

# The Regulatory Systems for Employee Benefits

BRIAN A. BENKO\*

I, for many years, have thoroughly enjoyed the tax lawyer's "dance with words." I'm gradually coming to believe, however, . . . that matters are in danger of getting out of control. Whole new courses in the tax curriculum may well be unteachable in a meaningful way. I am omitting vast segments of the law that I can no longer stand, understand, or certainly communicate to my increasingly befuddled students. They [include] such dubious intellectual joys as . . . ERISA (which is unknowable by either labor lawyers or tax lawyers).<sup>1</sup>

James S. Eustice

## I. Introduction

In 2000, the late Michael S. Gordon, who has been hailed as one of the architects of the Employee Retirement Income Security Act of 1974 (ERISA),<sup>2</sup> wrote a piece entitled *ERISA in the 21st Century*.<sup>3</sup> In his article, Mr. Gordon identified three issues that may affect the key assumptions underlying ERISA's regulatory approach. The three trends were: (1) the challenges to Social Security and the traditional defined benefit system, (2) health insurance reform, and (3) the increase in ERISA litigation.<sup>4</sup> He wrote that the value structure used by those who drafted ERISA was the best able to address these issues.<sup>5</sup> The value structure of which he wrote was a form of functionalism—"an approach that emphasizes pragmatic rather than theoretical concerns."<sup>6</sup>

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\*Associate, McDermott Will & Emery LLP, Washington, D.C. The author thanks David L. Wray, and his parents, Russ and Maureen, for their advice and counsel during the preparation of this Article. In addition, the author generally thanks William K. Bortz, Brandon C. Carlton, William M. Evans, Kathryn J. Kennedy, Helen H. Morrison, W. Thomas Reeder, Stephen B. Tackney, Sal L. Tripodi, and Harlan M. Weller. None are responsible for anything in the text.

<sup>1</sup>James S. Eustice, *Tax Complexity and the Tax Practitioner*, 45 TAX L. REV. 7, 8 (1990).

<sup>2</sup>Employee Retirement Income Security Act of 1974, Pub. L. No. 93-406, 88 Stat. 829 [hereinafter ERISA]; Vineeta Anand, "Core of Commitment": *ERISA Architect Gordon Dies*, PENSIONS & INVESTMENTS, Feb. 9, 2004, at 2.

<sup>3</sup>Michael S. Gordon, *Introduction to the Second Edition of STEVEN J. SACHER ET AL., EMPLOYEE BENEFITS LAW*, at lxiii (2d ed. 2000).

<sup>4</sup>*Id.* at lxiv.

<sup>5</sup>*Id.*

<sup>6</sup>*Id.*

In the ten years since Mr. Gordon's article was published, these three issues have remained generally unabated. All the while, experts have offered solutions. The particular solutions offered depend on how the issues are framed and what ends are pursued. As a consequence, experts have adopted polarizing theories of the best method to ensure retirement savings and healthcare security. Some hope for change because they believe that the current system is broken. Others, however, fear change because they believe that the system is not broken and that the solutions being offered offend the very principles on which this republic was founded. The distinction between hope and fear is driven by philosophical and political differences. Regardless of which side prevails, there is reason for hope, and none for fear, because employee benefits law, by its nature, is constantly evolving.

Employee benefits law is the compendium of responses to the human experience. Historical events that affected the lives of the people of this country spawned the endless defined terms and never-ending special exceptions within the rules and regulations under the 1986 Code and ERISA. The Studebaker bankruptcy in 1968 started the rallying cry for employee benefits regulation, resulting in ERISA.<sup>7</sup> The effect of the terrorist attacks on September 11, 2001 led Congress to enact the Pension Protection Act of 2006 to help the ailing airline industry's pension funding issues.<sup>8</sup> The legions unemployed due to the effects of the Great Recession led Congress to enact a provision in the American Recovery and Reinvestment Act of 2009 to subsidize the cost of health care continuation coverage to help the victims of layoffs.<sup>9</sup> Through several generations, the human experience has created the need for changes to benefits law.

It is this generation, however, which will likely be responsible for the next major change to benefits law. With Mr. Gordon's words on the value structure underlying ERISA in mind—"emphasizing pragmatic rather than theoretical concerns"<sup>10</sup>—this Article explains the regulatory system for employer-provided retirement benefits and health and welfare benefits. Understanding the structure of the system is important if it is to be changed. Enacting legislation without understanding the current regulatory system would create added complexity. New laws would form an additional layer on top of what already exists. To efficiently and effectively change benefits law, new legislation should be thoughtfully integrated into the system that has developed over many years. Hopefully this Article contributes to informed decision-making in the days ahead—by providing a systematic explanation of the system for regulating employer-provided benefits.

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<sup>7</sup>William S. Cohen, *Gambling with the Future*, N.Y. TIMES, Aug. 12, 1986, at A25.

<sup>8</sup>Pension Protection Act of 2006, Pub. L. No. 109-280, 120 Stat. 780; see Mary Williams Walsh, *Trying to Clear Fog From Pension Plans*, N.Y. TIMES, Feb. 3, 2008, at 5.

<sup>9</sup>Paul M. Hamburger & Joanna C. Enstice, *ARRA COBRA Premium Subsidy Law*, 22 BEN. L.J. 11 (2009).

<sup>10</sup>Gordon, *supra* note 3, at lxiii.

Developing a systematic explanation of employee benefits requires a several-step analysis. The first step in the analysis is to explain the historical developments of employee benefits. Part II reviews the development of employee benefits law. Through the years, benefits law has combined many areas of law to regulate retirement plans and health and welfare plans. It all started with the enactment of tax incentives to entice employers to offer benefits to employees. The law later developed with the enactment of ERISA, which added substantive labor law regulation and additional tax law requirements. ERISA's progeny included several dozen acts of Congress. The effect was layer after layer of regulation.

With an understanding of the historical development of employee benefits, employee benefits law can be explained as a system of laws. Part III explains the system and deems it the "overlapping system of laws." The overlapping system of laws uses tax law and labor law to create a cohesive body of laws. All of the rules under tax law and labor law can be categorized into two types of rules: the "incentive formulation" and the "sanction formulation." Tax law and labor law work together through the use of incentives and sanctions, fostering a system that encourages the provision of benefits and protects the rights of the actors within the system.

The explanation of the regulatory system is helpful, but the system needs to be explained in terms of how it affects the participants. Part IV explains the impact of the regulatory system on the motivations and conduct of employers, employees, and other actors in the benefits system. The regulatory system affects the relationships between the parties at two different levels: plan formation and plan operation.

In addition to explaining the effect of new laws, the regulatory system can be used to help guide the development of the law. At these two levels, the acts of Congress impact the regulatory system. Part V provides an analytical framework for using the regulatory system to help create the benefits law of tomorrow. Finally, Part VI is a brief conclusion.

Preliminarily, note the following point. This Article does not pontificate on how Congress should change the law. Nearly every article does so. What this Article offers is an explanation of the regulatory system for employee benefits as a means of understanding, and a method for analyzing, this complicated area of law.

## II. The Development of Employee Benefits Law

The rules and regulations for employer-provided benefits developed over the past century.<sup>11</sup> No one legislative act or policy decision created employee benefits law; in fact, legions of acts and decisions led to the creation of the current body of law. The rules developed in multiple stages. At first, employee

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<sup>11</sup>David L. Gregory, *A Symposium Conference upon the Twentieth Anniversary of ERISA: Introductory Remarks*, 68 ST. JOHN'S L. REV. 317, 317-18 (1994).

benefits were generally unregulated.<sup>12</sup> Then states provided some regulation. After that, Congress offered a tax preference for employer-provided benefits.<sup>13</sup> Ultimately, in enacting ERISA, Congress preempted all state laws related to employee benefit plans<sup>14</sup> and created substantive legal requirements<sup>15</sup> with statutorily prescribed civil actions.<sup>16</sup>

To understand the regulatory system for employee benefits, it is important to understand the history underlying its development. The history behind the policies and legal developments provides the context necessary to understanding benefits law. Before Congress enacted legislation encouraging employers to provide benefits to employees, the employee-employer relationship existed in a state of nature without significant regulation. The decision to provide benefits, and the form of the benefits provided, was not determined by law. Subsequent legislation, however, changed the relationship by encouraging employers to provide benefits to employees and by regulating the benefits received by employees. Over time, the relationship evolved with respect to the decision to provide benefits and the conduct in providing benefits.

#### A. *Employee Benefits in a State of Nature*

In the beginning, with respect to employee benefits, the employer-employee relationship nearly existed in a state of nature.<sup>17</sup> In the early days, although states regulated employer-provided benefits, there was very little regulation.<sup>18</sup> An important issue is what existed when there was little regulation. The relationship between the employer and employee was nearly unrestrained because conduct was not influenced or directed by the government.

An examination of how employee benefits functioned when it existed in a state of nature is essential. Without it, one's understanding of the law will lack context and depth. The relationship forms a base foundation for the rules by isolating the decision-making process involved in offering benefits, the type of benefits provided, and the interaction of the parties while the benefits are earned and received. Policy decisions regarding employee benefits affect the relationship at one or more of these levels.

So, what is the essence of employee benefits, and what about the relationship leads them to be provided? In the abstract, employee benefits involves the allocation of nonwage compensation from the employer to the employee. Employers decide to provide nonwage compensation because it provides a greater benefit to employees than the provision of additional cash wages. Further, benefit plans give employees something they desire or need. Nonethe-

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<sup>12</sup> See discussion *infra* Part II.A.

