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Notes

The Participant Status of Sole Shareholders under ERISA

*Kwatcher v. Massachusetts Service Employees Pension Fund*¹

George Kwatcher began working as a window-washer in 1934.² By 1948, he was the sole shareholder of the window-washing corporation, Astor Window Cleaning Company (Astor).³ From 1973 to 1982, Astor made contributions to the Massachusetts Service Employees Pension Fund (Fund) on behalf of Mr. Kwatcher.⁴ The Fund is a private retirement savings plan regulated under the Employee Retirement Income Security Act of 1974 (ERISA).⁵ Mr. Kwatcher retired from the window-washing trade in 1982, and began receiving retirement payments from the Fund.⁶ In 1983, the Fund discontinued payments, determining that Mr. Kwatcher did not qualify as a participant under the plan because of his status as an employer.⁷ Mr. Kwatcher filed an action for continued payment of retirement savings benefits.⁸ The First Circuit Court of Appeals, in *Kwatcher v. Massachusetts Service Employees Pension Fund*,⁹ denied Mr. Kwatcher's claim to payments.¹⁰

1. 879 F.2d 957 (1st Cir. 1985).

2. *Id.* at 958.

3. *Id.* In 1981, Mr. Kwatcher created AWC, Inc., a successor corporation to Astor. *Id.* at 958 n.1. Throughout this Note, AWC, Inc., and Astor Window Cleaning Co., will both be referred to as Astor.

4. *Id.*

5. Pub. L. No. 93-406, 88 Stat. 829 (1974) (ERISA's labor provisions are codified as amended at 29 U.S.C. §§ 1001-1461 (1982)).

6. *Kwatcher*, 879 F.2d at 958.

7. *Id.*

8. *Id.*

9. 879 F.2d 957 (1st Cir. 1989).

10. *Id.* at 963. The First Circuit affirmed the district court's granting of the Fund's motion for summary judgment.

The First Circuit held that Mr. Kwatcher was an employer under ERISA and that he was therefore ineligible to participate in the Fund's plan as an employee.¹¹ A California federal district court addressed the same issue in June of 1988, in *Dodd v. John Hancock Mutual Life Insurance Co.*¹² The Federal District Court for the Eastern District of California held that the sole shareholder of a corporation is eligible to participate in an ERISA pension plan as an "employee."¹³

This Note examines the ambiguous treatment of dual-status individuals under ERISA.¹⁴ A "dual-status" individual is an individual who qualifies as both an employer, by virtue of owning controlling shares of a corporation, and as an employee, by virtue of working for the corporation and earning compensation for services rendered. The *Kwatcher* court fails to recognize that ERISA does not address the treatment of a dual-status individual.¹⁵ The court then proceeds to develop an argument for its conclusion that ERISA prohibits a dual-status individual from participation in a pension plan. This Note examines three arguments of the court. First, the *Kwatcher* court supports its interpretation of the applicable statutory language with reference to 29 C.F.R. section 2510.3-3(c).¹⁶ Second, the court finds policy rationales to support its conclusion that dual-status individuals were not meant to be afforded protection as participants under ERISA.¹⁷ Finally, after determining that Mr. Kwatcher is an employer under ERISA, the court applies the anti-inurement regulations to prohibit Mr. Kwatcher's qualification as a participant.¹⁸

11. *Id.* The argument that Mr. Kwatcher cannot be a participant because he is an employer is attacked later in this Note. See *infra* text accompanying notes 131-50. The logic of the syllogism employed by the First Circuit runs as follows: An employer cannot be a participant under the terms of ERISA. Mr. Kwatcher is an employer; therefore, Mr. Kwatcher cannot be a participant. It is the proposition that an employer cannot be a participant under the terms of ERISA which is attacked herein.

12. 688 F. Supp. 564 (E.D. Cal. 1988).

13. *Id.* at 571. The *Dodd* opinion is discussed in Part III of this Note. See *infra* notes 69-87 and accompanying text.

14. See *infra* notes 69-90 and accompanying text.

15. See *Kwatcher*, 879 F.2d at 959.

16. This Note examines this regulation and its application to the facts of *Kwatcher* at text accompanying *infra* notes 91-101. For a discussion of the First Circuit's interpretation of the regulation, see *Kwatcher*, 879 F.2d at 961-62; see also *infra* notes 48-53 and accompanying text.

17. See *Kwatcher*, 879 F.2d at 960-61; see also *infra* notes 102-30 and accompanying text.

18. *Kwatcher*, 879 F.2d at 959-60; see *infra* notes 131-50 and accompanying text for a discussion of the scope of the anti-inurement regulation.
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I. ERISA

In 1974, Congress enacted ERISA to regulate the private pension system.¹⁹ The private pension system at that time covered about one-half of the United States industrial work force.²⁰ ERISA legislation is divided into four titles.²¹ Title I encompasses the congressional response to concern over the protection of employee benefit rights.²²

Under Title I, a person is eligible to participate in a pension plan if he or she is an employee and if he or she is a participant or beneficiary within the meaning of ERISA. The question addressed in *Kwatcher* is whether a sole shareholder may be a "participant" within the meaning of ERISA.

The starting point for determining whether an individual qualifies for pension payments under the structure of ERISA is section 3.²³ Section 3

19. A 1964 report concluded there was a strong public interest in the regulation of the private pension plan system based on four findings:

(1) [private pension plans] represent a major element in the economic security of millions of American workers and their families, (2) they are a significant, growing source of economic and financial power, (3) they affect the mobility of the American labor force, and (4) they are subsidized by the general body of taxpayers by virtue of the special tax treatment accorded them.

D. MCGILL, *FUNDAMENTALS OF PRIVATE PENSIONS* 34 (3d ed. 1975).

20. S. REP. NO. 127, 93d Cong., 2d Sess. 3, reprinted in 1974 U.S. CODE CONG. & ADMIN. NEWS 4838, 4839.

21. See Employee Retirement Income Security Act of 1974, PUB. L. NO. 93-406, § 1, 1974 CODE CONG. & ADMIN. NEWS (88 Stat.) 829 (codified at 29 U.S.C. § 1001 (1982)).

22. *Id.* See McGill, *supra* note 19, at 37. Federal jurisdiction over a private pension plan depends upon the commerce clause. See ERISA §§ 3, 4, 29 U.S.C. §§ 1002, 1003 (Supp. 1989). Also note, however, that federal jurisdiction over plans, as far as the regulation of plans as "qualified" for purposes of receiving tax benefits, depends on the taxing power of Congress. Under § 4 of ERISA, the regulations apply to a plan "if it is established or maintained . . . by any employer engaged in commerce or in any industry or activity affecting commerce; or . . . by any employee organization or organizations representing employees engaged in commerce or in any industry or activity affecting commerce." ERISA § 4, 29 U.S.C. § 1003(a)(1), (2) (1982).

23. ERISA § 3, 29 U.S.C. § 1002 (Supp. 1989).

contains definitions for Title I of ERISA.²⁴ To qualify for benefits, a person must be a plan "participant."²⁵ Section 3(7) defines "participant" as

any employee or former employee of an employer, or any member or former member of an employee organization, who is or may become eligible to receive a benefit of any type from an employee benefit plan which covers employees of such member or members of such organization, or whose beneficiaries may be eligible to receive such benefit.²⁶

The status of a participant is dependent on a person's qualification as an employee. An "employee" is "any individual employed by an employer."²⁷ Section 3(5) defines "employer" as any "person" who acts in the interest of an employer.²⁸

ERISA provides no guidelines for when a sole shareholder of a corporation may be considered an employee for determining whether the sole shareholder is a participant. For the question of the status of an individual who is the sole shareholder of a corporation and an employee of the corporation, ERISA is ambiguous.

II. *KWATCHER V. MASSACHUSETTS SERVICE EMPLOYEES PENSION FUND*

From 1948 until 1982, Mr. Kwatcher worked as a window-washer for Astor. Mr. Kwatcher, as the sole shareholder and chief officer of Astor, executed contracts, hired and fired employees and disciplined employees.²⁹ As chief executive officer, Mr. Kwatcher represented Astor in collective

24. ERISA §§ 1-514, 29 U.S.C. §§ 1001-1461 (1982). Section 3 is titled "Definitions," and begins with the language, "[f]or the purposes of this subchapter." ERISA § 3, 29 U.S.C. § 1002 (Supp. 1989). Subchapter I of ERISA is entitled "Protection of Employee Benefit Rights." ERISA § 1, 29 U.S.C. § 1001 (Supp. 1989).

