Introduction and *Hughes* Blues

Like all readers of *Benefits Law Journal*, we were sad to see Linda Laarman relinquish her post as Editor-in-Chief. We had come to rely on the consistent quality, rigor, and intellectual breadth of the Journal's articles under her guidance, and looked forward to reading each edition as it came out, each complete with one of Linda's thoughtful editorials. We are happy for Linda, however, that she is excited about resuming her full-time law and consulting practice.

We are also very pleased that Aspen Publishers has asked us to be the next Editors-in-Chief. While assuming Linda's title, we are not assuming her mantle or the bulk of her duties. The acquisitions and substantive editing that Linda did for the last three years amount to nearly a full-time job. These responsibilities will be assumed by Dianne Scent. Dianne is probably well known to readers as the long-time editor of *Employee Relations Law Journal*, and we look forward to seeing her carry to this journal the same creativity and enthusiasm she has brought to its sister publication.

Like Linda, we will write a "From the Editors" column with each issue. We gave considerable thought to what we would like to do with this space. Having alternately considered (and rejected) various forms of punditing, we have decided to use it mostly as a way to flag recent developments in benefits law that—because they are interesting, significant, or just plain scary—deserve placement on a "watch list" for scrutiny as they further develop.

We here review the Ninth Circuit's most recent assault on the "settlor function" doctrine—the long-standing principle that an employer is free even under ERISA to fashion the terms of its own benefit plans—in *Jacobson v. Hughes Aircraft Co.*, 105 F.3d 1288 (9th Cir. 1997), amended, rehearing en banc denied, 128 F.3d 1305 (1997), certiorari granted (1998). The Supreme Court will review *Hughes* this Fall.

We find *Hughes* particularly troublesome in that it upholds the "anti-inurement" rule of ERISA Section 403(c) as grounds for overturning benefit plan amendments. *Hughes* thus breathes new life into a rule that still lurks as a potentially powerful source of employee

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challenges to garden-variety plan design decisions. The Supreme Court's review bears added watching because *Hughes'* reach may extend well beyond plans with *Hughes*-like facts—that is, overfunded defined benefit pension plans with employee contributions—to inflict mischief on employers' freedom to alter benefit plans of all types, including welfare benefit plans, plans with no employee money, and even plans with no asset surplus.

Spink *Sets the Stage*

A little background is in order. *Hughes* may be best viewed against the Ninth Circuit's earlier decision in *Spink v. Lockheed Corporation*, 60 F.3d 616 (9th Cir. 1995), affirmed in part, reversed in part and remanded, 517 U.S. 882 (1996). The plan in this case conditioned a participant's receipt of enhanced benefits from a defined benefit pension plan upon the participant's release of all other employment-related claims, including non-ERISA claims against the employer. The court held that by fashioning and implementing a quid-pro-quo of this kind, the employer violated its fiduciary duties under ERISA (specifically, by engaging in a prohibited use of plan assets by a party in interest under ERISA Section 406(a)(1)(D)). The Supreme Court reversed, holding that when an employer designs the terms of a benefit plan, it acts as plan sponsor, rather than plan fiduciary. As the challenged plan provision was not the act of a fiduciary, it was not subject to review under ERISA's fiduciary restrictions. The Court thus affirmed the long-standing "settlor function" doctrine long used by the lower courts to uphold amendments of ERISA plans.

Hughes: *The 9th Circuit Responds to* Spink

The Ninth Circuit followed its reversal in *Spink* by releasing its decision in *Hughes. Hughes* involves an overfunded defined benefit plan containing both employer and employee contributions. Over several years, the plan sponsor amended the plan by introducing a subsidized early retirement benefit for existing participants, and by creating a new benefit structure covering all new participants and any existing participants who so elected. New participants were not covered by the old benefit structure.

Participants brought suit under several ERISA theories. The one that interests us here is their claim under ERISA Section 403(c)(1), which provides that "the assets of a plan shall never inure to the benefit of any employer. . . ." The plaintiffs argued that by its double-

barreled plan redesign—that is, by creating an early retirement benefit for old employees and a new, (apparently) more generous benefit structure for new employees—the employer used the assets of the plan to reduce its labor costs and increase the wages of new employees, a prohibited inurement under Section 403(c). The district court dismissed on summary judgment.

The Ninth Circuit saw things differently. Among other things, the Ninth Circuit held that an employer does not have sole discretion under Section 403(c) to "use that part of a plan's asset surplus attributable to employee contributions."

At first glance, the amendment seems like the act of an employer wearing its nonfiduciary "hat." So why not just wait for the Supreme Court to slap the Circuit's hand and send back the 403(c) opinion under *Spink*?