<sup>13</sup> See discussion *infra* Part II.B.

<sup>14</sup> ERISA § 514, 29 U.S.C. § 1144 (2006).

<sup>15</sup> ERISA tit. I, 29 U.S.C. §§ 1001–1191 (2006).

<sup>16</sup> ERISA § 502, 29 U.S.C. § 1132 (2006).

<sup>17</sup> See generally JOHN LOCKE, THE SECOND TREATISE OF GOVERNMENT ch. 2 (Thomas P. Peardon ed., Prentice Hall 1952) (1690).

<sup>18</sup> SACHER ET AL., *supra* note 3, at 1.

less, employers do not provide benefits due to altruism. The plans are often mutually beneficial for both the employer and its employees. For example, where the employer provides a health plan, employees benefit by having an opportunity to stay healthy, while the employer benefits by having healthy employees—employees who are more likely to perform their job well. In addition, by providing a health plan, an employer is able to distinguish itself from other employers who either provide benefits of lesser quality or none at all. Thus, providing benefits promotes employee retention and a sound employer-employee relationship.

In an effort to transition from the abstract discussion of what is being provided and why it is provided, an explanation of how a benefit is provided is beneficial. Regardless of the type of benefits at issue, there are some things that they all have in common. First, through the provision of benefits, an employer decides to provide employees with some specified benefit to be administered according to specified terms. Only after the employer decides to provide benefits can the employer decide how, when, and where to provide a benefit to employees. Second, the provision of a benefit involves a transfer of value. Employees either receive something of value in the present or a right to receive something in the future.

But the place from which value is transferred from the employer to the employee varies. The transference may involve a payment to an insurance company for an insurance contract under which the insurer agrees to insure employees. The transference may be a payment of an amount from the general assets of the employer to a separate account through which an amount will be paid to an employee at a specified time in the future. The transference may be a promise to reimburse employees for certain expenses related to medical treatment. Without regulation, there are an infinite number of ways to transfer value through the provision of benefits. In a preregulation state of nature, the employer is able to structure employee benefits as it sees fit.

Before the federal government started regulating benefits, employers provided them without restrictions and received no incentive to provide them. This system promoted a moral hazard. Employers could promise benefits and not follow through in providing what was promised. Further, there was no incentive for employers to provide retirement and health care security to employees. There was a way to change both of these issues. To promote the employer-provided system, tax preferences could be provided. And to protect employee rights, employers providing benefits could be required to comply with substantive regulation.

Together, tax preferences and substantive regulation ended the days when the employer-employee relationship existed in a state of nature—because existing in a state of nature means, in part, that the employer, its employees, and other parties servicing the relationship are free from restrictions and influence. As benefits law developed, changes occurred where the government wanted to influence an outcome or further a policy. The outcome was the provision of benefits by employers to employees, and the policies were several.

The various ends sought were pursued by enacting legislation and regulations thereunder.

### B. *The Original Incentives Under Tax Law*

In 1913, the United States of America amended the Constitution by adding the 16th amendment, allowing for an income tax.<sup>19</sup> In that same year, Congress passed the income tax law, which imposed a tax on the income of individuals and corporations.<sup>20</sup> Income included compensation for personal services, and thus benefits were taxed.<sup>21</sup> The first federal laws affecting employer-provided benefits were enacted as income tax laws. Through these laws, Congress created incentives encouraging employers to provide retirement benefits and health and welfare benefits to employees.

#### 1. *Incentives for Retirement Benefits*

The first tax incentive Congress enacted to promote employer-provided retirement benefits was the precursor to section 401(a).<sup>22</sup> The Revenue Act of 1921 excluded from income employer contributions to certain trusts and all earnings and income.<sup>23</sup> The tax preference applied to a trust created by the employer as a part of a stock bonus or profit-sharing plan for the exclusive benefit of some or all of its employees.<sup>24</sup> In other words, the trust, which held the funds to pay for benefits promised under a retirement plan, was exempt from the income tax until the funds were distributed to employees.<sup>25</sup> Congress enacted the next major change in the Revenue Act of 1926. There Congress included pension plans as a type of plan eligible for a tax preference.<sup>26</sup>

With the Revenue Act of 1928, Congress offered employers another incentive to provide retirement benefits.<sup>27</sup> Employers received an immediate deduction for contributions to employer-provided pension trusts.<sup>28</sup> Prior to the enactment of this deduction, employers often established pension plans for employees and made annual additions to a pension reserve fund, but not to a trustee.<sup>29</sup> To take advantage of the deduction, employer contributions to

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<sup>19</sup> U.S. CONST. amend. XVI.

<sup>20</sup> Tariff Act of 1913, ch. 16, 38 Stat. 114, 166, 172.

<sup>21</sup> *Id.* § II.B, 38 Stat. at 167.

<sup>22</sup> See Revenue Act of 1921, ch. 136, § 219(f), 42 Stat. 227, 247; see also I.R.C. § 401(a).

<sup>23</sup> Revenue Act of 1921, ch. 136, § 219(f), 42 Stat. 227, 247.

<sup>24</sup> *Id.*

<sup>25</sup> *Id.*

<sup>26</sup> Revenue Act of 1926, ch. 27, § 219(f), 44 Stat. 9, 33–34.

<sup>27</sup> Revenue Act of 1928, ch. 852, § 23(q), 45 Stat. 791, 799. The Employees' Trust provision at section 219(f) of the Revenue Act of 1926 became section 165 under the Revenue Act of 1928. *Id.* § 165, 45 Stat. 839.

<sup>28</sup> Revenue Act of 1928, ch. 852, § 23(q), 45 Stat. 791, 799. The cross-reference to section 165, which was entitled "Employees' Trusts," in section 23(q) of the Revenue Act of 1928 was a reference to the old section 219(f) from the Revenue Act of 1921. See Revenue Act of 1928, ch. 852, § 165 (1928), 45 Stat. 791, 839.

<sup>29</sup> S. REP. NO. 70-960, at 21 (1928).

a pension plan needed to be turned over to a trustee.<sup>30</sup> As a result of this new deduction, Congress created an incentive that worked in concert with the income exclusion. The federal government created mutually beneficial incentives for the employer and its employees, allowing an employer deduction before the compensation was included in income.

Thus, the tax preference for employer-provided pension trusts in 1928 was as follows. Compensation was not included in income when value was transferred from the employer to a trust for the benefit of the employees. The employer was permitted to deduct the contributions when they were made. This allowed for a mismatching of the inclusion of income and the deduction. While the compensation was in a pension trust, earnings and principal accumulated without the imposition of an income tax.<sup>31</sup> And when the employee received a distribution from the pension trust, the amount was taxed as ordinary income.<sup>32</sup> The tax preference for employer-provided retirement plans in 1928, one year before the Wall Street Crash of 1929 and the beginning of the Great Depression, is substantially similar to the tax preference in 2010.<sup>33</sup>

In 1939, Congress started the process that would create the great number of conditions, the satisfaction of which was necessary for being a tax-qualified plan. Before that time, it was possible for an employer to revoke or alter a retirement trust at any time, even though the trust was still exempt from income.<sup>34</sup> In other words, it was possible for employees to be deprived of the substantial retirement benefits they expected to receive.<sup>35</sup> To remedy the issue, Congress placed conditions on receipt of the tax preference.<sup>36</sup> Under the Revenue Act of 1938, to receive the substantial tax preference, the trust instrument and any collateral agreements could not permit any part of the corpus or income thereof to be at any time used for, or diverted to, purposes other than the exclusive benefit of employees.<sup>37</sup>

With this rule, Congress started down a path leading to the enactment of numerous laws affecting the tax preference for employer-provided retirement benefits.<sup>38</sup> Retirement trusts were required to comply with these rules

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<sup>30</sup> *Id.*

<sup>31</sup> Revenue Act of 1928, ch. 852, § 165, 45 Stat. 791, 839.

<sup>32</sup> *Id.*

<sup>33</sup> Compare I.R.C. §§ 401(a), 404, with Revenue Act of 1928, ch. 852, §§ 165, 23(q), 45 Stat. 791, 839 (1928).

<sup>34</sup> H.R. REP. NO. 75-1860, at 46 (1938) (concerning section 165 of the Revenue Act of 1938).

<sup>35</sup> *Id.*

<sup>36</sup> Revenue Act of 1938, ch. 289, § 165, 52 Stat. 447, 518.

<sup>37</sup> *Id.* Without this rule, an employer who terminated a pension plan could recover all assets contributed to the trust. See Norman P. Stein, *Reversions from Pension Plans: History, Policies, and Prospects*, 44 Tax. L. Rev. 259, 280 (1988).

<sup>38</sup> See I.R.C. § 401(a) (providing thirty-seven paragraphs of requirements for plan qualification).

as a condition for receipt of the tax preference.<sup>39</sup> New qualification requirements were often added because of abusive practices by some employers that thwarted the purpose of expending public funds on securing retirement for employees.<sup>40</sup>

The rules regarding which employees an employer needed to cover to maintain tax-qualified status is an example of how new requirements developed. During World War II, employers often chose to contribute an amount to a trust for their employees' retirement rather than pay 90% of the money as excess-profits taxes.<sup>41</sup> Some employers used retirement trusts in a way that favored high-level employees but not lesser-compensated ones.<sup>42</sup> In particular, some employers provided retirement plans that discriminatorily covered a higher percentage of highly compensated employees and provided benefits and contributions in a greater amount to highly compensated employees.<sup>43</sup> In 1942, this resulted in Congress changing the income exclusion for accumulations and earnings under an employer-provided retirement trust.<sup>44</sup> As a condition of receiving the tax preference, retirement trusts were required to cover a certain percentage of "nonhighly compensated employees" in relation to the number of "highly compensated employees" covered.<sup>45</sup> In addition, retirement trusts were prohibited from discriminating in favor of highly compensated employees when providing benefits.<sup>46</sup> These new requirements were Congress's attempt to end corporate pay practices that discriminated in favor of higher-level employees who sheltered compensation from the income tax.