25. ERISA § 502(1)(a), 29 U.S.C. § 1451(a)(1) (1982). Further, to sue for the payment of benefits in federal court, the person must be a participant. ERISA § 502, 29 U.S.C. § 1132 (1986).

26. ERISA § 3(7), 29 U.S.C. § 1002(7) (Supp. 1989).

27. ERISA § 3(6), 29 U.S.C. § 1002(6) (Supp. 1989).

28. ERISA § 3(5), 29 U.S.C. § 1002(5) (Supp. 1989). The *Kwatcher* court was able to point to Mr. Kwatcher's participation in the collective bargaining agreement which resulted in the creation of the Fund as "acting . . . in the interest of an employer." *Kwatcher*, 879 F.2d at 960. A person is defined in ERISA § 3(9) as "an individual, partnership, joint venture, corporation, mutual company, joint stock company, trust, estate, union corporation organization, association, or employee organization." ERISA § 3(9), 29 U.S.C. § 1002(9) (Supp. 1989).

29. *Kwatcher*, 879 F.2d at 958.

bargaining agreements with the Service Employees International Union.³⁰ At the same time, Mr. Kwatcher was a member of that union.³¹

In 1973, the Service Employees International Union and the Maintenance Contractors of New England, an employer organization, entered into an agreement creating the Fund, a pension fund for the benefit of union employees.³² Astor contributed to the Fund on behalf of Mr. Kwatcher.³³ In July of 1982, Mr. Kwatcher retired.³⁴

Mr. Kwatcher received pension payments from the Fund until 1983. At that time, the Fund determined that Mr. Kwatcher was a business owner, and therefore an employer. The Fund argued Mr. Kwatcher could not participate in the plan because he was an employer.³⁵ The district court determined ERISA precluded the participation of business owners in an ERISA pension plan, and granted summary judgment in favor of the Fund.³⁶ Mr. Kwatcher appealed to the First Circuit Court of Appeals.³⁷

Mr. Kwatcher raised three issues on appeal. First, Mr. Kwatcher argued that although he was an "employer," he also qualified as an "employee" under ERISA, and therefore could participate in the pension plan. Second, Mr. Kwatcher argued even if the court determined he was an "employer" under ERISA, the Fund should pay his pension out of contributions made for the period before he became the sole shareholder of Astor. Finally, if the court determined that he could not receive any benefits, then the Fund must return the contributions made by Astor on Mr. Kwatcher's behalf.³⁸ This Note will focus only on the first issue raised on appeal.

The issue before the First Circuit was whether the ERISA definitions of employee and employer are mutually exclusive terms.³⁹ After examination of ERISA's definitions of the two terms, the *Kwatcher* court reasoned if Mr. Kwatcher is an employer he cannot be an employee.⁴⁰ The *Kwatcher* court found that "[c]ongress intended [the definition of 'employee' at Section 3(6)] to encompass those persons 'who ha[ve] the status of an "employee" under a

30. *Id.*

31. *Id.* Mr. Kwatcher was a member of Local 254. *Id.*

32. *Id.*

33. *Id.*

34. *Id.*

35. *Id.*

36. *Id.*

37. *Id.*

38. *Id.*

39. *Id.* at 959. For the definitions of "employee" and "employer," see text accompanying *supra* notes 27 and 28.

40. *Kwatcher*, 879 F.2d at 960.

collective bargaining agreement."⁴¹ Looking to this statement of congressional intent, and analogizing to the definition of employer under federal regulation in the labor arena, the court concluded that "the 'employee' rubric seemingly excludes management figures."⁴² The court found that "[e]mployee' and 'employer' are plainly meant to be separate animals."⁴³

The court addressed whether "ERISA prohibits payments to [Mr. Kwatcher] from a qualified plan."⁴⁴ The court noted under section 403(c)(1) of ERISA, "[o]nce a person has been found to fit within the 'employer' integument, ERISA prohibits payments to him from a qualified plan."⁴⁵ Section 403(c)(1) provides: "The assets of a plan shall never inure to the benefit of any employer and shall be held for the exclusive purposes of providing benefits to participants in the plan and their beneficiaries and defraying reasonable expenses of administering the plan."⁴⁶ The court determined that Mr. Kwatcher was an employer and that payment to Mr. Kwatcher would constitute prohibited inurement of benefits to an employer.⁴⁷

The court's conclusion that Mr. Kwatcher was an employer and its conclusion that ERISA prohibited participation in a pension plan by an employer are grounded in two arguments. The court placed support on the applicability of 29 C.F.R. section 2510-3.3(c)⁴⁸ and on the policy behind ERISA.⁴⁹

The court cited the regulations promulgated by the Department of Labor under the authority of ERISA section 505:⁵⁰ "An individual and his or her spouse shall not be deemed to be employees with respect to a trade or business, whether incorporated or unincorporated, which is wholly owned by

41. *Id.* at 959 (citing H.R. REP. NO. 533, 93d Cong., 1st Sess. 10, *reprinted in* 1974 U.S. CODE CONG. & ADMIN. NEWS 4639, 4648; S. REP. NO. 127, 93d Cong., 1st Sess. 15, *reprinted in* 1974 U.S. CODE CONG. & ADMIN. NEWS 4838, 4851).

42. *Id.* at 960. The court makes an analogy to the definition of employer as interpreted by the First Circuit under the Fair Labor Standards Act. *Id.* (citing *Donovan v. Agnew*, 712 F.2d 1509 (1st Cir. 1983)).

43. *Id.* at 959.

44. *Id.* at 960.

45. *Id.* Section 403(c)(1) is codified as amended at 29 U.S.C. § 1103(c) (1985).

46. *Kwatcher*, 879 F.2d at 960. The court states a belief that the anti-inurement provisions and Part I's definition of "employer" are to be read together: "Read fully and in context, ERISA's background demonstrates that the anti-inurement caveat and Part I's expansive definition of "employer" are not mere window dressing." *Id.*

47. *Id.*

48. *Id.* at 961-62.

49. *Id.* at 960-63.

50. *Id.* ERISA § 505 is codified at 29 U.S.C. § 1135 (1985).

the individual or by the individual and his or her spouse"⁵¹ The court interpreted this regulation as prohibiting the participation of a sole-shareholder in a pension plan because of the sole-shareholder's status as an "employer."⁵² The court construed this Department of Labor regulation "to ban owner-employees from plan participation."⁵³

Mr. Kwatcher argued against the above interpretation of the statutory and regulatory language. The court recognized that the result of "block[ing] pensions for owner-operators would dissuade Congress' overriding goal of 'provid[ing] the maximum degree of protection to working men and women covered by private retirement programs.'"⁵⁴ The court decided, however, Congress had "ensured that working proprietors—incorporated or not—could make tax-favored retirement arrangements despite their exclusion from ERISA-qualified pension plans."⁵⁵ The court stated, "Any expectations [Kwatcher] developed must yield both to the strong public interest in keeping a principal ERISA safeguard intact, and to the perhaps prosaic (but still powerful) interest in maintaining the Fund's solvency."⁵⁶

The legislative history of ERISA revealed congressional intent "to insure that employer contributions are only for a proper purpose and . . . that the benefits from the established fund reach only the proper parties."⁵⁷ The anti-inurement rule was one of several basic fiduciary rules directed at providing "adequate safeguards" against the use of the reserves of funds for the benefit of the employer.⁵⁸ The court concluded that "[a]ll in all, the legislative history leaves little doubt that the anti-inurement rule should be construed to keep as strict a separation as practicable between employers and the funds set aside to benefit employees."⁵⁹

The court cited *Peckham v. Board of Trustees*,⁶⁰ a United States Court of Appeals case which held dual-status individuals ineligible to participate in

51. 29 C.F.R. § 2510.3-3(c)(1) (1988).

52. *Kwatcher*, 879 F.2d at 961.

