Flanigan v. GE: Last Nail in the Coffin of the Asset "Sale" Bugbear?

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In recent years, employers have worried that the sale of a corporate division or subsidiary, if accompanied by the transfer of surplus pension assets, might be viewed as a prohibited "sale" of pension assets, or might otherwise run afoul of ERISA. But developing case law has steadily eroded the most powerful ERISA theories used to challenge such asset transfers. The Second Circuit's recent decision in Flanigan v. General Electric Company *may be viewed as a logical extension of this trend. This article lists the various ERISA doctrines available to challenge transfers of pension asset surplus incident to the sale of a corporate entity. The article discusses the theoretical arguments that have developed in response to these doctrines, and evaluates them particularly in light of* Flanigan. *The article concludes that ERISA concerns generally should no longer impede transfers of surplus pension assets in corporate reorganizations.*

The Second Circuit's recent decision in *Flanigan v. General Electric Company,* 242 F.3d 78 (2d Cir. 2001), is the latest and clearest case to recognize the validity under ERISA of a common corporate transaction: The sale of a corporate division or subsidiary with an overfunded pension plan.

Until the last few years, transfers of overfunded pension plans in such deals have been clouded by the many ERISA issues that seem to arise upon the purported "sale" of pension asset surplus. *Flanigan* may be the first appellate decision clearly to apply emerging ERISA doctrine to uphold just such a transaction. While *Flanigan* may not stem the rush of litigation that typically follows on the heels of pension transfers incident to corporate reorganizations, it should speed up resolution of the issues.

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To illustrate the mischief caused by the asset "sale" spectre, consider the following hypothetical case. In the mid-1990s (say, 1995), Seller Corporation maintains a defined benefit plan for all its employees, with an asset surplus of $10 million. To rid itself of its incompatible widget manufacturing operations, Seller decides to divest its division, Target, to Buyer Corporation. As part of the deal, Buyer hires Target's employees, assumes their liabilities under Seller's pension plan, and acquires all the assets necessary to fund those liabilities—plus the entire asset surplus of $10 million. Buyer has an underfunded defined benefit plan of its own. Buyer intends to merge its new overfunded plan—that is, the liabilities plus assets plus surplus assets acquired from Seller—with its current underfunded plan. Buyer will thus use the $10 million asset surplus in part to fund benefits for its own, non-Target, employees.

Seller Corporation's remaining employees look at the deal, and go right to federal court to argue that the transaction violated a whole handful of ERISA rights. First, they argue that the sale violated ERISA's mechanical rules for allocating asset surplus in a plan "spinoff" under ERISA Section 208.

Second, they argue that the spinoff violated Seller's fiduciary duty under ERISA Section 404(a) to treat participants evenhandedly, by "unfairly" allocating a disproportionate share of asset surplus to Target employees (and ultimately, to Buyer's totally unrelated employees) at the expense of Seller's remaining employees.

Third, they argue that the sale price of Target expressly or implicitly included a $10 million markup for the $10 million asset surplus. The transaction was an impermissible "sale" of plan assets, they argue, which effectively turned plan assets into cash for Seller. Thus, they conclude, the transaction violated ERISA's "prohibited transaction" rules, which among other things, forbid a fiduciary from dealing with plan assets "in his own interest" or "for his own account" (the self-dealing rule of Section 406(b)(1)), or from receiving any "consideration" in connection with a transaction involving plan assets (the anti-kickback rule of Section 406(b)(3)).

Fourth, they argue that the purported "sale" of plan assets was a forbidden "inurement" to Seller under Section 403(c)—either directly by placing cash in Seller's hands, or indirectly by making the deal go more smoothly and thus advancing Seller's non-plan business interests.

In a fifth and related point, they argue that the transfer of a disproportionate share of surplus assets to Seller's Target employees, at the expense of Seller's remaining employees, was a prohibited 403(c) inurement to the "benefited" (Target) employees.

Recalling that our hypothetical takes place in 1995 or so, we see that Seller's advisors are worried. The Section 208 claim doesn't trouble them much (and participants don't push it hard). The Section 404(a) claim is a little more worrisome, however. Participants have cited *John Blair Communications, Inc. Profit Sharing Plan v. Telemundo Group, Inc. Profit Sharing Plan,* 26 F.3d 360 (2d Cir. 1994), which arguably creates an ERISA fiduciary duty to treat plan participants "fairly" with respect to the allocation of plan assets.

But really troublesome is participants' claim that the transaction is a prohibited "sale" of assets to Buyer. This concern is fueled by *In re Gulf Pension Litigation,* 764 F. Supp. 1149, 1210 (S.D. Tex. 1991), affirmed on other issues sub. nom. *Borst v. Chevron Corp.,* 36 F.3d 1308 (5th Cir. 1994), certiorari denied, 514 U.S. 1066 (1995). In *Gulf,* the employer sold a division with an overfunded defined benefit plan. During negotiations, the target's sale price was adjusted to reflect the assets of the overfunded plan. The district court held that this "payback" from buyer to seller was a prohibited transaction under both Sections 406(b)(1) and (b)(3) of ERISA.

On the one hand, Seller's advisors are comforted by the fact that Seller and Buyer were careful to avoid the exact facts of *Gulf.* The *Gulf* parties expressly readjusted the price in the sales documents to reflect the value of the transferred surplus. Buyer and Seller Corporations avoided explicit adjustments of this kind. But Seller's advisors are not entirely comforted by this thought. Seller and Buyer negotiated Target's price based on a careful evaluation of all Target's assets and liabilities. Even if reasonably sure the parties never discussed the asset surplus, can they persuade themselves—let alone a federal judge—that they never even thought about it?

In fact, they recognize, in the context of a business transaction it is almost impossible to argue that a $10 million asset is transferred with no benefit to the transferor. This reality of business life raises the possibility that *Gulf* is a *per se* prohibition of *any* surplus transfer in the context of a corporate reorganization.

Participants' 403(c) inurement claim is troublesome as well. The transfer arguably "inured" to Seller (and Buyer) in the sense that it was part of a deal that both parties wanted. Participants' other 403(c) claim is also worrisome. On its face, the argument that Section 403(c) prohibits "inurement" to any class of participants may seem to be a gross misreading of the statute. But participants are citing *Trapani v. Consolidated Edison Employees' Mutual Aid Society,* 891 F.2d 48 (1989), in which the Second Circuit upheld participants' challenge to a transfer of a disproportionate share of welfare benefit plan assets under just this theory.

Faced with the possibility of many theories with no clear answers, many companies were in a quandary with respect to transactions in which asset surplus—particularly a disproportionate share of asset surplus—was transferred as part of a corporate reorganization outside the seller's controlled group.