The early development of the tax preference and the initial conditions for its receipt are instructive of how and why the rules developed under tax law. There were primarily two reasons for adding new conditions for tax-qualified status. First, additional requirements produced the efficient achievement of the social goals at issue—to help secure retirement income.<sup>47</sup> Second, new requirements regulated tax expenditures.<sup>48</sup> Receipt of public funds was con-

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<sup>39</sup>H.R. REP. NO. 75-1860, at 46–47 (1938) (concerning section 165 of the Revenue Act of 1938); H.R. REP. NO. 77-2333, at 105–06 (1942).

<sup>40</sup>88 CONG. REC. 6,378 (1942) (statement of Rep. Disney).

<sup>41</sup>G. Waldron Snyder, *Employee Retirement Income Security Act of 1974*, 11 WAKE FOREST L. REV. 219, 222 (1975).

<sup>42</sup>88 CONG. REC. 6,378 (1942) (statement of Rep. Disney); SACHER ET AL., *supra* note 3, at 170.

<sup>43</sup>Snyder, *supra* note 41, at 222–23.

<sup>44</sup>Revenue Act of 1942, ch. 619, § 162, 56 Stat. 798, 862.

<sup>45</sup>*Id.*

<sup>46</sup>*Id.* The coverage and nondiscrimination rules under the Revenue Act of 1942 were the original formulation of the current coverage test under section 410(b) and the nondiscrimination test under section 401(a)(4).

<sup>47</sup>PRESIDENT'S COMMITTEE ON CORPORATE PENSION FUNDS AND OTHER PRIVATE RETIREMENT AND WELFARE PROGRAMS, PUBLIC POLICY AND PRIVATE PENSION PROGRAMS: A REPORT TO THE PRESIDENT ON PRIVATE EMPLOYEE RETIREMENT PLANS 64 (1965) [hereinafter PRESIDENT'S COMMITTEE]; SACHER ET AL., *supra* note 3, at 170.

<sup>48</sup>SACHER ET AL., *supra* note 3, at 170–71.

ditioned upon acting in accordance with public policy.<sup>49</sup> Even with these new requirements, the tax preference still provided sufficient encouragement for employers to offer retirement benefits to employees.<sup>50</sup>

## 2. *Incentives for Health and Welfare Benefits*

Similar to the development of retirement benefits, Congress initially passed laws on employer-provided health plans through revenue acts, to encourage employers to provide health benefits to employees. The first of these provisions was in the Revenue Act of 1918.<sup>51</sup> It provided an exclusion from gross income for amounts received through health insurance for injuries or sickness.<sup>52</sup> Thus, an individual who received compensation through health insurance paid no income tax on it.

The next major development happened during World War II. The Revenue Act of 1942 contained two important provisions. First, Congress added a deduction for individual medical expenses, including amounts paid for health insurance, to the extent such expenses exceeded five percent of adjusted gross income.<sup>53</sup> This provision reduced the heavy tax burden for individual medical expenses during World War II, and helped maintain a high level of public health.<sup>54</sup> Second, Congress amended the exclusion for amounts received through health insurance as compensation to prohibit exclusions for amounts attributable to deductions previously taken for medical expenses.<sup>55</sup> With these two provisions, the exclusion and the deduction worked in concert to insure that an individual did not receive a double tax benefit.

The 1954 Code brought two important new incentives to employer-provided health plans. First, all employer contributions to health plans for compensation were excluded from income.<sup>56</sup> Second, the income exclusion for amounts received under health insurance was changed so that amounts received through health insurance were excluded from income to the extent not attributable to employer contributions previously excluded from income or paid by the employer.<sup>57</sup> However, amounts received through health insurance or a health plan were included in income to the extent attributable to employer contributions and were previously not included in income or paid by the employer.<sup>58</sup> There was an exception for reimbursements for medical

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<sup>49</sup>Daniel I. Halperin, *Retirement Security and Tax Equity: An Evaluation of ERISA*, 17 B.C. INDUS. & COM. L. REV. 739, 747 (1976).

<sup>50</sup>Snyder, *supra* note 41, at 222.

<sup>51</sup>Revenue Act of 1918, ch. 18, 40 Stat. 1057.

<sup>52</sup>*Id.* § 213(b)(6); *see also* Haynes v. United States, 353 U.S. 81, 85 n.4 (1957).

<sup>53</sup>Revenue Act of 1942, ch. 619, § 27, 56 Stat. 798.

<sup>54</sup>S. REP. NO. 77-1631, at 6 (1942).

<sup>55</sup>Revenue Act of 1942, ch. 619, § 127(d), 56 Stat. 798, 826.

<sup>56</sup>I.R.C. § 106 (1954).

<sup>57</sup>I.R.C. § 104 (1954).

<sup>58</sup>I.R.C. § 105(a) (1954).

care expenses, including premium payments.<sup>59</sup>

In the early development of employee benefits law, the federal government offered a tax preference for both retirement and health plans, but the development of each differed. The tax preference for health plans was generally not conditioned upon the satisfaction of other rules or tests. The health plans did not have rigorous and restrictive design requirements. In contrast, retirement plans had numerous restrictions on plan design, including coverage and non-discrimination testing.<sup>60</sup>

### C. ERISA: Additional Regulation Under Tax Law and Labor Law

Early tax laws formed the foundation for the regulatory system for employee benefits, but ERISA fashioned its structural supports. Although Congress offered employers tax-preferred treatment and some compliance rules,<sup>61</sup> there was almost no substantive regulation protecting the rights of employees.<sup>62</sup> Because regulation was based in requiring compliance with certain requirements in order to become a qualified plan, regulation consisted primarily of whether or not the Service granted or disallowed tax-qualified status.<sup>63</sup>

Even with oversight from the Service in place, employers did not always make good on promises to provide benefits to employees.<sup>64</sup> This was a consequence of a system in which those with an inordinate amount of power have few restrictions or limitations—a relationship rife with moral hazards. The most famous example was the Studebaker bankruptcy in 1963.<sup>65</sup> About 4,500 workers lost 85% of their vested benefits because the plan did not have enough assets to pay liabilities.<sup>66</sup> The Studebaker employees did not receive

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<sup>59</sup>I.R.C. § 105(b) (1954). Several years later, in 1978, Congress created a nondiscrimination test for this exception, to insure that employers did not allow a disproportionate number of highly compensated employees to benefit. Revenue Act of 1978, Pub. L. No. 95-600, § 366(a), 92 Stat. 2763 (1978) (codified at I.R.C. § 105(h)). The provision has since been repealed. Pub. L. No. 101-140, § 202, 103 Stat. 830, 830 (1989).

<sup>60</sup>The impact of this distinction is further discussed *infra* Part III.

<sup>61</sup>I.R.C. § 401(a) (1954); 120 CONG. REC. 4,281 (1974) (statement of Rep. Gaydos).

<sup>62</sup>H.R. REP. NO. 93-533, at 3 (1973); 120 CONG. REC. 4,281 (1974) (statement of Rep. Gaydos). In 1958, Congress enacted the Welfare and Pension Plans Disclosure Act, Pub. L. No. 85-836, 72 Stat. 997 (1958) (formerly codified at 29 U.S.C. §§ 301–309, repealed by ERISA § 111(a)(1), 29 U.S.C. § 1031(a)(1) (Supp. IV 1975), creating certain disclosure requirements for plans, but the regulation proved inadequate. *See* H.R. REP. NO. 93-533, at 3 (1973).

<sup>63</sup>*See* 120 CONG. REC. 4,279 (1974) (statement of Rep. Brademas).

<sup>64</sup>*See* 120 CONG. REC. 4,278 (1974) (statement of Rep. Perkins).

<sup>65</sup>*Private Pension Plan Reform Part I: Hearings Before the Subcomm. on Private Pension Plans of the S. Comm. on Finance*, 93d Cong. 353 (1973) (statement of Hon. George P. Schultz, Secretary of the Treasury); *see also* JOHN H. LANGBEIN, SUSAN J. STABILE & BRUCE A. WOLK, *PENSION AND EMPLOYEE BENEFIT LAW* 72–76 (4th ed. 2006).