53. *Id.*

54. *Id.* at 962 (citing S. REP. NO. 127, 93d Cong., 1st Sess. 18, *reprinted in* 1974 U.S. CODE CONG. & ADMIN. NEWS 4850, 4850).

55. *Id.* The tax-favored retirement arrangements to which the court refers are the Individual Retirement Account (IRA) and Keogh plans. *Id.*

56. *Id.* at 963.

57. *Id.* at 961 (citing *Moglia v. Geoghegan*, 403 F.2d 110, 116 (2d Cir. 1968), *cert. denied*, 394 U.S. 919 (1969)). *Moglia* dealt with an interpretation of § 302 of the Labor-Management Relations Act which the anti-inurement principle in ERISA paralleled. *See Moglia*, 403 F.2d at 114-15.

58. *Kwatcher*, 879 F.2d at 960-61.

59. *Id.* at 961.

60. 653 F.2d 424 (10th Cir. 1981).

an ERISA-regulated pension plan.⁶¹ In *Peckham*, sole proprietors sued the pension plan to force payment of pension benefits based on the contributions to the plan made on behalf of the sole proprietors as employees.⁶² The Tenth Circuit held "dual-status individuals are not eligible for inclusion in employee pension benefit plans."⁶³ The *Kwatcher* court did not recognize any distinction between a dual-status individual who is a sole proprietor, and one who is a corporate owner-employee.⁶⁴ The authority of *Peckham* is therefore questionable on the issue of ERISA's treatment of dual-status individuals where the dual-status individual is a corporate owner-employee.

The First Circuit Court of Appeals rejected Mr. Kwatcher's claim for retirement benefits from the Fund concluding "sole shareholders" are "employers," and therefore cannot be "employees" for the purposes of plan participation.⁶⁵

III. ANALYSIS

The *Kwatcher* court's analysis of the status of a sole shareholder for determining that individual's eligibility to receive pension payments is divided into four sections. The court first looked to the language of ERISA.⁶⁶ Although the court found "the words of ERISA, and the casement in which they are set, go a long way toward resolving the central question,"⁶⁷ the language of ERISA is arguably ambiguous for determining the participant status of a sole shareholder who is also an employee of the corporation. The First Circuit next looked to extrinsic aids "[a]s a check upon [its] reading of the statute."⁶⁸ The two main tenets of the First Circuit's argument that Mr. Kwatcher was an employer are 29 C.F.R. section 2510.3-3(c)(1), which the

61. *Kwatcher*, 879 F.2d at 959.

62. *Peckham*, 653 F.2d at 425-26.

63. *Id.* at 427. The court in *Peckham* cited to the Department of Labor Regulation, 29 C.F.R. § 2510.3-3(c)(1) to support its conclusion that dual status individuals are excluded from participation under this regulation. *Kwatcher*, 879 F.2d at 427.

64. In *Kwatcher*, because Mr. Kwatcher operated Astor in the corporate form, he should have been able to take advantage of the separate entity theory of business organization. That is, Mr. Kwatcher should have been found to be employed by an entity separate from himself—the corporation. See *Kwatcher*, 879 F.2d at 958. In *Peckham*, the petitioners were sole proprietors. There is no authority to support a treatment of the proprietorship as an entity separate from the sole proprietor. See *Peckham*, 653 F.2d at 427.

65. *Peckham*, 653 F.2d at 427.

66. *Kwatcher*, 879 F.2d at 959-60.

67. *Id.* at 959.

68. *Id.*

court interpreted as a prohibition against the participant status of a sole shareholder, and the legislative history. Once the court determined that Mr. Kwatcher was an employer, it denied him participant status with support from the anti-inurement regulations.

1. Ambiguous Treatment of Dual-Status Individuals under ERISA

The *Kwatcher* court concluded the "words of ERISA, and the casement in which they are set, go a long way toward resolving the central question before us."⁶⁹

In 1988, the Eastern District Court of California addressed the same question faced by the *Kwatcher* court: What is the status of a sole shareholder for determining eligibility for pension benefits under an ERISA-regulated plan? The facts of *Dodd v. John Hancock Mutual Life Insurance Co.*⁷⁰ are similar to the facts of the *Kwatcher* case. John C. Dodd and his wife were the sole shareholders of James C. Dodd & Associates, Inc., a California corporation.⁷¹ The corporation participated in a group health plan ("Plan") issued by John Hancock Mutual Life Insurance Co..⁷² Mrs. Dodd suffered a stroke, and Mr. Dodd presented a claim for disability payments to the Plan.⁷³ The Plan refused to make payments, and Mr. Dodd brought suit in state court.⁷⁴ The Plan removed the action to the Federal District Court for the Eastern District of California.⁷⁵

Mr. Dodd argued against the removal to federal court because he could pursue more favorable remedies in state court.⁷⁶ Therefore, he argued the

69. *Id.*

70. 688 F. Supp. 564 (E.D. Cal. 1988).

71. *Id.* at 565.

72. *Id.* The Plan was administered by the California Council of the American Institute of Architects. *Id.*

73. *Id.*

74. *Id.*

75. *Id.* Mr. Dodd's state law claim alleged violation of various state statutes and certain common law rights. *Id.* Mr. Dodd opposed removal to federal district court presumably because state law provided a broader relief—tort law—than that provided under ERISA. *Id.* at 568.

76. *Id.* In *Massachusetts Mutual Life Insur. Co. v. Russell*, 473 U.S. 134 (1985), the Supreme Court held that extra-contractual damages were prohibited when the participant sues for equitable relief under 29 U.S.C. § 1109. 473 U.S. at 144. The *Dodd* court, applying the analysis of *Russell*, held that Mr. Dodd's claim under 29 U.S.C. § 1132 for benefits was limited to the remedies available under ERISA. *Dodd*, 688 F. Supp. at 572.

Plan was not an ERISA-qualified plan, and even if it was, Mr. Dodd was not a participant within the meaning of ERISA.⁷⁷ The question of whether Mr. Dodd was a participant under ERISA is the same question faced by the First Circuit in *Kwatcher*.⁷⁸

The *Dodd* court found the legislative history non-dispositive.⁷⁹ The court in *Dodd* examined the statutory language beginning with the definition of a participant.⁸⁰ The court noted Mr. Dodd "is only a participant in the plan if he is an employee."⁸¹ After reviewing the statutory language defining employee⁸² and employer,⁸³ the court stated that "the definitions do not preclude the possibility that an individual may have dual-status as both employer and employee, nor do they define precisely whether owners and stockholders of corporations are employees, employers or both."⁸⁴ The court found ambiguity in the terms employee and employer.⁸⁵

The court looked to the legislative history of ERISA but found that source "non-dispositive."⁸⁶ The court concluded that "the legislative history . . . does not resolve the issue at bar, [yet] it does suggest that owners of corporations were not necessarily within the class to be protected by the statute."⁸⁷

The test for whether an individual is an employer under ERISA is two-pronged: Is the individual a person within Section 3(9) of ERISA, and does the individual act directly, or "indirectly in the interest of an employer in relation to an employee benefit plan"?⁸⁸ The language defining an employer as one who acts "in the interest" of an employer is ambiguous. Applying the literal language of section 3(9), the category of employer might include "the

77. *Kwatcher*, 879 F.2d at 566. This Note only addresses the question of whether a sole shareholder of a corporation qualifies as an "employee" for the purpose of receiving benefits from an ERISA plan.

78. *See id.* at 959.

79. *Dodd*, 688 F. Supp. at 569.

80. *Id.* at 568-69 (citing ERISA § 3(7), 29 U.S.C. § 1002(7) (Supp. 1989)); see text accompanying *supra* note 26 for the language of ERISA § 3(7).

81. *Dodd*, 688 F. Supp. at 569.

82. *Id.* (citing ERISA § 3(6), 29 U.S.C. § 1002(6) (Supp. 1989)); see text accompanying *supra* note 27 for the language of ERISA § 3(6).

83. *Id.* (citing ERISA § 3(5), 29 U.S.C. § 1002(5) (Supp. 1989)); see text accompanying *supra* note 28 for the language of ERISA § 3(5).

84. *Dodd*, 688 F. Supp. at 569.