The *Hughes* court argued that *Spink* simply does not apply to 403(c). In contrast to the prohibited transaction rule at issue in *Spink*, the court noted, 403(c) is not by its terms confined to a fiduciary. The anti-inurement restrictions arguably apply to *all* acts of the employer, whether or not undertaken when the employer acts in its role as a plan fiduciary. The Ninth Circuit's bottom line: The employer's settlor function of designing plans may not be reviewed under ERISA's fiduciary restrictions—but may still be attacked under Section 403(c).

Granting this argument for the moment, do we have to worry about *Hughes* in a plan with no employee money? The holding is restricted to the surplus "attributable to employee contributions," and the Ninth Circuit in *Spink v. Lockheed Corp.*, 105 F.3d 1320 (9th Cir. 1997) ("*Spink II*"), has explicitly refused to extend its own *Hughes* theory to a plan without employee money.

We think we do have to worry, which is why the Supreme Court's review of *Hughes* is worth watching carefully.

Hughes *May Apply Even if Plan Has No Employee Money*

On examination, the employee-versus-employer-money distinction relied on by the Ninth Circuit in *Hughes* rests on pretty shaky grounds. The statute itself prohibits inurement with respect to "plan assets" generally. No distinction is made between funds attributable to employee and employer contributions.

Without direct statutory support, the *Hughes* court justifies the distinction in two ways. The first is the ERISA statutory scheme. The court observes that ERISA itself has a number of extra protections for employee contributions, including, for example, Section 4044, which

requires return of employee funds to employees after termination of a defined benefit pension plan. Therefore, the court reasons, Congress must have intended extra protections for such funds under ERISA generally.

Second, the court reasons backwards from the observation that, following termination of an overfunded defined benefit pension plan, ERISA Section 4044 lets surplus funds revert to the employer. Such reversions are permitted in part, the court reasoned, because surplus assets in an employer-funded plan is theoretically akin to a gift or gratuitous trust, and, at common law, a gratuitous trust may revert to the settlor. But employee money is not a component of a gratuitous trust. No gratuitous trust, no reversion at common law, and so no permitted ERISA inurement. QED.

Both arguments are puzzling. To consider the statutory argument first: The court argues that express restrictions on the disposal of assets after plan termination under ERISA Section 4044 are evidence of implied restrictions before termination. More generally, the court in effect argues that the presence of restrictions in some parts of the statute—where they are spelled out—is evidence of their presence in other parts of the statute, where they are not. This is at best weak statutory construction.

The gratuitous trust argument is just an unnecessary bit of theoretical baggage, given that Congress handled the disposition of post-termination surplus by statute. In any event, the common law argument suffers from the same defect as the statutory one: it has no necessary bearing on the status of employee funds *before* termination.

When the employer/employee money distinction collapses, what is left? Obviously, the theory that all ERISA plan assets are subject to the anti-inurement rule of Section 403(c).

So why worry? Courts have repeatedly upheld the ability of the employer to design its own benefit plans, even if these amendments use plan surplus. These cases rest on a couple of different and only loosely related theories. One line of cases under *Amato v. Western Union International, Inc.*, 773 F.2d 1402 (2d Cir. 1985), certiorari dismissed, 474 U.S. 1113 (1986), holds simply that Section 403(c) does not apply *at all* if the assets stay in the plan and there is no plan termination. No asset removal, threatened asset removal, or plan termination, no problem—and partial terminations do not count. (See, for example, *Aldridge v. Lily Tulip Inc. Salary Retirement Plan*, 953 F.2d 587 (11th Cir.), rehearing, en banc, denied, 961 F.2d 224 (1992); *Borst v. Chevron*, 36 F.3d 1308 (5th Cir.) *and cases cited therein*, rehearing, en banc, denied, 42 F.3d 639 (1994), certiorari denied, 14 U.S. 1066 (1995)).

To get around the *Amato* line of cases, the Ninth Circuit pulls a rabbit out of its hat in the form of a novel "constructive-termination" theory. The court remands to district court to determine whether, when the employer "froze enrollment" in the old benefit design (that is, covered all new participants under the new benefit design), it in fact terminated the plan, thus triggering application of Section 403(c).

So far so good. If viable, of course, the court's constructive termination theory certainly could be troublesome: Any going-forward modification of the plan's benefit design could set in motion the horrific machinery of a full termination under ERISA Title IV.

But we are betting, at least for purposes of this piece, that the Supreme Court will rule that no termination took place under the *Hughes* facts. From a legal perspective, the theory would appear to be without authority. From a practical perspective, the theory has aroused the opposition of the Pension Benefit Guaranty Corporation, the federal guarantor of terminated defined benefit pension plans. Apparently alarmed at this sudden and unwanted expansion of its potential jurisdiction, the agency filed an amicus brief in support of the defendant's certiorari petition, specifically arguing that the lower court's termination theory should be struck down.