<sup>66</sup>120 CONG. REC. 4,279 (1974) (statement of Rep. Brademas).

the benefits they expected to receive at retirement.<sup>67</sup> Studebaker became the rallying cry for reform.<sup>68</sup>

Congress seized the day by taking up the cause. The reform effort was based in the recommendations of a committee established by President Kennedy, the Committee on Corporate Pension Fund and Other Private Retirement and Welfare Programs.<sup>69</sup> Legislation was cultivated over several years.<sup>70</sup> By 1973, legislation began taking form, with labor committees and tax committees producing bills.<sup>71</sup> The efforts were combined into a single bill affecting both tax law and labor law, and apportioning jurisdiction between the Department of Labor (DOL) and the Department of the Treasury (Treasury).<sup>72</sup>

On Labor Day 1974, President Ford signed ERISA to remedy the problems with the system for providing benefits to employees.<sup>73</sup> At its core, ERISA encouraged employers to provide benefits and protected the rights of employees who were promised benefits. ERISA's policy was to protect the employees' interests in their employee benefit plans and protect interstate commerce.<sup>74</sup> This was effected by requiring disclosure and reporting to participants, beneficiaries, and the government, by establishing fiduciary responsibility for plans, by providing appropriate remedies and sanctions for noncompliance, and by providing access to the courts, among other things.<sup>75</sup> Furthermore, ERISA's policy was to protect pension plan participants and the federal taxing power.<sup>76</sup> This was effected by requiring the vesting of accrued benefits, satisfaction of the minimum funding standards, and the provision of plan termination insurance.<sup>77</sup>

To pursue their purpose, ERISA's architects changed labor law and tax law. They substantively changed labor law by amending Title 29 of the United

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<sup>67</sup> *Id.*; see also *Private Pension Plan Reform Part I: Hearings Before the Subcomm. on Private Pension Plans of the S. Comm. on Finance*, 93d Cong. 436 (1973) (statement of Paul J. Fasser, Assistant Secretary of Labor for Labor-Management); LANGBEIN ET AL., *supra* note 65, at 72-76.

<sup>68</sup> James A. Wooten, "The Most Glorious Story of Failure in the Business": *The Studebaker-Packard Corporation and the Origins of ERISA*, 49 BUFF. L. REV. 683, 726-36 (2001).

<sup>69</sup> PRESIDENT'S COMMITTEE, *supra* note 47, at 33.

<sup>70</sup> John W. Lee, *The "Elaborate Interweaving of Jurisdiction": Labor and Tax Administration and Enforcement of ERISA and Beyond*, 10 U. RICH. L. REV. 463, 463 (1976).

<sup>71</sup> *Id.* at 463-64; Jay Conison, *Foundations of the Common Law of Plans*, 41 DEPAUL L. REV. 575, 620-21 (1992). The labor bills were S. 4, 93d Cong. (1973) and H.R. 2, 93d Cong. (1973), and the tax bills were S. 1179, 93d Cong., (1973), and H.R. 12855, 93d Cong., (1974).

<sup>72</sup> Conison, *supra* note 71, at 620-22; Lee, *supra* note 70, at 464.

<sup>73</sup> ERISA § 2 (1974), 29 U.S.C. § 1001 (Supp. IV 1975); Gordon, *supra* note 3, at lxxx.

<sup>74</sup> ERISA § 2(b) (1974), 29 U.S.C. § 1001(b) (Supp. IV 1975).

<sup>75</sup> *Id.* It was also the stated policy to protect participants in private pension plans by requiring the vesting of accrued benefits, satisfaction of the minimum funding standards, and by requiring plan termination insurance. ERISA § 2(c), 29 U.S.C. § 1001(c) (Supp. IV 1975).

<sup>76</sup> *Id.*

<sup>77</sup> *Id.*

States Code, and tax law by amending the 1954 Code.<sup>78</sup> ERISA was contained in Titles I through IV, and each title served a different function.

### 1. *Title I: Participants Gain Rights Under Labor Law*

Title I of ERISA contained the first comprehensive federal substantive regulation for employee benefit plans.<sup>79</sup> The provisions under Title I of ERISA amended labor law under Title 29 of the United States Code. Title I had a broad reach over employee benefit plans because all employee benefit plans, in general, were within the scope of Title I.<sup>80</sup> Employee benefit plans included any employer-provided benefit plan that was a pension benefit plan or welfare benefit plan.<sup>81</sup> Basically, pension benefit plans included all employer-provided retirement plans, regardless of the method of calculating contributions or benefits.<sup>82</sup> ERISA Title I applied to defined benefit plans and defined contribution plans. Welfare benefit plans generally included all employer-provided insurance and health plans, among other types of welfare plans.<sup>83</sup>

The importance of the general regulatory scope of Title I was enhanced by the preemption clause. ERISA superseded “any and all State laws insofar as they may . . . relate to employee benefit plans.”<sup>84</sup> The purpose of ERISA preemption was to provide for uniform regulation of all benefit plans. Preempting all state laws created a coherent system of federal regulation. But for a few exceptions,<sup>85</sup> states no longer had the right to regulate employer-provided benefit plans. As a result, employees aggrieved with the provision of benefits were left to depend on the civil enforcement provisions in ERISA Title I to effect compliance with ERISA’s substantive protections.

Even with the broad scope and comprehensive regulation under ERISA, the laws were primarily directed at the regulation of employer-provided retire-

<sup>78</sup>ERISA, Pub. L. No. 93-406, tit. 1, 2, 88 Stat. 829, 932-994.

<sup>79</sup>Before ERISA, Congress had passed the Welfare and Pension Plans Disclosure Act (WPPDA), Pub. L. No. 85-836, 72 Stat. 997 (1958) (formerly codified at 29 U.S.C. §§ 301-309, repealed by ERISA § 111(a)(1) (1974), 29 U.S.C. § 1031(a)(1) (Supp. IV 1975)). See Jay Conison, *The Federal Common Law of ERISA Plan Attorneys*, 41 SYRACUSE L. REV. 1049, 1065-67 (1990), for a discussion of the regulation under the WPPDA.

<sup>80</sup>ERISA § 4(a) (1974), 29 U.S.C. § 1003(a) (Supp. IV 1975).

<sup>81</sup>ERISA § 3(3) (1974), 29 U.S.C. § 1002(3) (Supp. IV 1975).

<sup>82</sup>ERISA § 3(2) (1974), 29 U.S.C. § 1002(2) (Supp. IV 1975). Pension plans were to include any plan, fund, or program established or maintained by an employer or employee organization that provided retirement income to employees or resulted in a deferral of income by employees for a period extending to the termination of covered employment. *Id.*

<sup>83</sup>ERISA § 3(1) (1974), 29 U.S.C. § 1002(1) (Supp. IV 1975). Welfare benefit plans included any plan, fund or program established or maintained by an employer or by an employee organization, or both, for the purpose of providing participants and beneficiaries medical, surgical, or hospital care or benefits, or benefits in the event of sickness, accident, disability, death, or unemployment, or vacation benefits, apprenticeship or other training programs, or day care centers, scholarship funds, or prepaid legal services. *Id.*

<sup>84</sup>ERISA § 514(a) (1974), 29 U.S.C. § 1144(a) (Supp. IV 1975). The preemption clause rendered state laws regulating employee benefit plans ineffective. *Id.*

<sup>85</sup>See ERISA § 514(b)(2) (1974), 29 U.S.C. § 1144(b)(2) (Supp. IV 1975).

ment plans, not welfare plans. The reason was that Congress drafted ERISA primarily to fix failures of pension plans.<sup>86</sup> Under ERISA Title I, certain rules only applied to retirement plans.<sup>87</sup> There was no general regulation focused on the issues facing health and welfare plans.<sup>88</sup> Some rules, however, applied to both retirement plans and welfare plans.<sup>89</sup>

A few parts of ERISA Title I regulated both welfare and retirement plans, including reporting and disclosure, and fiduciary responsibility. The first part that regulated all benefit plans was the reporting and disclosure requirements.<sup>90</sup> Employers were required to report certain information to the government and disclose other information to participants and beneficiaries. The purpose for these provisions was to keep participants and beneficiaries apprised of their rights in order to facilitate informed decisions and assist the government in enforcing the law.<sup>91</sup> ERISA required plan administrators to send a summary plan description<sup>92</sup> and a summary annual report<sup>93</sup> to plan participants and beneficiaries. It also required plan administrators to file with the government a summary plan description,<sup>94</sup> a summary of material modifications to the plan,<sup>95</sup> a plan description,<sup>96</sup> and an annual report.<sup>97</sup> The reporting and disclosure provisions provided a means of keeping track of benefit plans and informing participants of their rights.

The second part that regulated all employee benefit plans was the fiduciary responsibility rules. These rules were Congress's effort to codify the law of trusts as it applied to employee benefit plans.<sup>98</sup> At their core, the rules protected plan assets. To further this end, ERISA required that all benefit plans be established and maintained pursuant to a written plan document with a named fiduciary,<sup>99</sup> and procedures for operating and administering the plan.<sup>100</sup> In addition, plan assets were required to be held in a trust by a trustee.<sup>101</sup> The fiduciaries named in the plan document were parties with dis-

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<sup>86</sup> See H.R. REP. NO. 93-807, at 3 (1974).

<sup>87</sup> See ERISA § 201(a) (1974), 29 U.S.C. § 1051 (Supp. IV 1975).

<sup>88</sup> See ERISA § 3(1) (1974), 29 U.S.C. § 1002(1) (Supp. IV 1975).

<sup>89</sup> See, e.g., ERISA tit. I, pt. 4 (1974), 29 U.S.C. §§ 1101-1114 (Supp. IV 1975).

<sup>90</sup> ERISA tit. I, pt. 1 (1974), 29 U.S.C. §§ 1021-1031 (Supp. IV 1975).

<sup>91</sup> SACHER ET AL., *supra* note 3, at 57.

<sup>92</sup> ERISA § 101(a)(1) (1974), 29 U.S.C. § 1021(a)(1) (Supp. IV 1975).

<sup>93</sup> ERISA § 101(a)(2) (1974), 29 U.S.C. § 1021(a)(2) (Supp. IV 1975).

<sup>94</sup> ERISA § 101(b)(1) (1974), 29 U.S.C. § 1021(b)(1) (Supp. IV 1975).

