ERISA's Better Mousetrap Backfires: Fifth Circuit Holds That Accounting Firm's Succession Plan Is *Not* an ERISA Plan

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This article examines the position that accounting firm Briggs & Veselka (B&V) took when two former shareholders brought suit against them in state court to recover payments under the CPA firm's succession plan. Briggs removed the case to federal court on the basis that the succession plan was an "ERISA plan." Why? Because if the plan was covered by ERISA, B&V had the unilateral right to terminate their retirement payments if it determined that the shareholders competed with the CPA firm anytime in the next 10 years or for any other "cause." On the other hand, if the succession plan was not an ERISA plan, as it turned out, disputes over benefit payments must be resolved in state court, where state laws generally protect employees from unreasonable competition and forfeiture clauses. It is not often easy to tell whether a plan is subject to ERISA, but the stakes are high. The author of this article is also one of the plaintiffs in the case.

Most accounting firms would not even consider their succession plans to be ERISA plans. Nonetheless, that is the position that Briggs & Veselka (B&V) took when two former shareholders brought suit in state court to recover payments that the company refused to pay them under their employment contracts.[1] B&V sought to have ERISA apply because if the plan was governed by ERISA, the dispute would have to be resolved under federal law, which generally affords considerable deference to the company's decision to pay, or not, under the plan.[2] But if the plan was not an ERISA plan, as it turned out in *Cantrell v. Briggs & Veselka*, disputes over the former employee's entitlement to payments would need to be resolved in state court, where state laws generally protect employees from unreasonable termination and forfeiture clauses.

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In a fact-specific determination, the US Court of Appeals for the Fifth Circuit found that the Cantrells' employment contracts did not require "enough ongoing, particularized, administrative discretionary analysis" to constitute an "ongoing administrative scheme" as required by ERISA. This ongoing administrative scheme requirement of ERISA was first articulated by the US Supreme Court in *Fort Halifax Packing Company, Inc. v. Coyne,* in which the Court described such a scheme as a commitment to "undertake[] a host of obligations, such as determining the eligibility of claimants, calculating benefit levels, making disbursements, monitoring the availability of funds for benefit payments, and keeping appropriate records in order to comply with applicable reporting requirements."[3] In other words, ERISA covers not merely employee benefits, but employee benefit *plans.*

The Fifth Circuit's finding that the deferred payments under the Briggs & Veselka plan did not constitute an ERISA plan can have enormous implications for CPA firms that pay deferred compensation to their retired owners. This is especially true when there are significant clawback or penalty provisions that reduce the originally agreed-upon payments to a former owner if he or she fails to transition their book of business, fails to give adequate notice before leaving, competes with the firm after retirement, or commits other enumerated transgressions. If a dispute arises over whether the retired owner violated one of these requirements, the outcome can depend on whether the plan is covered by ERISA or not.

Partnership plans are expressly excluded from ERISA coverage if they are partnership buy-out agreements described in Internal Revenue Code (IRC) Section 736.[4] However, accounting firms that are taxed as a corporation, such as Briggs & Veselka, face the critical issue of whether their deferred compensation or succession plan is an ERISA plan or not.

FACTS OF THE CASE

Cantrell v. Briggs & Veselka involved a dispute over whether two shareholders were entitled to the deferred compensation payments under their employment contracts when they retired and went into the practice of law together. By way of background, the Cantrells were married and operated a successful CPA firm for years before they merged their accounting firm with Briggs & Veselka Co. in 2000. Pursuant to the merger, the Cantrells and the B&V shareholders exchanged their shares in their former companies for restricted stock in the merged entity, a deferred compensation plan equal to four times salary, and a mandatory stock-redemption plan at cash-basis book value. B&V reported the merger as a "tax-free

exchange" on its tax returns, although the IRS never examined the transaction.

The B&V plan was a typical succession or "retirement pay" plan for a CPA firm as described in the AICPA 2012 Succession Survey.[5] The deferred payments were intended to compensate the owner for the value of his or her equity, goodwill, or "book of business" in the firm, and the stock redemption payments represented the owner's interest in the firm's tangible assets. B&V represented that it had no ERISA plans at the time of the merger except a cafeteria plan under IRC Section 125. Nonetheless, three months after the merger, B&V notified the Department of Labor (DOL) that it had nine separate ERISA "top hat" plans, which were exempt from the annual ERISA reporting requirements.