85. *Id.*

86. *Id.*

87. *Id.*

88. ERISA § 3(5), 29 U.S.C. § 1002(5) (Supp. 1989). *See Note, Interpreting ERISA: Corporate Officer Liability for Delinquent Contributions*, 1987 DUKE L. J. 710, 715.

payroll accountants who post the contributions, the comptroller or financial officers who transfer funds and even the personnel manager" because all act directly or indirectly in the interest of an employer as to a pension plan.⁸⁹ The language of sections 3(5) and (9) is also ambiguous because it fails to consider the situation where a sole shareholder desires participant status in the corporation-sponsored pension plan. The *Kwatcher* court reasoned that because the definition of an employee is "any individual employed by an employer," the terms employee and employer are "plainly meant to be separate animals."⁹⁰ This statement does not address the issue: If a sole shareholder *can* be an employee of the employer corporation, can the sole shareholder be a participant in an ERISA plan?

2. Defining Employer

a. 29 C.F.R. 2510.3-3(c)(1)

Title 29 C.F.R. § 2510.3-3 seeks to define the scope of the term "employee benefit plan."⁹¹ Paragraph (c) states, "[a]n individual and his or her spouse shall not be deemed to be employees with respect to a trade or business, whether incorporated or unincorporated, which is wholly owned by the individual and his or her spouse."⁹² The *Dodd* court, in addressing the applicability of 29 C.F.R. section 2510.3-3, recognized "the regulatory definition of employees expressly limits itself to the purposes of the regulation, i.e., clarifying the definition of employee benefit plan."⁹³ Title I of ERISA is designed to protect employee benefit rights.⁹⁴ The express purpose of Title I is to provide "minimum standards . . . assuring the equitable character of such plans and their financial soundness."⁹⁵ Regulation 2510.3-3 defines "employee benefit plan" for Title I.⁹⁶

The regulation discusses plans without employees which are not "employee benefit plans,"⁹⁷ and plans with employees which are not "employee benefit plans."⁹⁸ The regulations identify those employee-

89. Note, *supra* note 88, at 716.

90. *Kwatcher*, 879 F.2d at 959 (citing ERISA § 3(6), 29 U.S.C. § 1002(6) (Supp. 1989)).

91. 29 C.F.R. § 2510.3-3(a) (1988).

92. *Id.* § 2510.3-3(c)(1).

93. *Dodd*, 688 F. Supp. at 570.

94. ERISA § 2(a), 29 U.S.C. § 1001(a) (1982).

95. *Id.*

96. 29 C.F.R. § 2510.3-3(a) (1988).

97. *Id.* § 2510.3-3(b).

98. *Id.* § 2510.3-3(c).

employer relationships which require federal regulation to assure equitable treatment of employees and the financial soundness of plans.⁹⁹ The regulation defines relationships which should be excluded from Title I coverage based on the determination that "abuse is unlikely."¹⁰⁰

The Secretary of Labor, in promulgating 29 C.F.R. section 2510.3-3(c), discussed the purpose behind the regulation:

[T]he exclusion of sole proprietors and their spouses from the definition of 'employee' has been extended to sole proprietors of incorporated as well as unincorporated trades or businesses, since the risk of abuse *in the case of a plan covering only an incorporated sole proprietor and his or her spouse* is no greater than in the case of a plan covering only an unincorporated sole proprietor and his or her spouse.¹⁰¹

The types of plans to which Title I coverage applies are those which do not require federal regulation to assure equitable treatment of employees. Any justification for the sole proprietor exclusion exists only if the exclusion applies solely to those plans which have no other employees but the sole proprietor and his or her spouse. There is no other explanation why abuse is unlikely in such situations. The regulation cannot apply to sole shareholders of corporations where, as in *Kwatcher*, the corporation employs individuals other than the sole shareholder.

b. Policy

Congress enacted ERISA to "provide the maximum degree of protection to working men and women covered by private retirement programs."¹⁰² The general rule, under the regulations of ERISA, is protection of the reliance of workers on promises contained in the pension contract between the employer and the employee.¹⁰³ The *Kwatcher* court finds the exclusion of

99. 40 Fed. Reg. 34,526 & 34,528 (1975). Under 29 C.F.R. § 2510.3-3(c) certain employee-employer relationships are excluded from coverage under Title I: the "consideration on which the exclusion . . . [is] based—that abuse is unlikely—is applicable." *Id.*

100. 40 Fed. Reg. 34,526 & 34,528 (1975).

101. *Id.*

102. S. REP. NO. 127, 93d Cong., 1st Sess. 18, *reprinted in* 1974 U.S. CODE CONG. & ADMIN. NEWS 4838, 4854. The appellant argued that this language prohibited the exclusion of a sole shareholder from participant status. *Kwatcher*, 879 F.2d at 962. The *Kwatcher* court, in addressing this argument, states, "We understand the lyrics, but think the music is out of tune." *Id.*

103. S. REP. NO. 127, 93d Cong., 1st Sess. 18, *reprinted in* 1974 U.S. CODE
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a sole shareholder from participant status supported by Congress' "refin[ing] and deliver[ing] a wide variety of retirement savings options along with the ERISA package."¹⁰⁴ This argument is a negative inference: Given the existence of other retirement savings vehicles available to sole shareholders as employers, one infers Congress intended exclusion of the sole shareholder from the definition of participant for purposes of participation in employee benefit plans.¹⁰⁵

Another way of phrasing this argument is that the sole shareholder is excluded from participation status because Congress did not specifically include the sole shareholder as eligible for participation. Yet, there are multiple references to sole shareholder participants in the legislative history of ERISA and in the pension regulation legislation before and after the enactment of ERISA. Pension legislation history reveals Congress' desire to allow the sole proprietor the same benefits available to the sole shareholder of a corporation since the two types of business organizations are so similar.

This desire for equal treatment of the two types of employee-owners is tempered by Congress' concern that the retirement savings plans of self-employed individuals are subject to more abuse than plans maintained by a corporation.¹⁰⁶ The history of the tax treatment of the self-employed persons' retirement savings plans reveals the existence of retirement savings plans for the benefit of sole shareholders of corporations. The need to enact legislation for the benefit of the sole proprietor was premised on the long-standing inclusion of sole shareholder-employees among the participants of qualified pension, profit-sharing, stock-bonus and annuity plans.

In 1962, Congress enacted the Self-Employed Individuals Tax Retirement Act of 1962 (1962 Act).¹⁰⁷ Prior to the 1962 Act, self-employed individuals had no incentive to establish voluntary retirement plans outside the corporate form because the self-employed individual could not obtain the tax benefits awarded such corporate plans.¹⁰⁸ Tax benefits available to employers who established a qualified plan were threefold: immediate deduction by the

CONG. & ADMIN. NEWS 4838, 4854.

104. *Kwatcher*, 879 F.2d at 962.

105. The other retirement savings vehicles to which the *Kwatcher* court refers are the IRA and the Keogh plans. *Id.*

106. See S. REP. NO. 992, 87th Cong., 1st Sess. 3, *reprinted in* 1962 U.S. CODE CONG. & ADMIN. NEWS 2964, 2966.

107. Act of October 10, 1962, Pub. L. No. 87-792, *reprinted in* 1962 U.S. CODE CONG. & ADMIN. NEWS 945. The 1962 Act enacted House Resolution 10, and the retirement savings plans that were created under its provisions are commonly referred to as H.R. 10 plans.

108. See S. REP. NO. 992, 87th Cong., 1st Sess. 1, *reprinted in* 1962 U.S. CODE CONG. & ADMIN. NEWS 2964, 2964.

employer of the amount contributed to the plan for employees, tax-free treatment of the earnings of the plan's fund of contributions, and deferral of taxation on employees' income until actual distribution of the amounts received under the plan—both contributions to and earnings from the plan.¹⁰⁹ Generally, for a retirement plan to qualify for favorable tax treatment, it must be established for the exclusive benefit of employees or beneficiaries of employees.¹¹⁰

The 1962 Act inserted provisions into the Internal Revenue Code to allow the creation of trusts for self-employed individuals which would qualify for the triple tax benefits associated with qualified trusts.¹¹¹ These plans have

109. See J. LANGBEIN AND B. WOLK, PENSION AND EMPLOYEE BENEFIT LAW 70-75 (1990).

110. See S. REP. NO. 992, 87th Cong., 1st Sess. 9, reprinted in 1962 U.S. CODE CONG. & ADMIN. NEWS 2964, 2972. Although the fact that the plan is established and maintained for the exclusive benefit of the participants is the general concept, for qualification of a retirement plan at this writing, the Internal Revenue Code also demands compliance with standards relating to minimum participation, nonforfeatability of pension rights, contribution limits, fiduciary responsibilities, and nondiscrimination. See generally I.R.C. §§ 401-419 (1989); J. LANGBEIN AND B. WOLK, *supra* note 109, at 70-75.