<sup>95</sup> ERISA § 101(b)(3) (1974), 29 U.S.C. § 1021(b)(3) (Supp. IV 1975).

<sup>96</sup> ERISA § 101(b)(2) (1974), 29 U.S.C. § 1021(b)(2) (Supp. IV 1975).

<sup>97</sup> ERISA § 101(b)(4) (1974), 29 U.S.C. § 1021(b)(4) (Supp. IV 1975).

<sup>98</sup> See H.R. REP. NO. 93-533, at 11 (1974).

<sup>99</sup> ERISA § 402(a)(1) (1974), 29 U.S.C. § 1102(a)(1) (Supp. IV 1975).

<sup>100</sup> ERISA § 402(b) (1974), 29 U.S.C. § 1102(b) (Supp. IV 1975).

<sup>101</sup> ERISA § 403(a) (1974), 29 U.S.C. § 1103(a) (Supp. IV 1975). There was an exception, however, for any plan assets consisting of an insurance contract or policy issued by an insurance company qualified to do business in a state. ERISA § 403(b)(1) (1974), 29 U.S.C. § 1103(b)(1) (Supp. IV 1975).

cretionary authority or control over the plan assets held in trust.<sup>102</sup>

Congress created two important mechanisms for safeguarding plan assets. First, duties were imposed on plan fiduciaries.<sup>103</sup> Among them were the duties to act in the sole interest of participants and beneficiaries, to act with prudence, to diversify investments, and to act in accordance with the instruments governing the plan.<sup>104</sup> Second, ERISA Title I prohibited certain transactions between the plan and a party who stands to benefit from a transaction involving plan assets.<sup>105</sup> The fiduciary requirements created structural requirements for plans and imposed duties on those transacting with plan assets.

In addition to the rules applicable to all employee benefit plans, Title I of ERISA had two parts that only applied to pension benefit plans: participation and vesting rules, and funding rules.<sup>106</sup> These rules did not apply to any welfare benefit plans.

The first part applicable only to pension benefit plans covered the participation and vesting rules.<sup>107</sup> Participation standards were needed because many plans imposed overly restrictive age and service requirements, which needed to be met before an employee could participate in a plan.<sup>108</sup> These restrictions led to many employees being excluded from the private retirement system.<sup>109</sup> Congress enacted rules that would broaden an employee's right to participate in plans.<sup>110</sup> The new participation rules restricted the employer's right to condition plan participation on an employee being older than twenty-five years of age, or on a period extending beyond one year of service.<sup>111</sup> The age limit has since been reduced from twenty-five years of age to twenty-one.<sup>112</sup> In crafting the participation standards, Congress struck a balance between

<sup>102</sup>ERISA § 3(21) (1974), 29 U.S.C. § 1002(21) (Supp. IV 1975). There were additional types of conduct sufficient to render a party a fiduciary. *See id.*

<sup>103</sup>ERISA § 404 (1974), 29 U.S.C. § 1104 (Supp. IV 1975).

<sup>104</sup>ERISA § 404(a)(1) (1974), 29 U.S.C. § 1104(a)(1) (Supp. IV 1975).

<sup>105</sup>ERISA § 406 (1974), 29 U.S.C. § 1106 (Supp. IV 1975). *But see* ERISA § 408 (1974), 29 U.S.C. § 1108 (Supp. IV 1975) (exempting certain prohibited transactions).

<sup>106</sup>ERISA tit. I, pt. 2, 3 (1974), 29 U.S.C. §§ 1051–1085 (Supp. IV 1975). The purpose of these rules was to protect participants from abusive employer practices reducing the amount of benefits owed to employees. ERISA § 2 (1974), 29 U.S.C. § 1001 (Supp. IV 1975).

<sup>107</sup>ERISA § 201 (1974), 29 U.S.C. § 1051 (Supp. IV 1975).

<sup>108</sup>H.R. REP. NO. 93-807, at 3–4 (1974) (on H.R. 12855, 93d Cong. (1974), a predecessor of H.R. 2, 93d Cong. (1974)).

<sup>109</sup>*Id.*

<sup>110</sup>120 CONG. REC. 29,929 (1974) (statement of Sen. Williams).

<sup>111</sup>ERISA § 202(a)(1)(A) (1974), 29 U.S.C. § 1052(a)(1)(A) (Supp. IV 1975). After ERISA, plans were also required to allow an eligible employee to enter the plan as a participant on the earlier of six months after satisfying all participation requirements or the first day of the first plan year following satisfaction of all participation requirements. ERISA § 202(a)(4) (1974), 29 U.S.C. § 1052(a)(4) (Supp. IV 1975). There were also rules for calculating an employee's period of service and for determining what years an employee was entitled to receive credit for where he or she had a break in service. ERISA § 202(b) (1974), 29 U.S.C. § 1052(b) (Supp. IV 1975).

<sup>112</sup>ERISA § 202(a)(1)(A)(i) (1974), 29 U.S.C. § 1052(a)(1)(A)(i) (Supp. IV 1975), *amended by* Pub. L. 98-397, § 102(a), 98 Stat. 1426, 1426 (1984).

the need to grant employees the right to participate in plans with the need to avoid requiring plans to cover transient employees.<sup>113</sup>

Unless an employee was guaranteed the right to vest in his benefits, rules guaranteeing the right to coverage under a plan were all but meaningless.<sup>114</sup> To remedy this, ERISA contained minimum standards for the vesting of employer contributions.<sup>115</sup> Before 1974, nothing required an employer to vest an employee's benefits in the event he leaves or loses his job before retirement.<sup>116</sup> In times of layoffs and recessions, unemployment rises and vesting becomes even more important.<sup>117</sup>

With the enactment of ERISA Title I, if an employer contributed an amount to a retirement plan for the benefit of employees, then the plan was required to provide that an employee earned a nonforfeitable right after a specified number of years.<sup>118</sup> In addition, benefits under a defined benefit plan were required to accrue over years of participation, and accrued benefit formulas were generally prohibited from using certain discriminatory formulas.<sup>119</sup> Without these rules, the purpose of the vesting rules would be thwarted because employers would be allowed to provide the most valuable accruals just before retirement.<sup>120</sup> The new vesting rules provided security for employees in retirement by requiring retirement benefits to become nonforfeitable.

Other rules in this part required plans to offer a participant the right to elect an alternative form of benefit.<sup>121</sup> Before ERISA, plans were not required to offer a survivor annuity.<sup>122</sup> This created potential and real hardship for an individual who was dependent on his or her spouse's benefits for retirement income.<sup>123</sup> So, ERISA provided that plans were required to give a participant a distribution option where the benefit was payable for the joint lives of the participant and his or her spouse.<sup>124</sup>

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<sup>113</sup>H.R. REP. NO. 93-807, at 15 (1974) (on H.R. 12855, 93d Cong. (1974), a predecessor of H.R. 2, 93d Cong. (1974)).

<sup>114</sup>*Id.* at 18.

<sup>115</sup>ERISA § 203(a) (1974), 29 U.S.C. § 1053 (Supp. IV 1975). ERISA established a set of schedules with yearly percentages of vesting credit that an employee was required to receive under a plan. ERISA § 203(a)(2) (1974), 29 U.S.C. § 1053(a)(2) (Supp. IV 1975).

<sup>116</sup>H.R. REP. NO. 93-807, at 3. Although some employers provided vested benefits before retirement, most required lengthy periods of service before vesting a participant's benefits. *Id.*

<sup>117</sup>PRESIDENT'S COMMITTEE, *supra* note 47, at 33; *see also* Halperin, *supra* note 49, at 743.

<sup>118</sup>ERISA § 203 (1974), 29 U.S.C. § 1053 (Supp. IV 1975). The rules were not required to immediately and fully vest benefits because employers may have been deterred from providing benefits due to increased costs. H.R. REP. NO. 93-807, at 19.

<sup>119</sup>ERISA § 204 (1974), 29 U.S.C. § 1054 (Supp. IV 1975).

<sup>120</sup>Allan Gunn, *Participation and Vesting under the Employee Retirement Income Security Act of 1974*, 1975 U. ILL. L.F. 181, 186-87 (1975).

<sup>121</sup>ERISA § 205(a) (1974), 29 U.S.C. § 1055(a) (Supp. IV 1975).

<sup>122</sup>STAFF OF THE J. COMM. ON TAX'N, 93D CONG., *TAX TREATMENT OF PENSION PLANS PART ONE: PARTICIPATION, VESTING, FUNDING, PORTABILITY, INSURANCE, FIDUCIARY STANDARDS, REPORTING AND DISCLOSURE, AND ENFORCEMENT* 32 (Comm. Print 1973).

<sup>123</sup>*Id.*

<sup>124</sup>ERISA § 205 (1974), 29 U.S.C. § 1055 (Supp. IV 1975).

The second part that applied only to pension benefit plans was the minimum funding rules.<sup>125</sup> Even if a plan allows employees to participate in a plan and vests their benefits, employees receive no benefits if there are no funds to pay them.<sup>126</sup> The minimum funding rules required employers to adequately fund pension obligations on an ongoing basis.<sup>127</sup> Before ERISA, employers were free to elect to make contributions or continue making contributions, regardless of the amount set aside to pay promised benefits.<sup>128</sup> After ERISA, employers could no longer promise to pay benefits at retirement, fail to fund those benefits over the course of employment, and ultimately terminate the policy just before an employee's retirement. Employers were responsible for meeting certain funding obligations.

