ERISA Preemption: Personal Liability For Shareholders Of Closely Held Businesses

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Anyone who has ever held a job can attest to the importance of employee benefits. Pension and profit sharing plans, medical coverage, life insurance, disability, unemployment, severance pay — these benefits are the safety net that protects employees in the work force. At the same time, they constitute one of the biggest costs to running a business. Particularly in a tenuous economy, the cost of providing such benefits may become an economic hardship that the business simply cannot support. What happens when corporations fail to meet their financial obligations to employee benefit plans?

Employee benefit plans must comply with various federal and state laws. Failure to comply with the federal laws applicable to a particular benefit plan can result in costly civil or criminal penalties, lawsuits, and/or loss of favorable tax treatment. In general, the Employee Retirement Income Security Act of 1974 ("ERISA") applies to all employee benefit plans, including pension and employee welfare benefit plans, that are established or maintained by any employer engaged in commerce or in any industry or activity affecting commerce. To protect plan participants and their beneficiaries, ERISA mandates standards of conduct, responsibility and obligation for any person with control over employee benefits plans or their assets. The statute further prohibits certain types of transactions, and imposes a variety of reporting, disclosure and bonding requirements. To enforce its requirements, ERISA provides for remedies, sanctions and access to federal courts. ERISA does not, however, impose personal liability on the shareholders of a corporation that fails to meet its employee benefit obligations.

Prior to 1996, the shareholders of a corporation could be held personally liable under New York state law for such benefit obligations. Section 630(a) of the New York Business Corporation Law ("Section 630") imposes joint and several liability on the ten largest shareholders of a closely-held corporation for "all debts, wages or salaries due and owing to any of its laborers, servants or employees." Section 630(b) defines "wages and salaries" to include "employer contributions to or payments of insurance or welfare benefits [and] employer contributions to pension or annuity funds..." As it applies to pension plans, the statute imposes liability on shareholders only after the corporate entity fails to satisfy a judgment for delinquent contributions. After obtaining a judgment against a corporation for failure to make contributions to an employee pension plan, Section 630 allows a plan fiduciary or participant to enforce the judgment against the corporation's ten largest shareholders.

This was the situation that confronted the owner of a garment contractor business in *Romney* v. *Lin*, 94 F.3rd 74 (2nd Cir. 1996). In a test case for the owners of several hundred similarly situated businesses, Alan Lin, the principal shareholder of a closely-held New York corporation called Goodee Fashions, Inc., sought to prevent the Blouse, Skirt, Sportswear, Children's Wear and Allied Worker's Union, Local 23-25, ILGWU (now known as UNITE) (the "Union") from holding him personally liable for his company's failure to make required contributions under a collective bargaining agreement to certain Union welfare and pension funds. In the face of a shrinking domestic manufacturing base, Lin's company had begun to perform work for non-union manufacturers of garments. This was a common practice in the economically depressed garment industry where there no longer was enough union manufacturing work to go around. In so doing, however, Goodee Fashion became liable under the collective bargaining agreement with the Union for penalties which included, in part, the contributions to the Union's benefit funds that would have been paid in the course of work for a Union manufacturer.

Relying on Section 630, Edgar Romney, the Union's manager-secretary, filed suit against Lin personally in the New York State Supreme Court to enforce a judgment for the penalties that it had obtained against Goodee Fashions. Lin removed the case to the United States District Court for the Southern District of New York, which denied Romney's motion to remand on the grounds that the removal was properly based on ERISA preemption. The district court also granted Lin's motion to dismiss the complaint, finding that the Section 630 cause of action was preempted by ERISA. Romney appealed, and the Second Circuit affirmed the district court's decision.

In *Romney* v. *Lin*, 94 F.3d 74 (2d Cir. 1996), the Second Circuit Court of Appeals held that an individual shareholder cannot be held personally liable to a union under Section 630 for the debts his corporation incurred in connection with its ERISA-qualified benefit plans because ERISA preempted the state statute. Upon rehearing in *Romney* v. *Lin*, 105 F. 3rd 806 (2nd Cir. 1997) the Second Circuit adhered to its original decision but left open the door of personal liability to shareholders of companies whose conduct in regard to their ERISA-qualified plans violates a state statute that is based on principles of general applicability that are within a state's traditional purview.