111. See S. REP. NO. 992, 87th Cong., 1st Sess. 8, reprinted in 1962 U.S. CODE CONG. & ADMIN. NEWS 2964, 2971. House Resolution 10 established I.R.C. §§ 401(d), (e) setting out requirements for qualification for plans which benefit employees, "some or all of whom are owner-employees." I.R.C. § 401(d), Pub. L. No. 87-792; reprinted in 1974 U.S. CODE CONG. & ADMIN. NEWS (76 Stat.) 945, 948. These qualifications were in addition to the requirement that the plans established under H.R. 10 meet the criteria under § 401(a) (relating to the general qualification requirements for qualified status of retirement savings plans). *Id.* Plans established for the benefit of owner-employees, if they met both sets of criteria, would qualify for the triple tax benefits afforded qualified plans under I.R.C. § 401 (immediate deductibility of amounts contributed by the employer to a retirement savings plan, tax-free treatment on earnings from the trust established pursuant to such plan, and tax-deferred treatment of the amounts contributed to the plan on behalf of the employee). *Id.*

Section 401(d) set out eleven characteristics of a qualified plan which any retirement savings plan benefitting owner-employees must meet before qualified status could be achieved. Section 401(e) set up special restrictions regarding excess contributions to the plan made on the behalf of owner-employees. *Id.* at 948-52. A summary of the provisions relating to H.R. 10 plans is contained in S. REP. NO. 992, 87th Cong., 1st Sess. 25-26, reprinted in 1962 U.S. CODE CONG. & ADMIN. NEWS 2964, 2988-89.

The major characteristics of H.R. 10 relating to owner-employee and self-employed individual's plans required that all employees covered under the plan were 100% vested at the end of three years of service with the employer, revised the <https://scholarship.law.missouri.edu/mlr/vol55/iss4/6>

come to be known as H.R. 10 plans. The legislative history of the 1962 Act states that "[t]he primary reason for the [1962 Act] is to . . . correct a discrimination in the present law under which self-employed individuals—sole proprietors and partners—are prevented from participation in retirement plans established for the benefit of their employees although owner-managers of corporations may do so."¹¹²

In drafting the 1962 Act, Congress was concerned that the smaller size of the plans developed by self-employed persons would "offer somewhat greater opportunities for abuse than . . . corporate plans covering many employees."¹¹³ Thus, the provisions amending the Internal Revenue Code

definition of earned income as it relates to owner-employees for the purposes of setting contribution limits, set the contribution limits for plans with participating owner-employees at 10% of the earned income up to \$2,500, set a limit on the deduction of contributions in the amount of 100% of the first \$1,000 and 50% of the amounts in excess of \$1,000, and allowed for integration of the plan with social security subject to limits on the variance between the total amount of retirement savings (contributions under the plan and amount paid into the social security trust fund) of owner-employees and the total amount of retirement savings for all other employees participating in the plan. For a discussion of these provisions, see S. REP. NO. 992, 87th Cong., 1st Sess. 14, *reprinted in* 1962 U.S. CODE CONG. & ADMIN. NEWS 2964, 2980.

In addition to these restrictions, H.R. 10 addressed special rules for excess contributions, limitations on the timing of benefit payments to owner-employees, premature distribution penalties, lump sum distributions. *See* 1962 U.S. CODE CONG. & ADMIN. NEWS 2981-87.

112. S. REP. NO. 992, 87th Cong., 1st Sess. 8, *reprinted in* 1962 U.S. CODE CONG. & ADMIN. NEWS 2964, 2971.

113. *See* S. REP. NO. 992, 87th Cong., 1st Sess. 3, *reprinted in* 1962 U.S. CODE CONG. & ADMIN. NEWS 2964, 2966. Although the existence of this concern is documented, the reasons for the concern remain obscure. Presumably, the concern turned on the possibility of self-employed individuals operating essentially a retirement savings account for themselves, and thereby qualifying for the triple tax benefits, without providing retirement savings for their common law employees. The policy behind allowing favorable tax treatment for qualified plans was to promote the use of such plans as vehicles for encouraging persons to save for retirement years. *See generally* J. LANGBEIN AND B. WOLK, *supra* note 109, at 70-75.

The theory underlying the use of favorable tax treatment for this purpose is grounded on the classification of employees into essentially two groups: those who have adequate disposable income to save for retirement, and those who must be cajoled into saving money for retirement. Employees in the former group willingly reduce the amount of their pay from an employer operating a qualified plan to gain the tax-free treatment of income earned on the contributions made on their behalf to retirement savings, and to gain tax-deferral treatment of those amounts. The cost savings which accrue to the employer (in the form of reduced employee costs) are sufficient to allow the employer to offer to employees in the latter group a retirement savings plans as an

to allow for the qualification of H.R. 10 plans were accompanied by special standards relating to coverage, vesting, distributions, integration with social security, employee contributions, plan trustees and employees under common control.¹¹⁴ Although the 1962 Act allowed self-employed individuals to gain the triple tax benefits of qualified plans, it subjected those plans to more stringent qualifications than those required of other types of qualified trusts.

Of particular concern to Congress in considering ERISA was the inequitable treatment of self-employed individuals compared with the more favorable treatment afforded owner-employees of closely-held corporations and personal corporations. While there was "almost no practical limit on the amount of pension contributions that closely held corporations [could] make to qualified plans on behalf of owner-employees,"¹¹⁵ in contrast, the provisions relating to H.R. 10 plans set strict limits on the amount a self-employed individual could contribute. Congress was convinced that the "basic situation of certain proprietary-employees of closely-held corporations is so similar to that of self-employed people that they should generally be treated like self-employed people for pension purposes."¹¹⁶ Under ERISA, the goal was to make "contributions on behalf of proprietary employees under closely held corporate plans . . . subject to the same general limitations as apply to self-employed people."¹¹⁷

To carry out this purpose, the ERISA amendments to the Internal Revenue Code increased the deductions for amounts contributed to H.R. 10 plans.¹¹⁸ The legislation was intended to provide that corporate proprietary-employees "are limited to exactly the same deduction limitations as apply to self-employed people."¹¹⁹ This purpose was carried out, in large part, by

incentive to employment. *See generally* Wolk, *Discrimination Rules for Qualified Plans: Good Intentions Confront Economic Reality*, 70 VA. L. REV. 419, 426-33.

114. S. REP. NO. 992, 87th Cong., 1st Sess. 3, *reprinted in* 1962 U.S. CODE CONG. & ADMIN. NEWS 2964, 2966.

115. S. REP. NO. 383, 93d Cong., 1st Sess. 4, *reprinted in* 1974 U.S. CODE CONG. & ADMIN. NEWS 4890, 4892.

116. *Id.* at 9, 1974 U.S. CODE CONG. & ADMIN. NEWS at 4897.

117. *Id.* at 29, 1974 U.S. CODE CONG. & ADMIN. NEWS at 4912.

118. *See id.* at 9, 1974 U.S. CODE CONG. & ADMIN. NEWS at 4897. This increase was also made applicable to the equivalent in benefit levels. *Id.* The amendment defined corporate proprietary employees to include only those individuals who own at least two percent of the stock of the corporation and who together accounted for at least 25% of the accrued benefits of all employees under the plan. *Id.* Further, the deduction limitation applicable to contributions made by self-employed individuals under an H.R. 10 plan was increased to fifteen percent of earned income up to \$7,500 a year. ERISA also provided that portion of a self-employed individual's income which could be taken into account for this purpose would be limited to \$100,000.