In the last decade or so, a long line of cases has developed theories affirming plan sponsors' ability to dispose of plan asset surplus without unduly excessive ERISA constraints. Oddly, however, very little of the case law has involved one of the key facts in our own hypothetical—that is, a transaction in which plan asset surplus is transferred from seller to buyer (rather than retained by seller) incident to the sale of a corporate entity outside the seller's controlled group.

Flanigan, however, deals with a transfer of surplus. In a complicated deal, General Electric Company sold an aerospace division to Martin Marietta Corporation. As part of the deal, Martin Marietta acquired the liabilities attributable to the transferred aerospace employees, plus a portion of the assets and asset surplus from GE's overfunded defined benefit pension plan. Various groups of employees and retirees sued on numerous issues. Among other things, certain of the plaintiff classes argued that the transaction impermissibly inured to GE by converting its surplus assets to cash. The Second Circuit held that the transfer was a business decision, not subject to fiduciary review, and was not a prohibited inurement to GE.

The *Flanigan* court's decision represents an affirmation of recent trends in case law. *Flanigan* directly or indirectly responds to all participants' arguments raised in our hypothetical case. After *Flanigan*, plan sponsors have considerably more comfort that the sale of a division or subsidiary will not run afoul of ERISA merely because the sale involves—along with other assets—the transfer of pension surplus.

DETAILED DISCUSSION

To put *Flanigan* in context, we march through in considerable detail the ERISA doctrines that typically arise upon the kind of transaction discussed in our hypothetical: Sections 208, 404(a), 406, and 403(c) of ERISA.

ERISA Section 208

In ERISA terminology, Seller's transfer of a part of its plan to Buyer is a "spinoff" and "transfer," or, as we will call it for brevity's sake, a plan "spinoff."[1]

The very first hurdle Seller's transfer must overcome is ERISA Section 208, and its mechanical rules governing asset allocations in plan spinoffs and mergers. Section 208 requires that each participant must be entitled to a benefit after the asset spinoff and transfer no less than the benefit to which he or she would have been entitled immediately before.

Even before *Flanigan*, numerous cases involved the spinoff of ERISA plan assets and liabilities outside the employer's "controlled group"—that is, generally, the family of corporations 80-percent owned by the employer. In many of these cases, participants argued that ERISA Section 208 requires that the plan's asset surplus be allocated between the transferor and transferee plan in proportion to plan liabilities. Under this argument, Seller's transfer of the entire $10 million of surplus assets to Buyer in our hypothetical would be impermissible, because disproportionate to spun-off liabilities.

In case law of almost perfect uniformity, participants have failed to convince the courts of this argument.

Several cases have directly examined whether ERISA Section 208 requires any particular allocation of plan assets in a spinoff outside the seller's controlled group. The courts have held that Section 208 creates an entitlement to certain *benefits* under the transferor and transferee plans, but does not create an entitlement to any portion of the plan's surplus assets. (*Systems Council EM-3 v. AT&T Corp,* 159 F.3d 1376, 1380 (D.C. Cir. 1998); *Koch Industries, Inc. v. Sun Company Inc.*, 918 F.2d 1203, 1207 (5th Cir. 1990); see also *Bass v. Retirement Plan of Conoco, Inc.*, 676 F. Supp. 735 (W.D. La. 1988) (no additional Section 208 claim to assets in excess of those necessary to pay benefits under 208); cf. *Foster Medical Corp. Employees' Pension Plan v. Healthco, Inc.*, 753 F.2d 194, 199 (1st Cir. 1985) (in split-up of overfunded plan with transfer of one spinoff plan outside controlled group, ERISA requires only that spun-off plan be "fully funded"; does not require proportionate allocation of surplus).)

Two other courts have held that under ERISA Section 208 a disproportionate share of plan liabilities relative to assets may be transferred in a plan spinoff *within* the same controlled group—*Bigger v. American Commercial Lines, Inc.*, 862 F.2d 1341, 1347 (8th Cir. 1988), and *Van Orman v. The American Insurance Co.*, 608 F. Supp. 13, 25-6 (D.N.J. 1984).

In addition, a number of cases have involved challenges under ERISA Section 208 to the proper allocation of assets after a plan *merger*—that is, asset allocation after a transaction combining the assets and liabilities of two preexisting plans. In these cases, the courts

have held that ERISA Section 208 governs the level of post-merger benefits, but does not entitle participants to any particular portion of plan asset surplus. (*In re Gulf Pension Litigation,* 764 F. Supp. 1149, 1185 (S.D. Tex. 1991), affirmed on other grounds sub. nom. *Borst v. Chevron Corp.,* 36 F.3d 1308 (5th Cir. 1994), certiorari denied, 514 U.S. 1066 (1995); *Malia v. General Electric Co.,* 23 F.3d 828, 833 (3d Cir. 1994) (in defined benefit plan merger, Section 208 does not create entitlement to benefit increase "funded" by surplus in the overfunded pre-merger plan), certiorari denied, 513 U.S. 956 (1994); *Brillinger v. General Electric Co.,* 130 F.3d 61, 63 (2d Cir. 1997) (holding similar to *Malia*), certiorari denied, 525 U.S. 1138 (1999).)

The merger cases are relevant to the hypothetical spinoff we discuss in this article, because plan mergers and spinoffs are subject to the same statutory requirements. That is, under ERISA Section 208, the post-merger benefit entitlement of each participant must equal his or her pre-merger benefit entitlement—just as with benefits in a plan spinoff.[2] The merger cases would thus appear to be good authority for the argument Section 208 permits Seller to allocate a disproportionate share of asset surplus to the part of its plan spun-off to Buyer. The merger cases were in fact cited for this point by the *Systems Council* district court as well as the *Flanigan* district court (citing *Brillinger*).

The cases we have discussed so far of course are not on all fours with our hypothetical. They all involve mergers, or spinoffs in which a disproportionate share of asset surplus is held by the *seller's* plan rather than, as in our case, transferred to the *buyer's* plan. But in *Flanigan*, the district court and the Second Circuit closed this final "gap" in the authorities. Both opinions followed earlier case law in finding that Section 208 does not entitle participants in the seller's plan to any particular share of asset surplus.

In short, it would appear that Section 208 does not entitle any group of participants in a plan spinoff outside the plan sponsor's controlled group to any particular share of asset surplus. *Flanigan* is only the latest case to confirm this point. As the Second Circuit observed, the transferred participants in that case received "everything to which they were entitled," and the transaction satisfied Section 208.

ERISA Section 404(a)

Even if a spinoff passes the mechanical tests of ERISA Section 208, it must still pass muster under ERISA's more general fiduciary duties.

ERISA Section 404(a) requires that a fiduciary deal with plan assets for the exclusive benefit of plan participants. In a number of cases involving plan spinoffs outside the controlled group, participants have argued that the allocation of surplus between transferor and transferee plans violates Section 404(a), if the allocation is disproportionate to liabilities.