The Court of Appeals first pointed out that ERISA preemption provides a valid basis for removal jurisdiction only if the state statute is preempted by ERISA and the state-law cause of action is "within the scope" of the civil enforcement provisions of ERISA. Examining the preemption question, the Court noted that ERISA preempts state statutes that run counter to the basic purpose of preemption, which is to establish a uniform federal regulation. By holding individual shareholders liable for a company's failure to contribute to employee benefit plans, Section 630 creates a disincentive for employers to create and maintain ERISA plans - - a result that is contrary to the purpose of ERISA. Accordingly, ERISA preempts Section 630.

Second, the Court considered whether Romney's cause of action "to collect delinquent contributions to ERISA plans that Goodee Fashions was obligated to pay" falls under ERISA's enforcement provisions. ERISA § 502(a) sets forth a comprehensive civil enforcement scheme that includes a cause of action to enforce employer contributions to ERISA plans. Importantly, in structuring the enforcement provision, Congress chose not to impose personal liability on shareholders for employer contributions. Thus, the Court determined that permitting a Section 630 suit such as Romney's "would reallocate the burdens and benefits of establishing and maintaining ERISA plans for a class of New York corporations, and afford those ERISA plans special and stringent means of civil enforcement." Therefore, on the issue of civil enforcement, the Court concluded that Romney's cause of action falls within the scope of ERISA, and that the district court properly had removal jurisdiction.

On rehearing, the Court referred to a class of cases in which the owner of a small business could be personally liable for acts or omissions taken in regard to ERISA-qualified benefits plans. Where the theory of liability is based on principles of general applicability that are traditionally within the purview of the state – breach of contract, surety, conversion, and piercing the corporate veil, to name a few – federal courts will not disturb the state statute. *See, e.g.*, *Plumbing Indus. Bd.* v. *E.W. Howell Co., Inc*., 126 F.3d 61 (2d Cir. 1997) (holding that a state can enforce third-party obligations created without ERISA's mandate through generally applicable enforcement provisions that function irrespective of ERISA); *Costigan & Co., P.C.* v. *Costigan,* Civ. No. 00-6143, 2000 U.S. Dist. LEXIS, at *10-11 (S.D.N.Y. Nov. 8, 2000) (holding that plaintiff's conversion claim is not preempted by ERISA because it is based on a law of general applicability that has only an indirect effect on ERISA plans).

Conclusion

Following the Second Circuit's decisions in *Romney* v. *Lin*, it is clear that individual shareholders of privately held corporations cannot be held personally liable under Section 630 for the company's failure to contribute to employee benefit plans. In addition, shareholders or employers sued under a state statute that either "adds to the exclusive list of parties ERISA holds responsible for an employer's benefit obligations" or "provides an alternative means of vindicating the rights protected by" ERISA are similarly protected from personal liability. See *Plumbing Indus. Bd.,* 126 F.3d at 67. Indeed, shareholders who find themselves in such a position are well advised to remove the action to federal court and move to dismiss the complaint on ERISA preemption grounds.

This is not necessarily the end of the inquiry, however. There are many state and federal cases in which the corporate veil has been pierced or an alter-ego theory has been upheld to impose personal liability on individual shareholders for unpaid pension contributions or withdrawal liability. Even if the company files for bankruptcy, it is not difficult to imagine within the context of the developing federal common law that a purchaser of assets from a bankruptcy estate with advance notice of unpaid pension obligations who was a significant shareholder or relative of a significant shareholder of the bankrupt employer and who carries on substantially the same business operations with substantially the same employees might find him/herself responsible for the unpaid pension obligations of the previous employer. Certainly, a judgment for unpaid employee benefits will attach to the assets of the business and become the liability of any successor employer where there is substantial continuity in the business and the workforce and advance notice of the existence of the liability.

For Alan Lin, at least, as well as other similarly situated business owners, the Second Circuit's decisions allowed them to preserve their personal assets as they struggle to stay in business in a declining industry.

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