Fast forward 11 years after the B&V merger. Carol Cantrell announced her intention to retire and practice law with her husband, Patrick Cantrell, who was also a lawyer and a former B&V shareholder who had retired four years earlier. Both Cantrells were board certified in Tax Law by the Texas Board of Legal Specialization (TBLS), which includes tax planning, IRS examinations and appeals, and litigation. B&V was disgruntled with Carol Cantrell's decision and claimed that she and her husband would be competing in the "same business" as B&V because their law practice would necessarily involve the preparation of tax returns. Accordingly, B&V refused to accept her resignation, terminated her "for cause," and refused to pay either of the Cantrell's deferred compensation under their employment contracts.

The Cantrells disagreed that their tax law practice would be in the same business as B&V because they would not be providing public accounting and other financial services, which was B&V's business as defined in the merger agreement. Nor would the Cantrells have a practice unit license to do so. Likewise, B&V did not have a license to practice law. The mere fact that both businesses would prepare tax returns did not mean that they were in the same business, anymore than a heart surgeon and a dentist are competing in the same business because they both write prescriptions for the same pain medication. Accordingly, the Cantrells sued to recover their benefits in state court. Briggs & Veselka immediately removed the case to federal district court claiming that the deferred compensation payments were an "ERISA top hat" plan, entitling them to federal preemption over the Cantrell's state law protections.

WHAT IS A TOP HAT PLAN?

A top hat plan is a special breed of nonqualified plan under ERISA "maintained by an employer primarily for the purpose of providing deferred compensation for a select group of management or highly

compensated employees."[6] It is exempt from most of ERISA's oversight, reporting, and fiduciary duties.[7] All claims for benefits under a top hat plan must be submitted to the plan administrator, who has the sole authority to make decisions under the plan. If there is a dispute over benefits, the employee's state law claims and defenses are null and void because all state causes are trumped by federal law.[8]

It is common for a top hat plan to provide that an employee's benefits are entirely forfeited if the employee competes with the employer or is terminated "for cause." In that case, the plan administrator acts as the sole judge, jury, and arbiter of whether the employee competed or was terminated "with cause." This can be a serious conflict of interest in a closely held corporation if the employer is also the plan administrator. But it is entirely legal in an ERISA top hat plan. This is why top hat plans have become "an employer's best friend" according to an article by James P. Baker in the *Benefits Law Journal* titled "ERISA's Better Mousetrap" in the Spring 2011.[9]

The rationale for the lack of fiduciary duties in a top hat plan is that its participants are supposedly sophisticated enough to negotiate for themselves and do not need ERISA's protection.[10] But because a top hat plan is still an ERISA plan, a dispute over its benefits is governed solely by federal law. Employees are precluded from bringing any state law claims or defenses, such as the enforceability of an unreasonable noncompete provision in the plan. This is why the parties in *Cantrell v. Briggs & Veselka* fought so hard over whether they should be in state or federal court. And as it turns out, ERISA's better mousetrap backfired on the Briggs & Veselka accounting firm.

HOLDING

Applying Fifth Circuit and other precedent, the court held that deferred compensation provisions in B&V's employment contracts are not ERISA plans because they do not require "enough ongoing, particularized, administrative discretionary analysis" to be considered an ERISA plan. The payments were based on a one-time calculation using a fixed formula and paid over a 10-year period. They required only writing a check each quarter, which is "hardly an administrative scheme." Eligibility was based on a specific triggering event such as death, disability, or termination, which did not require any more than a "modicum of discretion." Even though the accounting firm could terminate the payments if the employee was fired with cause or competed with the employer during the 10-year period, this "minimal quantum of discretion" was not sufficient to turn it into an ERISA plan. Moreover, the plan did not expressly grant the employer the sole discretion to make the decision. The accounting firm had no system in place to monitor for competition, suggesting that one was not needed.

Nor could it explain how such a system would work or that it would require an ongoing administrative scheme to implement. Accordingly, the Fifth Circuit remanded case to state court where the dispute will be governed by Texas law, unless the case settles.

In a separate dissenting opinion, Judge Priscilla R. Owen perceived the provisions to be complex enough to constitute an ERISA plan. In particular, she focused on a benefit cap in the agreements. Such a cap is common in many CPA firm succession plans. It acts as a cash flow cushion by placing an annual ceiling on the total payouts to all retired partners in a single year. However, it does not change the total amount due under the contract. Any deficit is caught up and paid in later years when the ceiling does not apply. Thirty-six percent of CPA firms surveyed have such caps in their partner buy-out plans, according to a recent AICPA survey. Owen also said that the employer's ability to terminate an employee for cause was sufficient discretion to constitute an ongoing administrative scheme, despite a contrary holding in *Velarde v. PACE Membership Warehouse, Inc.*[11]

