bk(CON), —F.3d—, 2009 WL 1272632 (2d Cir. May 11, 2009).

2. See 29 U.S.C. §1104(a)(1) (requiring a fiduciary to "discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries"); 29 U.S.C. §1109(a) ("Any person who is a fiduciary with respect to a plan who breaches any of the responsibilities, obligations, or duties imposed upon fiduciaries by this subchapter shall be personally liable to make good to such plan any losses to the plan resulting from each such breach….").

3. 29 U.S.C. §1002(21)(A).

4. *In re Halpin*, 2009 WL 1272632 at *2.

5. *In re Halpin*, 2009 WL 1272632 at *2 (quoting U.S. Dept. of Labor, Advisory Op. No. 93-14A (May 5, 1993)).

6. Id. (quoting Employee Benefits Sec.Admin., U.S. Dept. of Labor, Field Assistance Bulletin 2008-1, at 1-2 (Feb. 1, 2008)).

7. Id. at *3 (quoting Restatement (Third) of Trusts §5, cmt. k; also citing *Mexican Nat'l R.R. Co. v. Davidson*, 157 U.S. 201, 206 (1895); 63C Am.Jur.2d Property §22 (2008)).

8. Id. at *5.

9. *United States v. LaBarbara*, 129 F.3d 81, 88 (2d Cir. 1997).

10. *In re Halpin*, 2009 WL 1272632 at *4 (emphasis in original).

11. See *In re M&S Grading Inc.*, 541 F.3d 859, 865 (8th Cir. 2008) ("corporate assets do not become plan assets merely because an employer has a corporate obligation to make payments to the plan."); *Cline v. Industrial Maintenance Engineering & Contracting Co.*, 200 F.3d 1223, 1224 (9th Cir. 2000) ("Until the employer pays the employer contributions over to the plan, the contributions do not become plan assets over which fiduciaries of the plan have a fiduciary obligation"); *In re Luna*, 406 F.3d 1192, 1199-1201 (10th Cir. 2005) (holding that unpaid employer contributions are not a plan asset, but the contractual right to collect them is); *ITPE Pension Fund v. Hall*, 334 F.3d 1011, 1013 (11th Cir. 2003) ("The proper rule, developed by caselaw, is that unpaid employer contributions are not assets of a fund unless the agreement between the fund and the employer specifically and clearly declares otherwise.").

12. *United States v. Jackson*, 524 F.3d 532, 542 (4th Cir. 2008).

13. *Jackson v. U.S.*, 129 S. Ct. 1307 (2009) (Mem.); see also Brief for the United States at 10-16, 21-25, *Jackson v. U.S.*, 129 S. Ct. 1307 (2009).

14. See *In re Luna*, 406 F.3d at 1200 (holding that unpaid employer contributions are not plan assets but the contractual right to collect them is); *LaBarbara*, 129 F.3d at 88 ("Once wages are paid to [the Union's] members, Strathmore had contractual obligations to the Funds that constituted 'assets' of the Funds by any common definition."); *In re Halpin*, 2009 WL 1272632 at *4 ("We did not find [in *LaBarbara*] that the unpaid funds were plan assets; rather, we concluded that Strathmore's contractual obligation to the plan was a *chose in action*, and hence an asset. …Consequently, we see no tension between *LaBarbara's* holding and our analysis here.") (emphasis in original).

15. *In re Luna*, 406 F.3d at 1198 ("although we disagree with the district court's conclusion that contributions are not plan assets, we nevertheless affirm the lower court's order because, in our view, the Lunas did not exercise authority or control respecting the management or disposition of a plan asset."); see also id. at 1201-08 (discussing at length why the defendants were not fiduciaries under ERISA).