119. *Id.* at 9, 1974 U.S. CODE CONG. & ADMIN. NEWS at 4897-98.

adding Section 415 to the Internal Revenue Code pension provisions.¹²⁰ Section 415 set limitations on the amount of contributions which could be made on behalf of participants in defined contribution and defined benefit plans.¹²¹

H.R. 10 plans were still subject to special qualification requirements in addition to the requirements applicable to more traditional employee benefit trusts. In particular, an employer using the H.R. 10 plan was further restricted in the amount of contributions or benefits which could be provided for a self-employed individual and in the amount of compensation used to calculate the benefit or contribution under the plan's formula.¹²² The special rules for H.R. 10 plans also required expanded coverage of eligible employees and faster vesting for the rank-and-file employees.¹²³ These special rules did not

120. See TREASURY STATEMENT ON H.R. 6410 (TAX EQUITY AND FISCAL RESPONSIBILITY ACT OF 1982 (TEFRA)) 4, reprinted in TAX MGMT. (BNA), series III, vol. 4, at 129. This report stated that § 415 limits "were intended both to place a ceiling on the retirement income that could be provided on a tax-favored basis and to constitute a step toward parity between self-employed and corporate plans." *Id.*

In more detail, the report summarized the provisions of § 415:

Under Section 415 of the Code, the annual additions to a participant's account under a defined contribution plan cannot exceed the lesser of \$45,475 or 25 percent of compensation. Annual benefits under a defined benefit pension plan cannot exceed the lesser of \$136,425 or 100 percent of compensation. Post-retirement medical benefits can be provided without reducing the dollar limit on benefits under a defined benefit plan. The dollar limits for both defined contribution and defined benefit plans are adjusted annually based upon the increases in the consumer price index. When originally established in 1974, the dollar limits were \$25,000 and \$75,000, respectively.

Id.

121. See I.R.C. § 415.

122. See DESCRIPTION OF H.R. 6410 (THE PENSION EQUITY ACT OF 1982) PREPARED FOR THE USE OF THE COMMITTEE ON WAYS AND MEANS, HOUSE OF REPRESENTATIVES, BY THE STAFF OF THE JOINT COMMITTEE ON TAXATION 12, reprinted in TAX MGMT. (BNA), series IV, vol. 3, at 125 [hereinafter DESCRIPTION OF H.R. 6410].

123. *Id.* at 13, TAX MGMT. (BNA) at 125. The special rules applicable to H.R. 10 plans covered areas concerning coverage, vesting, distributions, integration with social security, employee contributions, plan trustees and employees under common control. See generally *id.* at 13-17, TAX MGMT. (BNA) at 125-26.

As an example of the special restrictions applicable to H.R. 10 plans, consider the vesting requirements for H.R. 10 plans and traditional qualified plans. For traditional plans, the qualification requirements as to vesting set out three alternative minimum vesting schedules.

apply to owner-employees of corporations nor to partners with a less than ten percent interest in the partnership.¹²⁴

In 1982, Congress passed the Tax Equity and Fiscal Responsibility Act (TEFRA), which addressed most of the remaining inequitable tax features associated with the treatment of retirement savings plans of the self-employed compared to the treatment of corporate plans.¹²⁵ The purpose of the pension provisions of TEFRA was to "eliminate[] distinctions in the tax law between qualified pension, etc., plans of corporations and those of self-employed individuals, H.R. 10 plans."¹²⁶

TEFRA repealed certain qualification rules which applied only to H.R. 10 plans, extended other special qualification rules to all qualified plans and provided that the remaining special qualification rules applied to plans, whether maintained by corporate or noncorporate employers, which primarily benefit "key employees."¹²⁷ These top-heavy provisions, incorporating the

124. DESCRIPTION OF H.R. 6410, *supra* note 123, at 13, TAX MGMT. (BNA) at 125.

125. TREASURY STATEMENT ON H.R. 6410 (TEFRA) 1, 4, *reprinted in* TAX MGMT. (BNA), series III, vol. 4, at 129. TEFRA provided for changes in the limits on contributions and benefits, summarized by the Treasury Department Report as follows:

- 1) The annual dollar benefit limits be decreased to \$30,000 for defined contribution plans and \$90,000 for defined benefit plans;
- 2) Cost of living adjustments to the dollar limits would be eliminated;
- 3) Benefits to participants in multiple plans maintained by a single employer could not exceed those available under a single plan;
- 4) Actuarial reductions in the maximum dollar limits on pension benefits payable would be required if the individual retired before age 65; and
- 5) The dollar limits on maximum pension benefits would be reduced by the value of post-retirement medical benefits provided under a defined benefit plan.

Id. at 5, TAX MGMT. (BNA) at 130; see *id.* at 5-8, TAX MGMT. (BNA) at 130-31 for further explanation of these provisions.

126. S. REP. NO. 530, 97th Cong., 2d Sess. 617, 621, *reprinted in* TAX MGMT. (BNA), series III, vol. 4, 140, 142.

127. *Id.* "Key employees" were defined by TEFRA:

(A) IN GENERAL.—The term 'key employee' means any participant in an employer plan who, at any time during the plan year or any of the 4 preceding plan years, is—

- (i) an officer of the employer,
- (ii) 1 of the 10 employees owning (or considered as owning within the meaning of Section 318, the largest interests in the employer,
- (iii) a 5-percent owner of the employer, or

"key employee" distinction, were codified at section 416 of the Internal Revenue Code. The top-heavy provisions impose standards which address congressional concern over the potential abuse of smaller plans by self-employed individuals.¹²⁸ The top-heavy provisions further provide that all plans which skew pension benefits toward highly-compensated employees are

(iv) a 1-percent owner of the employer having an annual compensation from the employer of more than \$150,000.

For purposes of clause (i), no more than 50 employees (or, if lesser, the greater of 3 or 10 percent of the employees) shall be treated as officers.

(B) PERCENTAGE OWNERS.—

(i) 5-PERCENT OWNER.—For purposes of this paragraph, the term '5-percent owner' means—

(I) if the employer is a corporation, any person who owns (or is considered as owning within the meaning of Section 318) more than 5 percent of the outstanding stock of the corporation or stock possessing more than 5 percent of the total combined voting power of all stock of the corporation, or

(II) if the employer is not a corporation, any person who owns more than 5 percent of the capital or profits interest in the employer.

(ii) 1-PERCENT OWNER.—For purposes of this paragraph, the term '1-percent owner' means any person who would be described in clause (i) if '1 percent' were substituted for '5 percent' each place it appears in clause (i).

(iii) CONSTRUCTIVE OWNERSHIP RULES.—For purposes of this subparagraph and subparagraph (A)(ii)[sic]—

(I) subparagraph (C) of section 318 (a)(2) [relating to the application of aggregation rules] shall be applied by substituting '5 percent' for '50 percent', and

(II) in the case of any employer which is not a corporation, ownership in such employer shall be determined in accordance with regulations prescribed by the Secretary which shall be based on principles similar to the principles of section 318

TEFRA, Pub. L. No. 97-248, § 240(i)(2), *reprinted in* 1982 U.S. CODE CONG. & ADMIN. NEWS 519.

The principle reason for the creation of top-heavy plan provisions is to protect against abuse of smaller plans by employers who skew the benefits toward themselves, or other highly compensated employees. A plan is determined as top-heavy, generally, if the accrued benefits attributable to the "key employees" exceeds the accrued benefits attributable to all employees. Once top-heavy status is obtained, a plan must meet requirements imposed by an accelerated vesting schedule, and a minimum benefit provision, or suffer disqualification. *See* TEFRA § 240.