A consequence of creating parts that only applied to pension benefit plans was the lack of regulation on these aspects of welfare plans. The effect was to leave these provisions open to agreement by the parties. This was an intentional decision by Congress.<sup>129</sup> Take a moment to consider and appreciate the practical effect of this decision. Employers are free to reduce promised medical benefits unless agreed upon as nonforfeitable. In contrast, for retirement plans, benefits are required to vest after a certain period.

To enforce compliance with the new substantive requirements, ERISA Title I provided civil enforcement mechanisms.<sup>130</sup> Under the new law, benefit plans were to be provided under a plan, with a written plan document, and a trust to hold the assets. The right of the participants to receive benefits was protected, and the actions of fiduciaries with access to plan assets were restricted. Because ERISA preempted all state laws, there was no method of using a state cause of action to force compliance with the law. To effect compliance with the substantive provisions, the right to compel compliance was needed. So, Congress, under ERISA Title I, created statutorily prescribed civil actions.

There were several different statutorily prescribed civil actions.<sup>131</sup> The civil actions generally provided protections in three different types of circumstances.<sup>132</sup> First, certain parties were authorized to bring an action to enforce protections provided by ERISA Title I or terms of agreement.<sup>133</sup> Second, parties were authorized to bring an action where they wished to end actions that vio-

<sup>125</sup> ERISA tit. I, pt. 3 (1974), 29 U.S.C. §§ 1081–1086 (Supp. IV 1975). The funding rules were meant to prevent an employer from promising benefits to employees and then failing to adequately set aside funds for those promises.

<sup>126</sup> 120 CONG. REC. 4,279 (1974) (statement of Rep. Brademas).

<sup>127</sup> ERISA § 302 (1974), 29 U.S.C. § 1082 (Supp. IV 1975).

<sup>128</sup> PRESIDENT'S COMMITTEE, *supra* note 47, at 47.

<sup>129</sup> 129 CONG. REC. 29,942 (1974) (statement of Sen. Javits) (“[A] body of Federal substantive law will be developed by the courts to deal with issues involving rights and obligations under private welfare and pension plans”), *cited in* Firestone Tire & Rubber Co. v. Bruch, 489 U.S. 101, 110 (1989).

<sup>130</sup> ERISA § 502 (1974), 29 U.S.C. § 1132 (Supp. IV 1975).

<sup>131</sup> ERISA § 502(a) (1974), 29 U.S.C. § 1132(a) (Supp. IV 1975).

<sup>132</sup> *See generally* ERISA § 502 (1974), 29 U.S.C. § 1132 (Supp. IV 1975).

<sup>133</sup> *See, e.g.*, ERISA § 502(a)(1)(B) (1974), 29 U.S.C. § 1132(a)(1)(B) (Supp. IV 1975).

late the protections provided by ERISA Title I or the terms of agreement.<sup>134</sup> Third, parties were permitted to bring an action to enforce the fiduciary duties provided under the law.<sup>135</sup> Through the different types of civil actions, participants, beneficiaries, the Secretary of Labor, and plan fiduciaries were permitted to bring a cause of action.

## 2. Title II: New Tax Laws for Retirement Benefits

ERISA Title II had a different focus than ERISA Title I.<sup>136</sup> While Title I amended labor law under Title 29 of the United States Code, Title II amended the 1954 Code.<sup>137</sup> Besides relating to a different area of law, the rules in ERISA Title II applied to different benefits.<sup>138</sup> The amendments to tax law under ERISA Title II did not expansively apply to all employee benefit plans, both retirement and welfare benefits.<sup>139</sup> Instead, Title II generally related to qualified retirement plans.<sup>140</sup>

The amendments to the 1954 Code generally had two main focuses. First, Congress modified the qualification requirements for employer-provided retirement plans.<sup>141</sup> A good portion of ERISA Title II created new requirements that a plan needed to satisfy to maintain its status as a tax-qualified retirement plan.<sup>142</sup> The policy for some of the rules was similar to the policy underlying the addition of the coverage and nondiscrimination tests under the Revenue Act of 1942.<sup>143</sup> The new requirements addressed particular employer practices that threatened the efficiency and social policy underlying the provision of a substantial tax preference for qualified retirement plans.<sup>144</sup> In creating these new requirements, Congress was mindful of the importance of striking a delicate balance between placing additional requirements on employer-provided retirement plans and the cost of complying with the

<sup>134</sup> See, e.g., ERISA § 502(a)(3) (1974), 29 U.S.C. § 1132(a)(3) (Supp. IV 1975).

<sup>135</sup> ERISA § 502(2) (1974), 29 U.S.C. § 1132 (Supp. IV 1975).

<sup>136</sup> Compare ERISA tit. I (1974), 29 U.S.C. § 1001–1144 (Supp. IV 1975), with ERISA tit. II (1974), I.R.C. § 1 (amending the 1954 Code).

<sup>137</sup> Compare ERISA tit. I (1974), 29 U.S.C. § 1001 (Supp. IV 1975), with ERISA § 1001 (1974), I.R.C. § 410 (amending the 1954 Code).

<sup>138</sup> Compare ERISA tit. I (1974), 29 U.S.C. § 1001 (Supp. IV 1975), with ERISA tit. II (1974), I.R.C. § 1 (amending the 1954 Code).

<sup>139</sup> See ERISA tit. II (1974), I.R.C. § 1 (amending the 1954 Code).

<sup>140</sup> ERISA tit. II, subtit. A (1974), I.R.C. § 1 (amending the 1954 Code).

<sup>141</sup> 120 CONG. REC. 4,280 (1974) (statement of Rep. Madden). Title II did not only apply to employer-provided retirement plans but some sections applied to other types of retirement vehicles, such as Individual Retirement Accounts (IRAs). See, e.g., ERISA § 2002(b) (1974) (adding I.R.C. § 408, Individual Retirement Accounts to the 1954 Code); ERISA tit. II, subtit. A–B, §§ 1011–1024 (1974), I.R.C. § 1 (amending the 1954 Code).

<sup>142</sup> ERISA tit. II (1974), I.R.C. § 1 (amending the 1954 Code); H.R. REP. NO. 93-807, at 14 (1974) (on H.R. 12855, 93d Cong. (1974), a predecessor of H.R. 2, 93d (1974)).

<sup>143</sup> Revenue Act of 1942, ch. 619, § 162, 56 Stat. 798, 862; see *supra* discussion Part II.B.2.

<sup>144</sup> See H.R. REP. NO. 93-807, at 14 (on H.R. 12855, 93d Cong. (1974), a predecessor of H.R. 2, 93d (1974)).

requirements.<sup>145</sup> Because the employer-provided benefit system is a voluntary system, the effect of increased costs is important because employers may cease providing a retirement plan to employees if costs are too high.<sup>146</sup>

Many of the new qualification requirements under ERISA Title II were nearly identical to the provisions under ERISA Title I.<sup>147</sup> These provisions included the participation,<sup>148</sup> vesting,<sup>149</sup> and funding rules.<sup>150</sup> It is important to note that these were not only similar to the provisions in Title I—they were virtually identical.<sup>151</sup> Nonetheless, some of the new qualification requirements were not duplicated in ERISA Title I.<sup>152</sup> These provisions typically related to providing an unfettered right to the retirement plan tax preference. Extra qualification provisions promoted the policy of protecting and encouraging the provision of benefits. Along with these ends, the rules limited the tax expenditure for benefits. For example, Congress placed limitations on the amount of contributions and benefits that employees were permitted to receive under a plan.<sup>153</sup> Without these limits, extremely large retirement benefits could be provided to highly compensated employees at the expense of the public.<sup>154</sup> The new limits on benefits and contributions avoided abuse of the tax preference, while still permitting each participant to receive a sufficient retirement benefit.<sup>155</sup>

Second, Congress created certain rules that imposed excise taxes on certain conduct related to a qualified plan.<sup>156</sup> For example, Title II prohibited certain transactions involving plan assets.<sup>157</sup> Noncompliance resulted in the imposition of an excise tax.<sup>158</sup> Similar to the qualification requirements, the prohibited transaction rules in Title II were similar to those added to labor

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<sup>145</sup> *Id.* at 15.

<sup>146</sup> *Id.*

<sup>147</sup> *See, e.g.*, ERISA tit. I, § 203 (1974), 29 U.S.C. § 1053 (Supp. IV 1974); ERISA tit. II, § 1012 (1974), I.R.C. § 411 (amending the 1954 Code).

<sup>148</sup> ERISA tit. I, § 202 (1974), 29 U.S.C. § 1052 (Supp. IV 1975); ERISA § 1011 (1974), I.R.C. § 410(a) (amending the 1954 Code).

<sup>149</sup> ERISA tit. I, § 203 (1974), 29 U.S.C. § 1053 (Supp. IV 1975); ERISA tit. II, § 1012 (1974), I.R.C. § 411 (amending the 1954 Code).

<sup>150</sup> ERISA tit. I, § 302 (1974), 29 U.S.C. § 1082 (Supp. IV 1975); ERISA tit. II, § 1013 (1974), I.R.C. § 412 (amending the 1954 Code).

<sup>151</sup> *E.g.*, ERISA § 202, 29 U.S.C. § 1052 (Supp. IV 1975); ERISA § 1011 (1974), I.R.C. § 410(a) (1954); *see also* Halperin, *supra* note 49, at 741.

<sup>152</sup> Compare ERISA tit. I, 29 U.S.C. §§ 1001–1144, with ERISA tit. II (as codified in I.R.C. §§ 401(a)(16) and 415 of the 1954 Code).