Is there merit in this argument? Is there a fiduciary duty of even-handedness among plan participants, so that Seller in our hypothetical has a fiduciary obligation to allocate surplus uniformly among its retained employees and the transferred Target employees?

For some time, employers have been concerned that the answer to this question might be yes, and that ERISA Section 404(a) does indeed require equitable allocation of surplus among participants, under *John Blair Communications, Inc. Profit Sharing Plan v. Telemundo Group, Inc. Profit Sharing Plan,* 26 F.3d 360 (2d Cir. 1994).

In *Telemundo*, pursuant to the sale of several divisions, the sponsor of a defined *contribution* plan spun off the plan accounts of those employees transferred in connection with the sale. Between the dates of the valuation and actual spinoff, total plan assets gained about half a million dollars in value. The sponsor allocated these gains entirely to the accounts in the retained portion of the plan, and allocated zero to the accounts spun-off with the sold divisions. The Second Circuit held that the transaction violated the sponsor's fiduciary loyalty under Section 404(a) of ERISA to serve "all participants" in the plan, and to refrain from giving one class a "windfall" at the "expense of another."

Despite its holding, *Telemundo* does not affect the validity of the transaction we discuss here—as the *Flanigan* court confirmed.

First, and most simply, the *Telemundo* plan was a defined contribution plan, while Seller's plan is a defined benefit plan. The *Telemundo* court stated that the fiduciary violation arose because ERISA Section 208—and thus Section 404—prohibits the disproportionate allocation of assets in a defined *contribution* plan. The court recognized in dictum that this same Section 208 rule does not apply to a defined *benefit* plan, citing *Bigger* and *Koch Industries*. Rejecting participants' claims to an allocation of defined benefit plan surplus under *Telemundo*, the district court in *Systems Council* held that *Telemundo* does not apply to a defined benefit plan. (See also *Sanofi Synthelabo Inc. v. Eastman Kodak Company*, 2000 WL 1611068 (S.D.N.Y. 2000) (*Telemundo* does not apply to a defined benefit plan).)

But more fundamentally, we also believe that *Telemundo* fails to create a general fiduciary duty to allocate surplus plan assets equally among plan participants. The principle reason for our belief on this point is that developing case law has articulated the principle that Seller's decision to allocate assets is not a fiduciary act, but rather a business or "settlor" decision. As a historical note, we also observe that even among the older case law that preceded today's "settlor function" theory, courts did not hold there to be a fiduciary duty of "fair" asset allocation among participants. We discuss each of these theories in turn.

Settlor Function Theory

Affirming the reasoning of a long line of cases, the Supreme Court in the last decade has held that when an employer's act of amending a plan is a business or "settlor" decision, it is not reviewable under ERISA's fiduciary rules, in *Curtiss-Wright Corp. v. Schoonejongen,* 514 U.S. 73 (1995); *Lockheed Corp. v. Spink*, 517 U.S. 882 (1996); and *Hughes Aircraft Co. v. Jacobson*, 525 U.S. 432 (1999).

Many courts have applied settlor function theory to plan asset spinoffs. These cases have held that the employer's decision regarding allocation of plan assets in the spinoff of an overfunded defined benefit plan is a "settlor" function. Thus, in allocating spinoff assets, the employer is not acting in its capacity as an ERISA fiduciary, and the asset allocation is not reviewable under Section 404(a). (*Systems Council,* 159 F.3d at 1380, *Blaw Knox Retirement Income Plan v. White Consolidated Industries, Inc.,* 998 F.2d 1185, 1189 (3d Cir. 1993) (spinoff of pension plan assets and liabilities in connection with sale of division to buyer outside of controlled group a "corporate business decision," not subject to ERISA fiduciary review), certiorari denied, 510 U.S. 1042 (1994); *Sengpiel v. B.F. Goodrich Co.,* 156 F.3d 660, 666-67 (6th Cir. 1998) (in spinoff of welfare plan liabilities outside of controlled group, no fiduciary violation under ERISA Section 404 when seller retains plan surplus, under settlor function theories of *Systems Council* (district court) and *Blaw Knox*), certiorari denied, 526 U.S. 1016 (1999); *Kuper v. Iovenko,* 66 F.3d 1447 (6th Cir. 1995) (decision to transfer ESOP plan assets, rather than distribute as permitted by plan, no breach of fiduciary duty of prudence, because asset transfer is a corporate business decision, not a fiduciary one, under *Blaw Knox*); *Van Orman*, 608 F. Supp. at 24 (in plan spinoff within controlled group, allocation of plan surplus relative to plan liabilities a business decision not reviewable under ERISA Section 404).)

In addition, the settlor function doctrine has been applied to hold that an employer's decision with respect to the allocation of assets in plan mergers, termination/reversions, and plan amendments modifying benefits in ways expressly couched in relationship to plan surplus, are not reviewable under ERISA's fiduciary standards. (*Malia,* 23 F.3d at 833 (plan merger is a business decision, not reviewable under ERISA fiduciary duties); *Bennett v. Conrail,* 168 F.3d 671 (3d Cir.) (employer's decision to terminate plan and take reversion of surplus assets rather than distribute to participants or provide benefit increases, a settlor decision not reviewable under ERISA Section 404(a)), certiorari denied, 120 S.Ct. 173 (1999).)

Settlor function doctrine has also been applied to hold that an employer's amendment of its overfunded pension plan is a settlor act, not reviewable under Section 404(a) of ERISA, even when the surplus assets used to fund the benefits for one class of participants are attributable to contributions made on behalf of another class of participants. (*Johnson v. Georgia-Pacific Corp.,* 19 F.3d 1184, 1188 (7th Cir. 1994) (amendment of overfunded plan to provide benefit increase only for active employees and not for retirees, when purpose of amendment is to soak up plan assets as part of "poison pill" strategy to ward off hostile takeover bid, not reviewable as fiduciary decision); *Hughes Aircraft Co. v. Jacobson,* 525 U.S. 432 (1999) (amendment of overfunded defined benefit plan to create new benefit structures for new participants, so that surplus plan assets contributed for one set of employees in effect used to fund new benefits for new employees, a settlor act, not reviewable under Section 404).)

Although they deal with plan amendments, *Georgia-Pacific* and *Hughes* are relevant to the hypothetical spinoff we discuss here. Like the spinoff cases cited above (*Systems Council, Blaw Knox, Sengpiel), Georgia-Pacific* and *Hughes* deal with the employer's ability to make use of plan assets within the plan trust. And like the *Systems Council* courts, the Supreme Court in *Hughes* based its decision on its earlier opinions in *Curtiss-Wright* and *Spink.* While the spinoff cases reach farther than *Georgia-Pacific* and *Hughes* (assets may be used for benefits of employees outside the original controlled group), all of these cases contemplate the use of assets to fund new benefits for a new class of employees. By their structure and reasoning, *Hughes* and *Georgia-Pacific* thus support the holding of *Systems Council* et al., that the employer's dispositions of surplus in a plan spinoff is simply not a fiduciary act and is not subject to review under Section 404 of ERISA.