128. *See supra* note 115 and accompanying text.

disqualified, unless the plan meets certain special vesting and minimum benefits rules.¹²⁹

The tax treatment of retirement plans maintained by self-employed individuals reveals Congressional concern that self-employed individuals should be afforded the same favorable tax treatment in establishing retirement plans as that afforded corporate owner-employees. The contention of the *Kwatcher* court is that H.R. 10 plans are substitutes for other qualified pension arrangements; the court states, "Conscious that ERISA would not cover everyone in the workplace, Congress refined and delivered a wide variety of retirement savings options along with the ERISA package."¹³⁰ Instead, it appears from the brief summary above, that Congress acknowledged the disparate treatment of self-employed individuals and corporate owner-employees and sought to correct that treatment in the 1962 Act, ERISA and TEFRA. It is essential to note that in order for Congress to be concerned about eliminating the inequitable tax treatment of the retirement savings plans available to the self-employed, there must have been qualified retirement savings plan options for the corporate owner-employee. The process of affording self-employed individuals the same tax-favored treatment of retirement savings plans available to corporate owner-employees demands the existence of qualified retirement savings plans for corporate owner-employees. Congress recognized the ability of owner-employees to participate in corporate pension plans; there is no statutory authority preventing that participation.

c. *Anti-Inurement*

Section 403(c)(1) of ERISA contains the anti-inurement provision which states that "the assets of a plan shall never inure to the benefit of any employer and shall be held for the exclusive purposes of providing benefits

129. Present I.R.C. § 416(g)(1)(A) (1989) contains the present definition of top-heavy status:

[T]he term "top-heavy plan" means, with respect to any plan year—

(i) any defined benefit plan if, as of the determination date, the present value of the cumulative accrued benefits under the plan for key employees exceeds 60 percent of the present value of the cumulative accrued benefits under the plan for all employees, and

(ii) any defined contribution plan if, as of the determination date, the aggregate of the accounts of key employees under the plan exceeds 60 percent of the aggregate of the accounts of all employees under such plan.

Id.

130. *Kwatcher*, 879 F.2d at 962.

to participants in the plan and their beneficiaries and defraying reasonable expenses of administering the plan."¹³¹

Once the *Kwatcher* court determined Mr. Kwatcher was an employer, it applied the anti-inurement provision of ERISA to deny his right to pension payments.¹³² The court stated, "Once a person has been found to fit within the 'employer' intendment, ERISA prohibits payments to him from a qualified plan."¹³³ It is not clear that Congress intended the anti-inurement provision to be applied blindly to deny benefits to any person who acts in the interest of an employer.¹³⁴

In enacting ERISA, Congress was concerned with the conduct of plan administrators in operating the pension plans.¹³⁵ A major impetus to including fiduciary standards in ERISA was the disclosure of numerous cases of abuse of the private employee benefit system.¹³⁶ ERISA targeted the

131. ERISA § 403(c)(1), 29 U.S.C. § 1103(c)(1) (1986).

132. *Kwatcher*, 879 F.2d at 960.

133. *Id.*

134. ERISA § 3(5) defines employer as "any person acting directly as an employer, or indirectly in the interest of an employer, in relation to an employee benefit plan." ERISA § 3(5), 29 U.S.C. 1002(5) (1986). The *Kwatcher* court determined that the definition of employee, "any individual employed by an employer," and employer were mutually exclusive. See *supra* note 90 and accompanying text; employee is defined at ERISA § 3(6), 29 U.S.C. § 1002(6) (1986).

As pointed out at *supra* note 89 and accompanying text, the literal application of the employer definition would include "payroll accountants who post the contributions, the comptroller or financial officers who transfer funds and even the personnel manager" because all act in the interest of an employer in relation to an employee benefit plan. Note, *supra* note 88, at 716.

135. See H.R. REP. NO. 533, 93d Cong., 2d Sess. 7, reprinted in 1974 U.S. CODE CONG. & ADMIN. NEWS, 4639, 4645.

136. The Senate Permanent Subcommittee on Investigations, chaired by Senator John L. McClellan, investigated the Allied Trade Council and Local 815 of the International Brotherhood of Teamsters. The investigation revealed serious abuse in the handling of employee benefit funds. See M. Gordon, "Overview: Why was ERISA Enacted?," printed in U.S. Senate Special Committee on Aging, The Employee Retirement Income Security Act of 1974: The First Decade 1-25, 10 (Information paper) (1984); J. LANGBEIN AND B. WOLK, *supra* note 109, at 518. The investigation by the committee revealed that George Barasch, founder of the International Brotherhood of Teamsters, had manipulated and diverted the funds of the plans to the end of making himself a prospective millionaire. Barasch, as the Trustee of the plan, hired a consulting firm which he owned to manage the assets, and, at the time of the committee's investigation, Barasch was in the process of transferring four million dollars worth of assets of the funds to two "dummy" corporations owned principally by Barasch. M. Gordon, *supra*, at 11.

protection of the interests of participants of all employee benefit plans by establishing standards of conduct for the persons managing the funds.¹³⁷

Before the enactment of ERISA, legislation concerning certain forms of employee benefit plans had implemented common law trust principles to regulate the management of the retirement savings assets of the plans.¹³⁸ ERISA required the use of the trust form for the maintenance of assets of an employee benefit plan.¹³⁹ Congress wanted to make clear that a participant could rely on the traditional remedies of the common law of trusts to enforce his or her rights under the plan.¹⁴⁰ In hearings before the Committee on Education and Labor, the Committee found that courts were "reluctant to apply concepts of equitable relief" and refused "to disregard technical document wording."¹⁴¹ The combination of a lack of federal standards and the reluctance of courts to apply common law trust principles resulted in widespread "maladministration in the plans."¹⁴²

A different aspect of fiduciary abuse was cited in the Interim Report of Activities of the Private Welfare and Pension Plan Study, 1971. In that report, instances were cited where a pension fund's assets were invested for the employer. The Woolworth Company had invested over \$39 million, or approximately 35 percent of the plan's total assets, in its own real estate or in mortgages or in its own property. S. REP. NO. 634, 92d Cong., 2d Sess. 85 (1972).

137. See ERISA § 2(a), 29 U.S.C. § 1001(a) (1986).

138. The Labor Management Relations Act implemented mandatory requirement that employee benefit funds of multi-employer plans be placed in a trust form. Labor-Management Relations Act § 302(c)(5), 29 U.S.C. § 186(c)(5) (1986). The Internal Revenue Code provisions relating to the triple tax benefits available to certain employee benefit plans phrased the language for qualification in terms of trust principles. See Revenue Act of 1921, ch. 136, § 219(f), 42 Stat. 247 (1921), 26 U.S.C. § 401(a) (1986).

139. ERISA § 403(a), 29 U.S.C. § 1103(a) (1986).

140. See H.R. REP. NO. 533, 93d Cong., 2d Sess. 4, *reprinted in* 1974 U.S. CODE CONG. & ADMIN. NEWS 4639, 4643.

141. *Id.*

142. *Id.* at 10, 1974 U.S. CODE CONG. & ADMIN. NEWS at 4648. The Committee on Education and Labor identified four reasons for the codification of fiduciary standards. First, the committee noted that many of the plans in existence were set up in such a way that it was "unclear whether the traditional law of trusts is applicable." *Id.* at 12, 1974 U.S. CODE CONG. & ADMIN. NEWS at 4650. Plans such as insured plans did not use traditional trust means of funding. Further, administrators of such plans were subject to minimal or unclear state law standards. *Id.*

Second, the committee found that even in cases where traditional trust means of funding were employed, "reliance on conventional trust law often is insufficient to adequately protect the interests of plan participants and beneficiaries." *Id.*

Third, the committee found that participants were inadequately equipped to safeguard their interests in the absence of "standards by which a participant can

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The fiduciary responsibility section of ERISA "codifies and makes applicable to . . . fiduciaries certain principles developed in the evolution of the law of trusts."¹⁴³ ERISA's fiduciary standards sections codified "[t]he principles of fiduciary conduct . . . from existing trust law, but with modifications appropriate for employee benefit plans."¹⁴⁴ Under ERISA, every fiduciary carries a twofold duty "to act in his relationship to the plan's fund as a prudent man in a similar situation and under like conditions would act, and to act consistently with the principles of administering the trust for the exclusive [benefit of the participants and beneficiaries]."¹⁴⁵ Congress viewed the enactment of these fiduciary standards as a codification of the fiduciary principles developed in the common law of trusts.¹⁴⁶

measure the fiduciary's conduct." *Id.*

Finally, the committee found the enactment of fiduciary standards desirable to promote uniformity of decisions in an area that was increasingly interstate. *Id.*

143. *Id.* at 11, 1974 U.S. CODE CONG. & ADMIN. NEWS at 4649.

144. *Id.* at 13, 1974 U.S. CODE CONG. & ADMIN. NEWS at 4651.