<sup>153</sup> ERISA § 2004 (1974) (adding I.R.C. §§ 401(a)(16) and 415 to the 1954 Code).

<sup>154</sup> H.R. REP. NO. 93-807, at 35 (on H.R. 12855, 93d Cong. (1974), a predecessor of H.R. 2, 93d (1974)).

<sup>155</sup> *Id.*

<sup>156</sup> *See, e.g.*, ERISA § 2003 (1974), I.R.C. § 4975 (amending the 1954 Code).

<sup>157</sup> ERISA § 2003 (1974), I.R.C. § 4975(c) (amending the 1954 Code).

<sup>158</sup> ERISA § 2003 (1974), I.R.C. § 4975 (amending the 1954 Code).

law in ERISA Title I.<sup>159</sup> The difference, however, was the scope of the plans affected and the effect of a prohibited transaction.<sup>160</sup> Under Title II, only certain qualified retirement plans were covered, whereas the Title I rules applied to all employee benefit plans.<sup>161</sup> As for the effect of noncompliance, an excise tax was assessed on the amount involved in a prohibited transaction.<sup>162</sup> Ultimately, Title I and Title II of ERISA were interconnected even though the former changed labor law and the latter changed tax law.<sup>163</sup>

### 3. *Title III: Regulatory Jurisdiction*

Title III of ERISA covered various issues, but, of most importance, it allocated regulatory jurisdiction over ERISA. Congress assigned jurisdiction over Title I and Title II to both the DOL and Treasury.<sup>164</sup> Jurisdiction was split between these two agencies because some provisions under ERISA affected both labor law and tax law, while others only applied to either labor law or tax law.<sup>165</sup> The more fundamental reason for splitting jurisdiction was that administration and compliance with two sets of regulations, one from the DOL and another from Treasury, would make providing pensions too costly.<sup>166</sup>

Regulatory jurisdiction was important because some provisions were duplicated in both labor law and tax law.<sup>167</sup> Congress directed Treasury and the DOL to work together to avoid unnecessary expense and duplication.<sup>168</sup> Besides this general guidance, Congress allocated jurisdiction over some of the duplicative provisions. For the qualification provisions that are duplicated in both Title I and Title II, Congress gave Treasury the authority to prescribe regulations under some sections.<sup>169</sup> The DOL had the authority to prescribe regulations under other sections.<sup>170</sup> And for some other sections, Congress divided regulatory authority between Treasury and the DOL.<sup>171</sup> The effect of Congress's decision has puzzled many practitioners who infrequently handle matters related to benefits law. They have little luck finding the vast majority of the regulations for the vesting provisions under Title I because they are

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<sup>159</sup> See ERISA § 406 (1974), 29 U.S.C. § 1106 (Supp. IV 1975); ERISA § 2003 (1974), I.R.C. § 4975 (amending the 1954 Code).

<sup>160</sup> Compare ERISA § 406 (1974), 29 U.S.C. § 1106 (Supp. IV 1975), with ERISA § 2003 (1974), I.R.C. § 4975 (amending the 1954 Code).

<sup>161</sup> Compare ERISA § 502 (1974), 29 U.S.C. § 1132 (Supp. IV 1975), with ERISA § 2003 (1974), I.R.C. § 4975 (amending the 1954 Code).

<sup>162</sup> ERISA § 2003 (1974), I.R.C. § 4975 (amending the 1954 Code).

<sup>163</sup> See generally 119 CONG. REC. 29,995–30,000 (1973).

<sup>164</sup> ERISA § 3004 (1974), 29 U.S.C. 1204 (Supp. IV 1975).

<sup>165</sup> See *id.*

<sup>166</sup> 120 CONG. REC. 4,274 (1974).

<sup>167</sup> See, e.g., ERISA § 202 (1974), 29 U.S.C. § 1052 (Supp. IV 1975); ERISA § 1011, I.R.C. § 410 (amending the 1954 Code).

<sup>168</sup> ERISA § 3004(b) (1974), 29 U.S.C. § 1204 (Supp. IV 1975).

<sup>169</sup> ERISA § 3002(c) (1974), 29 U.S.C. § 1202 (Supp. IV 1975).

<sup>170</sup> ERISA § 505 (1974), 29 U.S.C. § 1135 (Supp. IV 1975).

<sup>171</sup> ERISA § 3004 (1974), 29 U.S.C. § 1204 (Supp. IV 1975).

Treasury Regulations, not DOL Regulations.<sup>172</sup> But Congress did not intend to puzzle non-benefits attorneys. Congress created a dual-jurisdictional scheme so that Treasury and the DOL would work together in carrying out complicated laws affecting two seemingly distinct areas of law—labor and tax—that were inseparably forged together in ERISA.<sup>173</sup>

#### 4. *Title IV: Defined Benefit Retirement Plan Insurance*

Before 1974, if an employer terminated a plan, regardless of the reason, the employer had no further obligation to make a contribution to the trust fund.<sup>174</sup> Beyond the contributions, employers incurred no liability to contribute to the plan.<sup>175</sup> The effect of the problem was evident, given that in 1972 “about 19,400 out of the 23,100 claimants in 546 plans lost benefits because of insufficient assets at plan termination.”<sup>176</sup>

To resolve the issue, Congress created the Pension Benefit Guaranty Corporation (PBGC) under Title IV of ERISA.<sup>177</sup> Congress charged the PBGC with administering an insurance plan for defined benefit plans in the event of insolvency.<sup>178</sup> The new insurance program was thought of as similar to the insurance provided by the Federal Deposit Insurance Corporation.<sup>179</sup> The PBGC insurance program was to be funded by premium payments from defined benefit plans.<sup>180</sup> The insurance premiums would pay for any vested unfunded liabilities upon termination.<sup>181</sup> Even with the new funding requirements, plans were not required to be fully funded because the market value

<sup>172</sup> See Reg. §§ 1.411(a)-1 to -11; 29 C.F.R. §§ 2530.203-1 to -03 (2007).

<sup>173</sup> ERISA § 3004(a), 29 U.S.C. § 1204 (Supp. IV 1975). In addition, the goal was to efficiently administer the laws regulating employee benefits. For example, Treasury was required to consult with the DOL before sending a tax bill to a retirement plan for a prohibited transaction. ERISA § 3003 (1974), 29 U.S.C. § 1203 (Supp. IV 1975).

<sup>174</sup> PRESIDENT’S COMMITTEE, *supra* note 47, at 57–58.

<sup>175</sup> *Id.*

<sup>176</sup> DEPT. OF THE TREASURY & DEPT. OF LABOR, STUDY ON PENSION PLAN TERMINATIONS, 1972, at 18 (1973); see also 120 CONG. REC. 4,289 (1974) (statement of Rep. Railsback).

<sup>177</sup> ERISA § 4002 (1974), 29 U.S.C. § 1302 (Supp. IV 1975).

<sup>178</sup> *Id.* Defined contribution plans were not covered because their benefits were defined based on the amount of the employer contribution, rather than in terms of promised, defined benefits to be paid in the future. 119 CONG. REC. 33,267 (1973) (Summary of H.R. 4200).

<sup>179</sup> 120 CONG. REC. 4,279 (1974) (statement of Rep. Perkins); see also *Private Pension Plan Reform Part I: Hearings Before the Subcomm. on Private Pension Plans of the S. Comm. on Finance*, 93d Cong. 352 (1973) (statement of Hon. George P. Schultz, Secretary of the Treasury); *Private Pension Plan Reform Part I: Hearings Before the Subcomm. on Private Pension Plans of the S. Comm. on Finance*, 93d Cong. 436–44 (1973) (statement of Paul J. Fasser, Assistant Secretary of Labor for Labor-Management).

<sup>180</sup> ERISA § 4007 (1974), 29 U.S.C. § 1307 (Supp. IV 1975); see Press Release, Staff of the S. Fin. Comm., Summary of Printed Amendments Intended to be Proposed to Pension Reform Bill (Sept. 19, 1973) (on file with author).

<sup>181</sup> STAFF OF THE J. COMM. ON TAX’N, 93D CONG., TAX TREATMENT OF PENSION PLANS PART ONE: PARTICIPATION, VESTING, FUNDING, PORTABILITY, INSURANCE, FIDUCIARY STANDARDS, REPORTING AND DISCLOSURE, AND ENFORCEMENT 38–44 (Comm. Print 1973).

of assets varies from year to year.<sup>182</sup> With ERISA Title IV, Congress created a way to ensure that defined benefit plan participants would not be forced to accept insolvency or forsaken promises as the rationale for why their employer did not provide promised benefits. Put another way, Congress systematically insured defined benefit plans without using taxpayer money.

#### D. *Significant Developments Since 1974*

Since ERISA's enactment in 1974, employee benefits law has changed so many times that it is nearly impossible to keep track of all of the changes. The developments have been broad, encompassing legislative and regulatory changes. In the immediate aftermath of ERISA, the DOL and Treasury prescribed many regulations. In addition, Congress passed new laws, which amended the existing rules. Some of the provisions applied to health and welfare plans, others applied to retirement plans, and some to both.