Until recently, only a handful of cases expressly applied settlor function theory to the seller's decision to transfer asset surplus to a buyer outside its controlled group. (See, for example, *BiCoastal Corp. v. Northern Trust Co.,* 146 B.R. 486, 490 (Bankr. M.D. Fla. 1992).) But in *Flanigan*, the Second Circuit applies settlor function theory unambiguously to hold that the transfer of surplus assets from Seller to Buyer is not reviewable under ERISA's fiduciary doctrine, and so cannot be a violation under Section 404(a).

Fiduciary Theory Cases

For the sake of completeness, we also note that before the development of settlor-function theory, a number of courts examined the validity of plan asset spinoff/transfers under Section 404 of ERISA.

Unlike the later, settlor-function, cases, these earlier opinions assume that the disposition of plan assets is subject to fiduciary review. These cases hold that as long as the asset allocation does not violate ERISA Section 208 or any other express provision of ERISA, Section 404 does not carry any additional duty to allocate plan assets in any particular way. That is, even assuming a spinoff of plan assets is subject to ERISA fiduciary review, there is no fiduciary violation merely because assets and liabilities are allocated disproportionately or otherwise "unfairly." (*Foster Medical Corp.*, 753 F.2d at 199 (in plan spinoff pursuant to sale of division outside of controlled group, failure to spin off pro-rata share of asset surplus not a fiduciary breach because participants' benefits not affected by surplus asset allocation); *Blaw Knox,* 998 F.2d at 1190 (in plan spinoff pursuant to sale of division outside of controlled group, no fiduciary breach where allocation of assets and liabilities complies with ERISA Section 208); *Bigger,* 862 F.2d at 1347 (in plan spinoff within controlled group, no violation of ERISA Section 404 when transferor plan retains disproportionate share of surplus, when allocation complies with ERISA Section 208); *United Steelworkers of America, Local 2116 v. Cyclops Corp.,* 860 F.2d 189, 198-9 (6th Cir. 1988) (in plan spinoff pursuant to sale of division outside of controlled group, no fiduciary breach where allocation of assets and liabilities complies with ERISA Section 208); *Ganton Technologies, Inc. v. National Industries Group Pension Plan*, 76 F.3d 462 (2d Cir. 1995) (when employer leaving multiemployer pension plan requested that plan transfer proportional share of liabilities and assets to single employer plan, held that the fund's refusal did not violate ERISA Section 404(a)). Cf. *Bennett v. Conrail,* 168 F.3d at 677, 679 (no duty under ERISA Section 404(a) to

distribute asset surplus "fairly" among participants pursuant to full or partial termination—fiduciary rule protects benefits due under the plan, not assets).)

In short, it would appear that *Telemundo* does not create a duty under Section 404(a) to allocate assets "fairly" among plan participants, and does not invalidate the hypothetical spinoff we discuss here. Even under the older fiduciary theory case law, most courts declined to find a fiduciary duty to allocate assets among participants in any particular way (except as necessary to comply with Section 208). And under the more recent development of "settlor function" theory, courts have held that such asset allocation is not subject to fiduciary review, period. By applying this theory to situations where asset surplus is transferred outside the seller's contolled group, *Flanigan* clarifies and confirms the trend of recent case law.

ERISA Section 406(b)

A third hurdle our transaction must overcome is the prohibited transaction rules under Section 406 of ERISA, in particularly Sections 406(b)(1) and (b)(3). Section 406(b)(1) states that a fiduciary may not deal with the assets of the plan in his own interest or for his own account. Section 406(b)(3) states that a fiduciary may not receive any consideration for his own personal account from any party dealing with the plan in a transaction involving plan assets.

As we note at the beginning of this article, any plan spinoff involving the transfer of surplus plan assets outside the seller's controlled group raises concerns under both these provisions after *In re Gulf Pension Litigation*. In *Gulf,* recall, the employer sold a division with an overfunded defined benefit plan. The district court found as a matter of fact that the target's sale price was adjusted to reflect the assets of the overfunded plan. The court held that the transaction was a "payback" from buyer to seller, and a prohibited transaction under Sections 406(b)(1) and (b)(3) of ERISA.

Gulf is a source of concern because under its reasoning the disposition of any business unit with an overfunded plan could arguably be viewed as a "sale" of the surplus assets, prohibited under ERISA Section 406(b)(1) and (b)(3), to the extent the sale price of the unit could be shown to reflect the value of the surplus.

The validity of *Gulf* on this point has been steadily eroded by the accumulating weight of cases applying "settlor function" theory to asset transfers. As the district court pointed out in *Systems Council,* the prohibited transaction rules of ERISA Section 406(b) apply by

their terms only to fiduciaries. Thus the "threshold inquiry" for reviewing any act under Section 406(b) is whether it is a fiduciary act or a settlor act. And when this "inquiry" is made of the allocation of asset surplus pursuant to a plan spinoff, the answer is that the act is settlor in nature. (*Systems Council,* 159 F.3d at 1380; *Blaw Knox,* 998 F.2d at 1189; *Kuper,* 66 F.3d at 1447; *Sengpiel,* 156 F.3d at 660; cf. *Lockheed Corp. v. Spink*, 517 U.S. 882 (1996); *Hughes Aircraft Co. v. Jacobson*, 525 U.S. 432 (1999); *Curtiss-Wright Corp. v. Schoonejongen,* 514 U.S. 73 (1995).)

It should follow from these cases that *Gulf* is simply wrong. As the allocation of asset surplus in a plan spinoff is a settlor act, it is therefore not subject to ERISA Section 406(b)(1) or (b)(3). As with the other theories we have discussed, before *Flanigan*, case law was sparse on this point with respect to transactions like those in our hypothetical—that is, in which surplus was transferred from seller to buyer (rather than retained by seller). (See, however, *BiCoastal Corp. v. Northern Trust Co.,* 146 B.R. 486, 490 (Bankr. M.D. Fla. 1992) (applying settlor function theory to hold that seller's alleged "sale" of plan asset surplus not a prohibited transaction under ERISA Section 406(b)).) But in *Flanigan*, the Second Circuit applied settlor function theory to dismiss all participants' "inurement claims" under Sections 404 and 406(a) of ERISA (and apparently under Section 406(b) as well). Because GE was acting as a "settlor, not a fiduciary, when it transferred the surplus to Lockheed," its fiduciary obligations under these sections were not implicated.

In short, after *Flanigan*, the district court's contrary opinion in *Gulf* would appear to be even more isolated, and even more clearly wrong. *Flanigan* is only one more reason that *Gulf* should not pose a threat to transactions in which asset surplus is transferred from seller to buyer as part of a corporate transaction, and should not pose a threat to the hypothetical transaction we discuss here.