Hughes *Applies Even if Plan Termination Theory Struck Down*

If no termination, no *Hughes* problem?

No. The *Amato* rule—no actual or threatened asset removal, no 403(c) violation—is not found in the literal words of the statute, is not the universal position of the federal courts, and is not the position of the Ninth Circuit. A second line of cases, under *Holliday v. Xerox Corporation*, 732 F.2d 548 (6th Cir.), certiorari denied, 469 U.S. 917 (1984), holds that when an employer amends a plan, the employer does not trigger Section 403(c) merely because the amendment serves its business interests, as long as the employer's benefit is "incidental." The potential reach of *Holliday's* incidental benefit rule, at least in the 403(c) context, may have been obscured by a number of cases that appear to read the rule as a mere surrogate for other ERISA requirements: for example, ERISA's prohibitions against cutting back protected benefits by plan amendment, or removing assets from the plan except to pay benefits. (See *Fletcher v. Kroger,* 942 F.2d 1137 (7th Cir. 1991); *Hlinka v. Bethlehem Steel Corporation,* 863 F.2d 279, 283 (3d Cir. 1988); and *Aldridge v. Lily-Tulip Inc. Salary Retirement Plan,* 953 F.2d 587 (11th Cir. 1992), rehearing en banc, denied, 961 F.2d 224 (1992).)

The *Hughes* court refused to read the incidental benefit doctrine as a mere surrogate for any other rule. The opinion focuses on the "incidental" part of the test, and instructs the district court to determine whether the employer's benefit from its various plan amendments is in fact incidental. In short, in the eyes of the Ninth Circuit, the incidental benefit test is an affirmative hurdle that must be cleared by every plan amendment. Thus, a plan amendment can trigger prohibited "inurement" even if the assets stay in the plan. And every plan amendment is open to scrutiny to weigh whether the employer's benefit is sufficiently "incidental."

The 9th Circuit does not wrap up its 403(c) review with the incidental benefit doctrine. In a footnote, the *Hughes* court helpfully prompts plaintiffs to develop additional theories of recovery under Section 403(c). To this end, the court cites dictum from *Johnson v. Georgia Pacific Corporation*, 19 F.3d 1184 (7th Cir. 1994). In *Georgia Pacific,* the retirement benefits of active employees were significantly increased for various business reasons, and the plan's surplus was as a result depleted. Retirees—whose benefits were not increased—cried foul and brought suit under various theories, including an anti-inurement theory. The plaintiffs lost. But the *Georgia Pacific* court's opinion takes a short detour to scold plaintiffs' attorneys for not pursuing an alternative line of argument to show that Section 403(c) had been violated:

> A transaction of this kind could reduce the expected value of benefits. Writing additional promises without increasing the assets available to fund those promises increases the risk that at some time in the future . . . the trust will be unable to satisfy all its obligations.

The *Hughes* court brings this passage to the attention of plaintiffs and, like its *Georgia-Pacific* brethren, suggests that the Ninth Circuit might entertain some kind of potential-asset-depletion argument under Section 403(c).

Hughes *Revives 403(c) Problems—But Did Not Invent Them*

To review the state of play: The Ninth Circuit held in *Hughes* that an employer's settlor act of amending a plan may be challenged under the anti-inurement rule of Section 403(c). Among other theories, the court said that Section 403(c) may bar the amendment if the employer's benefit from the plan redesign is not "incidental." The Ninth Circuit also appeared to suggest that Section 403(c) might

possibly bar an amendment if the amendment weakens the funded status of existing plan benefits in some unspecified way.

The Ninth Circuit did not entirely invent either of these theories. But by reviving them, the court highlights and perpetuates the underlying problem that they are almost entirely void of definition. Assume that the employer's benefit from a plan amendment may not be more than "incidental." What does this mean? That the employer's benefit from any plan redesign must be very small by some absolute measure? Small in comparison with the benefit received by employees? Of any magnitude as long as the redesign does not harm participants in any way (that is, a quasi-prudence rule grafted onto a loyalty rule)? A full discussion of these possibilities is grist for an article, and beyond the scope of this piece.

The quasi asset-sufficiency argument hinted at by both the *Hughes* and *Georgia Pacific* courts is equally puzzling. While inchoate, the theory would appear to be related to the notion that an amendment cannot benefit the employer if it hurts participants. This vague idea has also arguably been sketched out in *Amato*. As we noted above, the straightforward holding of this case is that Section 403(c) does not apply to assets unless they are removed from the plan. But the court rambles on to say:

> [S]ection 403(c) protects the policy interest that employers not be permitted to eliminate certain kinds of non-accrued benefits solely for the purposes of using existing assets to meet other obligations under the pension plan.