PLANNING IMPLICATIONS FOR CPA FIRM SUCCESSION PLANS

Accounting firms with succession plans that have forfeiture provisions should carefully review their plans to determine whether they are ERISA plans. Whether a plan has *enough* ongoing, particularized, administrative discretionary analysis to make it an ERISA plan is a fact-specific determination generally made by balancing the weight of all the facts. If the employer wants ERISA to apply, it should generally avoid plans that contain a one-time calculation using a fixed formula. CPA firms typically compensate a retired owner for his or her equity in the firm by paying the owner a fixed sum over time, based on the retiree's share of the firm's value. This can be calculated in a number of ways. The most common ways are listed in a survey conducted by the AICPA in 2012 and include payments based on the number of shares owned, a multiple of the shareholder's average salary, or the value of his or her book of business.

Eligibility for benefits should not be based solely on fixed and determinable events, such as death, disability, or retirement, but rather on factors that require more than a modicum of discretionary analysis. The right to terminate an employee "for cause" does not require enough discretionary analysis to meet ERISA's standard, according to the Fifth Circuit. An example of sufficient discretionary analysis would be the employer's right to determine whether the employee suffered a substantial reduction in job responsibilities before and after a merger, according to another recent Fifth Circuit case.[12] In addition, if the plan contains a noncompete provision, the plan should expressly reserve

the sole authority to the employer to decide whether the employee, in fact, competed and describe how the employer will make that decision and monitor for such activity.

Based on all of these factors, if the "succession plan" is found to be an ERISA plan, the retired owner can lose all or part of his or her hard-earned equity if the plan administrator decides that he or she has violated one of the provisions. Therefore, both the firm and the employee should seek competent legal advice on whether the plan is subject to ERISA before entering into such an agreement.

INCOME TAX CONSIDERATIONS

ERISA's application to a firm's succession plan can also have significant income tax consequences. If ERISA applies, the payments will be deductible by the firm as compensation and reported to the employee as ordinary income on Form W-2.[13] But if ERISA does not apply, the payments will not likely be deductible by the employer but, rather, constitute redemption payments, which the former owner should report as long-term capital gain upon the sale of his or her interest in the firm.

As noted previously, partnership succession plans are expressly excluded from ERISA coverage under the DOL regulations if they are partnership buy-out agreements described in IRC Section 736.[14] Thus, retirement payments made by an entity taxed as a partnership in liquidation of a retired partner's interest are generally treated as a distributive share of partnership income or as a guaranteed payment. This includes a partner's share of unrealized receivables and unstated goodwill of a general partnership. However, payments for a partner's interest in property, including goodwill expressly provided for in the partnership agreement, are IRC Section 736(b) payments, which are treated as distributions by the partnership and taxable as capital gain to the partner to the extent they exceed the basis of his partnership interest.

CONCLUSION

Accounting firms taxed as corporations should carefully review their succession plans to determine whether ERISA applies. If ERISA applies, disputes over coverage and benefits must be resolved in federal court where employees have no state law protections. If ERISA does not apply, employees can invoke favorable state law protections to protect against losing valuable deferred compensation benefits. Not all "broken" plans can be amended. If the plan is part of an enforceable contract with the employee, both the employee and the employer must agree to any changes.

NOTES

1. *Cantrell v. Briggs & Veselka Co.*, No. 12-20294 (5th Cir. 2013), *cert. denied* (U.S. Mar. 10, 2014) (No. 13-824).

2. ERISA § 514(a); 29 U.S.C. § 1144(a).

3. Fort Halifax Packing Company, Inc. v. Coyne, 482 U.S. 1 (1987).

4. 29 C.F.R. 2510.3-3(b).

5. AICPA 2012 PCPS Succession Survey, available at *http://www.aicpa.org/InterestAreas/PrivateCompaniesPracticeSection/StrategyPlanning/center/DownloadableDocuments/SuccessionSurveyMultiComm.pdf*.

6. 29 U.S.C. § 1051(2).

7. 29 U.S.C § 1101(a).

8. ERISA § 514(a); 29 U.S.C. 1144(a).

9. James P. Baker, "ERISA's Better Mousetrap," *Benefits Law Journal*, Vol. 24. No. 1, Spring 2011.

10. DOL Opinion No. 90-14A, 1990 WL 123933, at *1 (E.R.I.S.A).

11. Velarde v. PACE Membership Warehouse, Inc., 105 F3d 1313 (9th Cir. 1997).

12. *Clayton v. ConocoPhillips*, No. 12-20102, 2013 WL 3357574 (5th Cir. 2013).

13. IRC § 3401(a)(22) (flush language).

14. 29 C.F.R. 2510.3-3(b).