ERISA Section 403(c)—No Employer Inurement

The final hurdle for transactions like our hypothetical is Section 403(c) of ERISA. Section 403(c) requires that the assets of a plan may not "inure" to the benefit of the employer, and must be held for the "exclusive purpose" of providing benefits to participants.

Section 403(c) is thus drafted—and is sometimes treated by the case law—as two different rules: one governing the participants' rights to plan assets as against to their employer, and one governing

participants' rights as against one another. We first discuss the first or "inurement" prong of the rule.

Recall that in our hypothetical, Seller's remaining participants argue that under Section 403(c), Seller's transfer of the $10 million surplus to Buyer impermissibly "inures" to the benefit of Seller to the extent the transfer raises the price of the deal. Even without a showing of enhanced deal value, participants also argue that the transfer of surplus "inures" to Seller by advancing Seller's non-plan-related business interests. The *Flanigan* participants, incidentally, made both these arguments to the Second Circuit.

Do Seller's participants have a good argument here?

Even before *Flanigan*, case law indicated that the answer is no. As a general matter, the courts have decided that an employer's use of plan assets to increase its own value is not prohibited inurement as long as assets stay in the plan for the purpose of paying benefits, and absent self-interested manipulation of trust investments. To reach the same destination, however, courts have used a variety of different theories. We list them here.

1. Settlor Function Theory

First, a number of cases hold that the employer's decision with respect to the transfer of assets and liabilities is a settlor act, rather than a fiduciary act, and not subject to review under Section 403(c). These cases thus apply the settlor function doctrine developed to shield decisions from review under ERISA Sections 404(a) and 406 (*Systems Council, Blaw Knox, Sengpiel*) and apply it to shield decisions from review under 403(c) as well.

One court has applied settlor function theory to the transfer of an overfunded plan in connection with a sale of a division to a buyer outside the seller's controlled group, where the sale price explicitly included an adjustment for the "sale" of the plan's surplus. The court held there was no Section 403(c) inurement, because the transaction was settlor in nature. (*BiCoastal Corp.*, 146 B.R. at 490-91.)

A number of cases have applied the settlor function doctrine to conclude that there is no Section 403(c) review permitted (1) when an employer amends its pension plan to pay pension inflation-adjustment supplements out of plan, rather than as before, out of corporate assets (*In re Gulf Pension,* 764 F. Supp. at 1213), or (2) when participants' liabilities are "spun off" from one plan to another within the same controlled group (*Van Orman*, 608 F. Supp. at 23). While not

entirely clear on this point, in *Flanigan*, the Second Circuit arguably may be said to apply settlor function theory to conclude that the transfer of surplus assets was not a prohibited inurement to GE (although arguably reaches its final 403(c) holding on other theoretical grounds).

In short, under the settlor function theory of these cases, the transfer of surplus assets in our hypothetical is not subject to review under Section 403(c), because it is a business decision not subject to that section.

2. Section 208 "Safe Harbor" Theory

A number of cases have taken a different route and held that any transfer, spinoff, merger, or other transaction governed by ERISA Section 208 must automatically satisfy Section 403(c) if it satisfies Section 208. Under this theory, satisfaction of Section 208 is safe-harbor satisfaction of Section 403(c).

Several cases have applied the section 208 safe-harbor theory to a transfer of assets outside the employer's controlled group. (*Cyclops Corp.*, 860 F.2d at 201 (no 403(c) violation when company transfers underfunded plan outside of controlled group, even though company thereby benefits via net reduction in liabilities, because spinoff satisfies ERISA Section 403(c) if it satisfies ERISA Section 208); *BiCoastal Corp.*, 146 B.R. at 490-91 (no 403(c) violation when company transfers overfunded plan outside of controlled group for consideration, because transaction satisfies ERISA Section 208; cites *Bigger* and *Foster*).) The Second Circuit in *Flanigan* concluded, among other things, that the transfer of surplus plan assets resulted in no "inurement" under Section 403(c), because participants received "everything to which they were entitled" under Section 208.

Courts have also applied the safe-harbor theory to a spinoff of plan assets and liabilities or other transaction *within* the employer's controlled group. Although they deal with intra-employer transactions, these cases are relevant to the spinoff/transfer at issue here because their reasoning applies to *any* transaction subject to Section 208. (*Lynch v. J.P. Stevens & Co.*, 758 F. Supp. 976, 997-98 (D.N.J. 1991) (when employer split overfunded defined plan into two, and allocated surplus to one plan which was then terminated so that employer could recoup surplus, neither asset transfer nor termination/reversion a prohibited 403(c) inurement, because both the transfer and termination/reversion met ERISA Section 208); see *Hickerson v. Velsicol Chemical Corp.*, 778 F.2d 365 (7th Cir. 1985) (when

employer converted defined contribution plan to defined benefit plan, for purpose of reaping future earnings on assets, no prohibited 403(c) inurement, because amendment satisfied transfer/merger requirements of ERISA Section 208), certiorari denied, 479 U.S. 815 (1986).)

Under the Section 208 safe-harbor theory of these cases, the transfer of surplus asset in our hypothetical is permitted under Section 403(c) because permitted under Section 208. *Flanigan* is only the latest in a long line of cases to reach this conclusion.

3. Incidental Benefit Theory

Third, a long line of cases holds there is no 403(c) inurement in a transaction in which assets stay in the plan for the purpose of paying plan benefits, even if the transaction has "the incidental side effect of being prudent from the employer's economic perspective." (*Holliday v. Xerox Corp.*, 732 F.2d 548, 551 (6th Cir. 1984), certiorari denied, 469 U.S. 917 (1984).)

Put another way, as long as the assets stay in the plan to pay benefits (and absent manipulation of trust investments), they are permitted to accomplish indirectly—increase employer cash or otherwise advance non-plan-related business interests—what they might not be permitted to do directly. (See, for example, *Aldridge v. Lily Tulip*, 953 F.2d 587, 592, n. 6 (11th Cir. 1992) (Section 403(c) can only be violated if there has been "a removal of plan assets for the benefit of the plan sponsor or anyone other than the plan participants"), certiorari denied, 516 U.S. 1009 (1995); *Bass v. Retirement Plan of Conoco, Inc.*, 676 F. Supp. 735, 744 (W.D. La. 1988) (Section 403(c) applies only to the employer's conversion of funds or "self serving investments" of plan assets).)

In *Flanigan* the Second Circuit squarely applied incidental benefit theory to conclude that the transfer of surplus assets outside the seller's controlled group was not prohibited inurement. "Although GE might have received some benefit, such as a higher sale price, because it was able to transfer some of the surplus to Martin, [ERISA Section 403(c)] focuses exclusively on whether fund assets were used to pay pension benefits to plan participants. . . Any benefit received by GE was at most indirect." (*Flanigan v. General Electric Co.*, 242 F.3d at 87.)