What does this mean? Anything? That a plan amendment could be subject to extra scrutiny under Section 403(c) if it depletes assets below some unspecified level necessary to protect benefits?

That is, three appellate courts (in *Hughes*, *Georgia Pacific,* and *Amato*) have at least mused on the possibility that ERISA's anti-inurement rule forbids an employer from amending a plan if the amendment jeopardizes the funded status of benefits in some (unspecified) way. As with the incidental benefit doctrine, it is not clear what this standard means in practice. Nor is it clear how this notion is related to a common law definition of inurement, or to the competing definitions set forth in *Holliday* and *Amato*.

Yet another possible Section 403(c) standard has been advanced by the Second Circuit in *Trapani v. Consolidated Edison Employees' Mutual Aid Society,* 891 F.2d 48 (2d Cir. 1989). In *Trapani*, one of three locals covered by a collectively bargained plan entered a new

collective bargaining agreement, and became covered by a new plan. The *Trapani* court held that ERISA Section 403(c) required that the employer transfer "aliquot share" of plan assets (attributable to both employer and employee contributions) to the successor plan.

Trapani is more noteworthy in its theory than in its result. ERISA watchers know well that an employer's fiduciary duty of loyalty might embrace the obligation not to discriminate with respect to plan assets among different classes of participants (for example, under *Winpisinger v. Aurora Corp.*, 456 F. Supp. 559 (N.D. Ohio 1978) and *John Blair Communications, Inc. Profit Sharing Plan v. Telemundo Group, Inc. Profit Sharing Plan*, 26 F.3d 360 (2d Cir. 1994)). *Trapani* is different from these other cases, and relevant to our discussion here, because it suggests that the employer's duty of nondiscrimination is not just a fiduciary duty, but resides as well in the employer's noninurement obligations under Section 403(c). That is, under *Trapani* an employer's nondiscrimination duty arguably binds not only its fiduciary acts of plan administration, but also its settlor functions of designing and amending the plan.

In light of these earlier cases, *Hughes* reminds us—but did create out of thin air—that Section 403(c) may serve as a readily available weapon for participants seeking to challenge an employer's design and redesign of its benefit plans. *Hughes* also reminds us, but did not create, the further problem that the 403(c) standards of extant case law are multiple, vague, and only tenuously related to one another or to any common sense or common law notion of "inurement." As we have seen, 403(c)'s anti-inurement rule may mean any of a number of things: The employer's benefit from a plan redesign must be small in absolute terms; must be small compared to the benefit received by participants; must not come at the expense of (undefined) harm to existing benefits promised to existing plan participants; or must not coincide with any (undefined) discrimination among various classes of interests.

In short, if this part of *Hughes* is upheld, the chaotic state of the law under Section 403(c) will ensure that the federal courts are perpetually involved in reviewing employer's plan amendments—with virtually no standard by which to conduct the review.

Of course, so far the threat of Section 403(c)—at least as applied against employer contributions—lurks mostly in dicta and general principles. Furthermore, Labor Department guidance may be modestly helpful in defanging its potential bite. Unhelpfully, a footnote in 1981 guidance released by the Labor Department, Opinion Letter 81-21A (1981), suggested that funds contributed to a VEBA for one

purpose may never be used for another purpose. But more recent Department guidance suggests that the merger of two VEBAs may not violate Section 403(c)'s anti-inurement rule (or a variety of other rules) just because the surplus of the overfunded VEBA is used to pay different benefits for the same group of employees, Opinion Letter 88-14A, or similar benefits for different employees. (See dictum in Information Letters to Florida United Food and Commercial Workers Unions (May 8, 1984) and Local 816 Labor and Management Severance Trust Fund (November 28, 1994)).

In short, we think that *Hughes* bears watching because it has put Section 403(c) in play as a weapon for employees' challenge to employers' plan amendments. Its potential to do mischief exists, in our view, even in the case of plans that do not share the *Hughes'* plan facts—plans without employee money, plans without significant asset surplus, and welfare benefit plans—and even absent affirmation of the Ninth Circuit's constructive termination theory. If upheld, *Hughes'* 403(c) theory could subject every plan amendment to scrutiny by the federal judiciary, and so plunge every plan design decision into the morass of competing, vague and half-baked articulations of what kind of "inurement" it is that Section 403(c) prohibits. For these reasons, we look forward to the Supreme Court's review of the case. And—under the assumption that the Court will impart to their *Hughes* opinion the same crystal clarity it has given to nearly every other ERISA decision—we look forward to years of editing interesting articles on the issues raised by this case.

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