145. *Id.* The language of ERISA tracks this statement:

[A] fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries and—

(A) for the exclusive purpose of:

(i) providing benefits to participants and their beneficiaries; and

(ii) defraying reasonable expenses of administering the plan;

(B) with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims.

ERISA § 404(a)(1), 29 U.S.C. § 1104(a)(1) (1986).

146. See H.R. REP. NO. 533, 93d Cong., 1st Sess. 11, *reprinted in* 1974 U.S. CODE CONG. & ADMIN. NEWS 4639, 4649; S. REP. NO. 127, 93d Cong., 1st Sess. 1, *reprinted in* 1974 U.S. CODE CONG. & ADMIN. NEWS 4838; see also *Central States, Southeast & Southwest Areas Pension Fund v. Central Transport, Inc.*, 522 F. Supp. 658, 665 (E.D. Mich. 1981), *rev'd on other grounds*, 698 F.2d 802 (6th Cir. 1983), *rev'd on other grounds*, 472 U.S. 559 (1985).

In *Firestone Tire and Rubber Co. v. Bruch*, 109 S.Ct. 948 (1989), the Supreme Court recognized "ERISA's legislative history confirms that the Act's fiduciary responsibility provisions . . . 'codif[y] and make[] applicable to [ERISA] fiduciaries certain principles developed in the evolution of the law of trusts.'" *Id.* at 954 (citing H.R. REP. NO. 533, 93d Cong., 1st Sess. 11, *reprinted in* 1974 U.S. CODE CONG. & ADMIN. NEWS 4639, 4649). The issue in *Firestone* was the appropriate standard to be used by federal courts in reviewing the decisions of plan trustees. In determining the appropriate standard, the Court stated, "[W]e are guided by principles of trust law." *Id.* See Austin, *The Role and Responsibilities of Trustees in Pension Plan Trusts*,

One of the cornerstones of the fiduciary responsibility provisions of ERISA is the "exclusive benefit rule," which provides "a fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries."¹⁴⁷ The anti-inurement provision of ERISA was enacted as a part of the "exclusive benefit rule."¹⁴⁸ The "exclusive

EQUITY, FIDUCIARIES AND TRUSTS 111 (Youdau ed. 1989); Blass, *ERISA: An Overview for Uses—ERISA Cettarways*, A.B.A.J. 72 (May 1989); Fischel and Langbein, *ERISA's Fundamental Contradiction: The Exclusive Benefit Rule*, 55 U. CHI. L. REV. 1105 (1988).

147. ERISA § 404(a), 29 U.S.C. § 1104(a) (1986).

148. Section 404(a) of ERISA states "a fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and their beneficiaries." ERISA § 404(a), 29 U.S.C. § 1104(a) (1986).

Section 403(c) of ERISA states "the assets of a plan shall never inure to the benefit of any employer and shall be held for the exclusive purposes of providing benefits to participants in the plan and their beneficiaries." ERISA § 403(c), 29 U.S.C. § 1103(c) (1986).

Paragraph (1) of § 403(c) states the anti-inurement provision while paragraphs (2) and (3) provide exceptions to the anti-inurement rule. Paragraph (2) states the anti-inurement paragraph shall not apply in the case of an employer contributing to the plan under a mistake of fact; paragraph (3) states the anti-inurement paragraph shall not apply in the case of an employer contributing excessively to the plan. ERISA § 403(c)(2), (c)(3), 29 U.S.C. § 1103(c)(2), (c)(3) (1986). ERISA § 403(c)(2) states:

(A) In the case of a contribution . . . made by an employer . . . by a mistake of fact, paragraph (1) [the anti-inurement provision] shall not prohibit the return of such contribution to the employer within one year after the payment of the contribution.

(B) If a contribution is conditioned on initial qualification of the plan under section 401 or 403(a), of title 26, and if the plan receives an adverse determination with respect to its initial qualifications, then paragraph (1) shall not prohibit the return of such contribution to the employer within one year after such determination

(C) If a contribution is conditioned upon the deductibility of the contribution under section 404 of title 26 then, to the extent the deduction is disallowed, paragraph (1) shall not prohibit the return to the employer of such contribution (to the extent disallowed) within one year after the disallowance of the deduction.

ERISA § 403(c)(2), 29 U.S.C. § 1103(c)(2) (1986).

Paragraph (3) of Section 403(c) states:

In the case of a contribution which would otherwise be an excess contribution (as defined in section 4979(c) of title 26) paragraph (1) shall not prohibit the return to the employer of such contribution (to the extent disallowed) within one year after the disallowance of the deduction.

ERISA § 403(c)(3), 29 U.S.C. § 1103(c)(3) (1986).

benefit rule" is a codification of the duty of loyalty found in the common law of trusts.¹⁴⁹

Under common law trust doctrine, the settlor of the trust could be the sole beneficiary or one of several beneficiaries of the trust.¹⁵⁰ The employee benefit trust, as to Mr. Kwatcher, is analogous to a trust created by the settlor for the benefit of himself and other employee participants. The trustee of the Fund is under a duty to administer the trust solely in the interest of the beneficiaries, of which class Mr. Kwatcher, as an employee, is a member. Regardless of Mr. Kwatcher's status as an employer, if he is a participant, the anti-inurement rule of ERISA does not prevent the payment of pension benefits to him as a participant.

IV. CONCLUSION

The *Kwatcher* court is wrong to deny Mr. Kwatcher his retirement savings. The analysis the court uses is flawed in four respects. The court fails to recognize the ambiguity of ERISA's language in addressing the participant status of an individual who is both the owner and an employee of a corporation. The *Dodd* court addressed the same issue in a better reasoned opinion. The analysis which should be employed to address the participant status of dual-status individuals should begin with a recognition of the ambiguous language of ERISA.¹⁵¹

A court should recognize 29 C.F.R. section 2510-3.3(c) for its intended purpose. The regulation was designed to define retirement savings plans which would not be covered under ERISA because of the unlikely nature of abuse within those plans.¹⁵² A court should also avoid drawing an inference from the history of congressional legislation of the private pension system.

149. Under the RESTATEMENT (SECOND) OF TRUSTS § 170(1) (1959), "[t]he trustee is under a duty to the beneficiary to administer the trust solely in the interest of the beneficiary." *Id.*

150. RESTATEMENT (SECOND) OF TRUSTS § 114 (1959) provides that "[t]he settlor of a trust may be one of the beneficiaries of or the sole beneficiary of the trust." Comment a states:

[A] trust may be created by a transfer inter vivos by the owner of property to another person as trustee for the transferor or for a third person. The transferor may be the sole beneficiary of the trust created by him, or he may be one of several beneficiaries.

RESTATEMENT (SECOND) OF TRUSTS § 114, comment a (1959).

The trustee may also be a beneficiary of a trust. The trustee/beneficiary is still obliged to administer the trust for the sole benefit of the beneficiaries and to be impartial as among all beneficiaries. A. SCOTT, SCOTT ON TRUSTS § 115 (1960).

151. See *supra* notes 69-90 and accompanying text.

152. See *supra* notes 91-101 and accompanying text.

The *Kwatcher* court infers from the existence of H.R. 10 plans that Congress intended *all* corporate shareholders, if they desired to set up a retirement savings plan for their benefit, to use the H.R. 10 plan.¹⁵³ In fact, the H.R. 10 plan was intended as a retirement savings vehicle for use by sole-proprietors in an effort by Congress to provide a retirement savings vehicle for the unincorporated business owner parallel to that available for the incorporated business owner.¹⁵⁴

Finally, whenever a court determines that an individual falls within ERISA's definition of "employer," there should be hesitation before blindly applying the anti-inurement provision of the act. The anti-inurement provision of ERISA is one part of the codification in ERISA of common law principles of trust law. Under common law, a person creating a trust could designate himself as one of several beneficiaries.¹⁵⁵ So long as the ERISA safeguards are available to protect the rights of the non-settlor beneficiary of the plan, there is no rationale for denying the settlor-beneficiary the right to participate in the plan.

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153. See *supra* text accompanying note 55.

154. See *supra* notes 102-30 and accompanying text.

155. See *supra* notes 131-150 and accompanying text.