Even before *Flanigan*, incidental benefit theory has been applied to uphold under Section 403(c) the transfer of plan assets and liabilities outside the controlled group pursuant to an asset sale, where the

transfer increased the employer's net economic position. (*Cyclops*, 860 F.2d at 201 (under incidental benefit theory of *Holliday*, no 403(c) violation when employer transferred underfunded pension plan to buyer outside of controlled group for purpose of reducing its net liabilities); *BiCoastal Corp.*, 146 B.R. at 490-91 (under incidental benefit theory, no 403(c) violation when company transfers overfunded plan outside of controlled group for consideration).)

In addition, the incidental benefit theory has been applied to uphold a spinoff/transfer outside the control group where a disproportionate surplus was *retained*, and then later "used" to fund an early retirement subsidy for retained employees. Even conceding that by restricting benefit enhancements to retained employees, the company accomplished its admitted objectives of reducing its workforce, the court held that there was no 403(c) inurement because the "direct benefit" of the transaction was reaped by the participant/recipients of the benefit enhancement. (*Bass,* 676 F. Supp. at 744.)

The incidental benefit theory has also been applied to uphold under Section 403(c) the split-up of an overfunded plan into two plans, where the employer allocated the surplus to only *one* of the spinoff plans with the intention of terminating the plan and taking a reversion of the surplus assets. (*Lynch*, 758 F. Supp. 976 (no 403(c) inurement in disproportionate allocation of surplus to spinoff plan within controlled group with ultimate purpose of termination/reversion, because employer's benefit only incidental under *Holliday*).)

In addition, under the incidental benefit theory, a large number of cases have held there is no Section 403(c) inurement when an employer amends a plan to modify benefits, even though the purpose and effect of the benefit amendment is to reduce current or prospective liabilities of the employer. (*Spink v. Lockheed Corp.,* 125 F.3d 1257, 1260 (9th Cir. 1997) ("*Spink II*") (in plan without employee contributions, no prohibited inurement when early retirement subsidy was made contingent on employee's agreement to relinquish all other claims (ERISA and non-ERISA) against the employer, under "incidental benefit" theory of *Aldridge v. Lily Tulip*); *Holliday*, 732 F.2d at 551 (when employer effectuated amendment and intra-plan transfer so that certain participants' accounts offset (reduced) other benefits payable to them under the plan, no 403(c) inurement, even conceding that the transfer/offset reduced employer's future funding obligations. Reasoning: As long as assets used to pay benefits from plan, employer's reduction of net future cost increases is only "incidental benefit"); *Hlinka v. Bethlehem Steel Corp.,* 863 F.2d 279, 283

(3d Cir. 1988) (no 403(c) inurement when early retirement benefits paid at employer's discretion and only when employer deems retirement "in its interest"); *In re Gulf Pension,* 764 F. Supp. at 1211 (no 403(c) inurement when assets of merged plans are used to pay enhanced benefits to plan beneficiaries, even if disproportionately paid to members of only one of two pre-merger plans, in part because benefits employer received from and other employees only incidental under *Bass* and *Holliday*); *Walling v. Brady*, 917 F. Supp. 313, 318 (D. Del. 1996), reversed on other issues, 125 F.3d 114 (3d Cir. 1997) (when employer amends pension plan to increase retiree's pension payout by $100 per month, and simultaneously amends health plan to require $100 per month employee/participant premium, no 403(c) inurement even conceding increased pension payout helped employer by subsidizing reduction in employer health plan costs; under *Holliday*, direct beneficiaries are plan participants who receive $100/month, and employer's benefit is permissibly "indirect").)

In short, under the incidental benefit theory of these cases, the transfer of surplus assets in our hypothetical is permitted under Section 403(c) because assets in both of the post-splitoff plans will be retained in the plans to pay benefits. According to the theory of these cases, any economic benefit to Seller Corporation from our hypothetical transaction is indirect, and is permitted under Section 403(c).

4. Reversionary Interest Theory—Employer's Statutory Right to Plan Surplus

Fourth, a number of cases have taken as their starting point the observation that ERISA Section 403(c) expressly gives the employer an interest in a defined benefit plan's surplus assets after all benefits have been paid, and certain other conditions met. (See, for example, *Chait v. Bernstein,* 835 F.2d 1017 (3d Cir. 1987); *Wright v. Nimmons,* 641 F. Supp. 1391 (S.D. Tex. 1986); *Borst v. Chevron Corp.*, 36 F.3d 1308, 1321 (5th Cir. 1994).)

Building on *Chait*, *Nimmons*, *Borst,* et al., a number of courts have held that, because of the employer's right under Section 403(c) to asset surplus following plan *termination*, it follows that the employer has the same rights to the asset surplus (or prospective surplus) of an ongoing plan.

For example, under the reversionary interest theory, a court upheld a transaction in which an employer transferred an overfunded pension plan to a buyer outside the controlled group, when the sales price expressly reflected the value of the plan's surplus. (*BiCoastal*

Corp., 146 B.R. at 190-91 (sale of assets no 403(c) violation because employer has right to post-termination surplus).)

Also under the reversionary interest theory, a court upheld a transaction in which a company acquired an overfunded pension plan as part of its purchase of a division from an unrelated seller. The buyer merged the overfunded plan into its own plan. The court held there was no prohibited 403(c) inurement in retaining the surplus rather than paying enhanced benefits to the plaintiffs (target employees terminated after the sale), *even assuming* that in the deal the buyer paid *less* than full value for the $3.7 million surplus. (*Koenig v. Intercontinental Life Corp.*, 880 F. Supp. 376, 379 (E.D. Pa. 1995) (employer's rights under *Chait* and *Borst* to post-termination surplus under ERISA Section 403(c) apply as well to surplus assets in ongoing plan).)

Also under the reversionary interest theory, several courts have upheld under 403(c) the employer's right to sell, pledge, or assign its future right to a reversion of the plan's surplus after plan termination. (*In re Long Chevrolet Inc.*, 79 B.R. 759, 763-4 (N.D. Ill. 1987) (upholding employer's right to grant secured creditor a right to employer's future interest in post-termination surplus of ongoing plan, held no ERISA Section 403(c) violation because employer has reversionary right to plan surplus); *Young v. Paramount Communications, Inc., [a/k/a In re Wingspread Corporation],* 155 B.R. 658, 664 (Bankr. S.D.N.Y. 1993) (in sale of overfunded plan outside controlled group, when, as part of Purchase Agreement, seller retained right in surplus assets if buyer terminated plan within five years of sale, seller held to express terms of agreement. Seller's reversion "transferable and alienable" without violating ERISA 403(c)). See *FDIC v. Marine National Exchange Bank of Milwaukee*, 500 F. Supp. 108, 110-11 (E.D. Wis. 1980) (under ERISA 4044(c), employer has reversionary right to post-termination surplus, and has the right to sell or alienate this right.); cf. *In re Benefit Management Corp.* 10 E.B.C 1651 (Bankr. W.D. Wis. 1988) (ERISA Section 403(c) does not allow employer to create security interest in future right to asset reversion in plan where there is no surplus, citing *In re Long Chevrolet* and *Marine National Exchange Bank*).)

In part under the reversionary interest theory, a court has upheld an employer's conversion of a defined contribution plan to a defined benefit plan so that the employer could capture the value (via a reduction in its future contribution obligations). The court reasoned in part that Section 403(c) does not give rise to participants' interest in plan assets. (*Hickerson,* 778 F.2d at 373.)

Under the reversionary interest theory of these cases, the transfer of plan surplus assets in our hypothetical does not give rise to prohibited inurement because the employer is entitled to obtain value from a plan's surplus indirectly, by selling, pledging or assigning it, no less than it can do directly, by terminating the plan and recapturing the surplus.

ERISA Section 403(c)—Fair Allocation Among Participants

Participants have sometimes argued that Section 403(c) embodies a second prong as well: a requirement that in certain transactions, assets be allocated "fairly" among different groups of participants. This argument is of course relevant to our hypothetical transaction. Surplus assets disproportionate to liabilities are spun off from the participants who arguably "earned" them to cover not only Seller's Target division employees, but ultimately Buyer's completely unrelated employees.

The principle source of this variety of Section 403(c) "inurement" is the Second Circuit's decision in *Trapani v. Consolidated Edison Employees' Mutual Aid Society*, 891 F.2d 48 (1989). In *Trapani*, the employer maintained a funded welfare benefit plan. Following negotiation of a new collective bargaining agreement, a portion of the employees covered by the plan became covered by a new plan. The *Trapani* court held that Section 403(c) requires that the employer transfer all assets contributed by or on behalf of this particular group of employees from the old plan to the new plan. Otherwise, the court reasoned, these assets would impermissibly inure to the benefit of the participants remaining in the plan.

Trapani has never been expressly overruled, and has been applied as recently in the last two years to block certain asset transfers involving welfare benefit plans. (*Long Island Head Start Child Development Services, Inc. v. Kearse*, 2000 U.S. Dist. LEXIS 2617 (E.D.N.Y. March 3, 2000); *Campbell v. Schifman*, 1992 U.S. Dist. LEXIS 1233 (W.D. Mo. January 31, 1992), Mem. Op.)

Trapani Has Been Superceded

Despite its recent use in lower court decisions, we believe *Trapani* is not good authority for invalidating the transfer of surplus assets at issue in our hypothetical transaction.

First, in those few cases where *Trapani* has been applied, it has been confined to welfare benefit plans, the courts agreeing in dictum

that the case does not apply to pension plans. (*Long Island Head Start Child Development Services, Inc. v. Kearse*, 2000 U.S. Dist. LEXIS 2617 (E.D.N.Y. March 3, 2000); *Campbell v. Schifman*, 1992 U.S. Dist. LEXIS 1233 (W.D. Mo. January 31, 1992), Mem. Op.) The reasoning of the courts on this distinction is sparse, however. It is not entirely clear why these same courts would reach a different conclusion with respect to transfers of pension assets. Also, the welfare/pension plan distinction is not comforting to plan sponsors faced with transfers of VEBA or other welfare benefit plan assets.

Second, and more generally, *Trapani* has arguably been overruled by emerging theory that an employer's use of plan assets is a settlor decision, not reviewable under Section 403(c). The use of settlor theory to overrule Section 403(c) challenges is not well developed in the case law, however. (See our discussion of Section 403(c) inurement cases, above.) Moreover, it could be argued that settlor function theory does not address the *Trapani* issue of fair allocation of assets among different groups of participants. The district courts in *Kearse* and *Campbell* did not discuss or address settlor function theory in their own *Trapani* holdings.

Third, and more on point, even without the settlor function theory of *Hughes*, it could be argued that *Trapani* has been superceded by emerging 403(c) doctrines holding that the employees have no right to any share of surplus, even if contributed on their behalf. A number of cases have examined directly whether, in the context of a plan merger or plan amendment, Section 403(c) requires allocation of any particular share of surplus to an identifiable group of participants. These courts have decided that Section 403(c) does not give rise to such a claim, even assuming those assets were contributed pursuant to the employment of those employees raising the claim. (*Georgia-Pacific Corp.*, 19 F.3d at 1189 (when poison pill amendment was triggered, and benefits of active employees, but not retirees, were increased to extent necessary to soak up surplus, held, in part, no 403(c) violation merely because retirees did not get same increase, even conceding the surplus was built from their contributions. Reasoning: 403(c) does not give rise to claim on assets); *In re Gulf Pension*, 764 F. Supp. at 1212 (no 403(c) violation when surplus assets of merged overfunded plans used to pay enhanced benefits to plan beneficiaries, even when disproportionately paid to members of only one of two pre-merger plans, and even when merged plans were originally funded under separate employers. Apparent theory: fungibility of assets—benefits "could just as likely have been paid from" surplus of one plan as the other); *Hughes*, 525 U.S. 432 (when

employer amended an overfunded defined benefit plan to include new benefits, and to cover new employees, no 403(c) inurement even though assets surplus contributed by or for old employees, in part because Section 403(c) does not give rise to participant claim for assets).)

Fourth, we discussed above the many cases holding that plan asset transfers do not "inure" to the employer. It can be concluded that they do not impermissibly "inure" to any particular group of participants either. In the cases that most clearly illustrate this point, the challenged transaction involved a plan that was split into two, and assets and liabilities allocated disproportionately within or outside of the controlled group (*Koenig*, *Bass*, *Lynch*). As we discuss above, the courts have upheld these transactions under Section 403(c), concluding that assets do not "inure" to the employer merely because of the disproportionate allocation. Because the facts necessarily imply that certain groups of employees ended up with "more" assets relative to liabilities than others, it can be concluded that these transactions likewise do not give rise to impermissible 403(c) benefit to any group of employees.

Fifth, and as we also discuss above, a number of cases have held that the employer has the exclusive right under Section 403(c) to surplus assets, either after plan termination (*Chait*, *Nimmons*, *Borst)* or before (*Koenig, BiCoastal Corp., Young v. Paramount, FDIC v. Marine National Exchange Bank of Milwaukee, Hickerson).* If the employer's right to asset surplus is exclusive, it follows that different groups of employees do not have a right to any particular allocation of the surplus.

In short, if *Trapani* were ever valid, it has apparently been superceded by emerging 403(c) doctrines holding that the employees have no right to any share of surplus, even if contributed on their behalf (*Hughes, Georgia-Pacific, In re Gulf*), and no right to surplus generally (*Chait*, *Nimmons*, *Borst, Koenig, BiCoastal Corp., Young v. Paramount, FDIC v. Marine National Exchange Bank of Milwaukee, Hickerson).*

Trapani Isn't Even an ERISA Case

Amidst the sea of cases pointing in the other direction, *Trapani* sticks out as an oddity. We think the simplest explanation for *Trapani* is this: The holding was under ERISA Section 403(c). But *Trapani* was in fact decided and reasoned entirely in accordance with the court's earlier decisions under the "exclusive benefit" rule of

LMRA Section 302(c)(5) (permitting payments by employer only with respect to funds paid to trust "for the sole and exclusive benefit" of employer's employees). When *Trapani* is viewed as an LMRA case, rather than an ERISA case, it may be clearly seen that it has been overruled.

Specifically, *Trapani* was decided under the Second Circuit's earlier decision in *Local 50, Baker & Confectionary Workers Union, AFL-CIO v. Local 3, Baker & Confectionary Workers Union, AFL-CIO,* 733 F.2d 229, 233-34 (2d Cir. 1983). Like *Trapani, Local 50* involved employees of a single employer who became covered by a new collective bargaining agreement and a new welfare benefit fund. Under LMRA Section 302(c)(5), the *Local 50* court held that the old fund must transfer an "aliquot" share of assets to the new fund. Otherwise, the court reasoned, the assets would "have inured solely to the benefit of the remaining participants" in the old fund, and plaintiffs "would have derived no benefit from that portion of the past contributions." After discussing *Local 50* in detail, the *Trapani* court concluded, "The decision in *Local 50* controls our resolution here that [the old fund] is not permitted to retain the funds in question."

In short, *Trapani* was an LMRA Section 302(c)(5) case, and not an ERISA Section 403(c) case. The *Trapani* decision was "controlled by" the court's earlier decision in *Local 50,* itself expressly an LMRA Section 302(c)(5) case. And like *Local 50, Trapani* is couched in terms of policy considerations peculiar to LMRA Section 302(c)(5)—that is, equities among different groups of employees—rather than the employer versus employee concerns found on the face of ERISA Section 403(c).

But *Local 50* is no longer good law. In *Demisay v. Local 144 Nursing Home Pension Funds,* 935 F.2d 528 (2d Cir. 1991), reversed, 508 U.S. 581 (1993), an employer left a multi-employer pension and welfare fund in favor of another set of funds. Under *Local 50,* the Second Circuit held that LMRA Section 302(c)(5) required that funds paid to the old fund on behalf of the employer's employees be transferred to the new fund. The Supreme Court reversed, holding that federal courts lack jurisdiction to reform the operation of trusts to conform with LMRA Section 302(c)(5). The Supreme Court remanded for consideration under ERISA, but the Second Circuit dismissed the case.

Since *Demisay,* the Second Circuit has heard at least one "proportional asset transfer" case under ERISA. In *Ganton Technologies, Inc. v. National Industries Group Pension Plan,* 76 F.3d 462 (2d Cir. 1995), an employer leaving a multiemployer pension plan requested

that the plan transfer a proportional share of liabilities and assets to a single employer plan. The court held that the fund's refusal did not violate the "exclusive benefit" rule of ERISA Section 404(a). As the *Trapani* court believed that ERISA Section 403(c) was also an "exclusive benefit" rule, it may be concluded that *Ganton* also implies that the transaction satisfied Section 403(c) as well. Parenthetically we observe that, apparently because of *Demisay*, the employees' simultaneous claim under LMRA Section 302(c)(5) was withdrawn. (See also *Ronald v. Caterino*, 8 F.3d 878 (1st Cir. 1993) (when employees covered under multiemployer pension fund attempted transfer of proportional assets to new, single employer fund, challenge under 302 of LMRA dismissed under *Demisay*, but case heard under ERISA Section 404(a)).)

It can be seen that the lower courts' decisions following *Trapani* are wrongly decided. In *L.I. Head Start Child Development Services, Inc. v. Kearse,* 86 F.Supp. 2d 143 (E.D. N.Y. 2000), an employer transferred to a new welfare benefit fund. The employer and its employees as a class sued the fund for a transfer of a proportional share of surplus to the new fund. The district court held that transfer was required under ERISA Sections 403(c) and 404(a). In support, the court cited the Second Circuit's decisions in *Local 50*, *Trapani,* and *Demisay*. The *Kearse* court further distinguished the Second Circuit's decision in *Ganton Technologies* (no proportional transfer required under ERISA Section 404(a)) on the grounds that *Ganton* dealt with a pension plan rather than welfare benefit plan.

The *Kearse* court is of course just plain wrong. The Second Circuit's LMRA 302(c) holdings in *Local 50* and *Demisay*—which are relied on by the *Kearse* court—were expressly overruled by the Supreme Court, as the Second Circuit itself has recognized. (*Devito v. Hempstead China Shop, Inc.* 38 F.3d 651, 653 n.3 (2d Cir. 1994).) Because decided under—in fact "controlled by"—*Local 50*, *Trapani* is also an LMRA 302(c) case, and has also been overruled. Under this line of analysis, the reasoning of *L.I. Head Start* that *Ganton* is distinguishable because it is a pension case rather than a welfare benefit case misses the point. The distinguishing factor is rather that *Ganton* is an ERISA case, and *Trapani* is an LMRA case. It would appear that *Trapani* no longer governs, while *Ganton* and *Flanigan* do.

CONCLUSION

We have examined the validity under ERISA of a common kind of corporate transaction: The sale of a corporate entity, together with

the spun-off portion of an overfunded defined benefit plan, including asset surplus. We have concluded that the transaction is permissible under an array of ERISA doctrines that might be raised to challenge it. The Second Circuit's decision in *Flanigan* may be the clearest affirmation of the transaction, but is better seen as the culmination of a long line of consistent cases leading to this result.

NOTES

1. ERISA Section 208 is governed by regulations promulgated by the Internal Revenue Service under "mirror" Section 414(l) of the Code. Under "Reorganization Plan No. 4 of 1978," these regulations govern ERISA Section 208 as well as Code Section 414(l). Executive Order 12108, 44 *Fed. Reg.* 1065 (Dec. 28, 1978), 1979-1 C.B. 480. According to the IRS's regulations, the "spinoff" we describe in our hypothetical is two transactions: the "spinoff" itself, or splitting of the plan into two plans, and transfer of one of those plans outside of Seller Corporation's controlled group. Treas. Reg. §1.414(*l*)-1(b)(3), (4), and -1(o). For brevity, we refer to the entire spinoff and transfer as simply the "spinoff."

2. Treas. Reg. §1.414(l)-1(a)(2)(ii).