Significant changes to retirement benefits and health and welfare benefits were enacted in 1978. Amendments to the 1954 Code created incentives that allowed employees to receive a tax preference for paying for a portion of their benefits. First, under the Revenue Act of 1974, Congress added the cash or deferred arrangement as an optional feature for certain types of qualified retirement plans.<sup>183</sup> These are more commonly known as "401(k) plans" because they were codified in that section of the 1954 Code.<sup>184</sup> Second, Congress created the cafeteria plan.<sup>185</sup> Under a cafeteria plan, an employee may elect to have the employer contribute an amount of compensation toward certain health and welfare benefits rather than receive the compensation and include it in income.<sup>186</sup> Employers may allow employees to elect to contribute compensation before taxation.<sup>187</sup> Part of the policy for creating cafeteria plans was to require employers to provide health and welfare benefits to employees on a nondiscriminatory basis.<sup>188</sup> Cafeteria plans served a similar function to the early qualification requirements for retirement plans. In addition to cafeteria plans, Congress created a number of tax-free benefits, such as dependent care assistance programs,<sup>189</sup> qualified legal service plans,<sup>190</sup> educational

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<sup>182</sup> *Id.* at 39.

<sup>183</sup> Revenue Act of 1978, Pub. L. No. 95-60, § 135, 92 Stat. 2763, 2785-87 (adding section 401(k) to the 1954 Code).

<sup>184</sup> *Id.*

<sup>185</sup> *Id.* § 134, 92 Stat. at 2783-85 (adding section 125 to the 1954 Code).

<sup>186</sup> *Id.*

<sup>187</sup> *Id.*

<sup>188</sup> Daniel C. Schaffer & Daniel M. Fox, *Tax Law as Health Policy: A History of Cafeteria Plans 1978-1985*, 8 AM. J. TAX POL'Y 1, 5 (1989).

<sup>189</sup> I.R.C. § 129 (added by the Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 124, 95 Stat. 172, 198-201).

<sup>190</sup> I.R.C. § 120 (added by the Tax Reform Act of 1976, Pub. L. No. 94-455, § 2134(a), 90 Stat. 1520, 1926-27).

assistance programs,<sup>191</sup> and qualified commuter transportation programs.<sup>192</sup>

There were a significant number of changes to benefits law after 1978. Some of the changes continued ERISA's tradition of amending labor law and tax law. For example, Congress passed two major changes in the Consolidated Omnibus Budget Reconciliation Act of 1986 (COBRA)<sup>193</sup> and the Health Insurance Portability and Accountability Act of 1996 (HIPAA).<sup>194</sup> COBRA amended the Code and ERISA Title I to require group health plans to provide continuation health coverage upon the occurrence of certain events yielding a separation of service.<sup>195</sup> Similar provisions were provided in both ERISA Title I and the Code.<sup>196</sup> Noncompliance with the continuation coverage provisions under ERISA Title I created a cause for a civil action,<sup>197</sup> and the provisions under the Code imposed an excise tax.<sup>198</sup> HIPAA amended the Code and ERISA Title I to restrict a health insurance issuer's right to refuse to cover certain preexisting conditions.<sup>199</sup> As for retirement plans, the Pension Protection Act of 2006 (PPA of 2006) amended the minimum funding requirements under ERISA and the Code, and created automatic enrollment.<sup>200</sup> Some important changes for retirement plans only affected the Code, such as the changes to the limits on retirement contributions under the Tax Reform Act of 1986<sup>201</sup> and the Economic Growth and Tax Relief Reconciliation Act of 2001.<sup>202</sup>

The changes under the Code for retirement plans and health and welfare plans were similar to some extent, but dissimilar in a more fundamental respect. Some new Code requirements for health and welfare plans and retirement plans were similar in that they imposed excise taxes on certain prohibited conduct<sup>203</sup> and conditioned receipt of tax-preferred status on compliance with

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<sup>191</sup>I.R.C. § 127 (added by the Revenue Act of 1978, Pub. L. No. 95-600, § 164(a), 92 Stat. 2763, 2811-13).

<sup>192</sup>I.R.C. § 132(a)(5) (added by the Energy Tax Act of 1978, Pub. L. No. 95-618, § 242(a), 92 Stat. 3174, 3193-94 (originally codified as I.R.C. § 124)).

<sup>193</sup>Pub. L. No. 99-272, 100 Stat. 82.

<sup>194</sup>Pub. L. No. 104-191, 110 Stat. 1936.

<sup>195</sup>ERISA tit. I, pt. 6 (1986), 29 U.S.C. §§ 1161-1169 (Supp. IV 1987); I.R.C. § 162(k) (recodified at I.R.C. § 4980B(f), (g) by the Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, § 3011, 102 Stat. 3342, 3619-20).

<sup>196</sup>ERISA § 601 (1986), 29 U.S.C. § 1161 (Supp. IV 1987); I.R.C. § 4980B(f).

<sup>197</sup>ERISA § 502, 29 U.S.C. § 1132 (2006).

<sup>198</sup>I.R.C. § 4980B(a).

<sup>199</sup>Pub. L. No. 104-191, 110 Stat. 1936; ERISA tit. I, pt. 7 (1996), 29 U.S.C. §§ 1181-1183 (Supp. III 1997); I.R.C. § 9801-9806 (1996).

<sup>200</sup>Pub. L. No. 109-280, §§ 101, 902, 120 Stat. 780, 784, 1033.

<sup>201</sup>Pub. L. No. 99-514, § 1101, 100 Stat. 2085, 2411-14.

<sup>202</sup>Pub. L. No. 107-16, § 611, 115 Stat. 38, 96-100.

<sup>203</sup>For example, for health plans, Congress imposed an excise tax under the Code for non-compliance with the new rules concerning continuation coverage and preexisting conditions. I.R.C. §§ 4980B, 4980D. For retirement plans, Congress imposed an excise tax under the Code on certain excessive contributions to certain plans. Tax Reform Act of 1986, Pub. L. No. 99-514, § 1117(b)(1), 100 Stat. 2085, 2459-63 (adding I.R.C. § 4979).

additional requirements. Excise taxes were primarily used to regulate health plans, not retirement plans.<sup>204</sup> Retirement plans used a different approach. The retirement plan rules under the Code built upon the trend established with the adoption of the nondiscrimination and coverage requirements in the Revenue Act of 1942—conditioning qualification on compliance with specific requirements.<sup>205</sup> The growth of new qualification requirements was fast and furious. In 1974, section 401(a) had ten requirements, while section 401(a) in 2010 had thirty-seven requirements.<sup>206</sup> In contrast, the Code rules relating to health and welfare plans generally never conditioned receipt of the tax preference on compliance with specific requirements. Yet, there were some requirements, such as the nondiscrimination rules for cafeteria plans.<sup>207</sup> In addition, for example, the section 105(h) nondiscrimination test for self-insured reimbursement plans limits a plan's ability to benefit highly compensated individuals.<sup>208</sup> Where a plan complies with that test, an employee may exclude from income reimbursement payments from an employer.<sup>209</sup> If a self-insured reimbursement plan does not satisfy the section 105(h) test, then the employee must include such reimbursement payments in income.<sup>210</sup>

In addition to the various changes to tax law and labor law, employee benefits intersect with other parts of law. These include the Americans with Disabilities Act<sup>211</sup>, the Bankruptcy Code,<sup>212</sup> the Civil Rights Act,<sup>213</sup> family Law, labor and employment Law, and others.<sup>214</sup> In addition to these other areas of law, the regulation under ERISA created another sphere of rules. That sphere was federal common law, and it acted to fill the gaps in the regulatory system created by the acts of Congress.<sup>215</sup>

### III. An Explanation of the Regulatory System for Employee Benefits

The historical development of the regulatory system for retirement plans and health and welfare plans left many wrinkles deep in the law. Incremental change created a complex code full of pitfalls, which grew deeper with each

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<sup>204</sup> See I.R.C. subtit. D, ch. 43.

<sup>205</sup> For example, defined benefit plans were required to pass an additional coverage test in the Tax Reform Act of 1986. Pub. L. No. 99-514, § 1112(a), 100 Stat. 2085, 2440-44 (codified at I.R.C. § 401(a)(26)).

<sup>206</sup> Compare I.R.C. § 401(a) (1954), amended by ERISA 1974, Pub. L. No. 93-406, 88 Stat. 829, with I.R.C. § 401(a) (2006 & Supp. II 2008).

<sup>207</sup> I.R.C. § 125(b).

<sup>208</sup> Revenue Act of 1978, Pub. L. No. 95-600, § 366(a), 92 Stat. 2763, 2855.

<sup>209</sup> *Id.*

<sup>210</sup> *Id.*

<sup>211</sup> See, e.g., Pub. L. No. 101-336, tit. I, 104 Stat. 327, 330 (governing employment of Americans with disabilities).

<sup>212</sup> See, e.g., 11 U.S.C. § 1301 (governing debt adjustments for employed individuals).

<sup>213</sup> See, e.g., Pub. L. No. 88-352, tit. VII, 78 Stat. 241 (governing Equal Employment Opportunity).

<sup>214</sup> See, e.g., 29 U.S.C. § 2612 (2006) (governing Family and Medical Leave).

<sup>215</sup> Conison, *supra* note 71, at 620; see also Conison, *supra* note 79, at 1098-1118.

new layer of regulation. Two distinct areas of law, tax law and labor law, were molded together to create a unique regulatory landscape.<sup>216</sup> In drafting the regulatory system, Congress challenged conventional understandings of tax law and labor law. The architects of the regulatory system created a framework that would drive the approach used by subsequent generations to modify and amend it.

The mechanisms for compelling compliance with regulation were fundamental to the creation of the regulatory system. Congress used a combination of sanctions and incentives to secure health and retirement security. Congress, however, did not uniformly use these mechanisms. Under tax law, Congress created incentives to promote the employer-provided system,<sup>217</sup> and sanctions in the form of excise taxes to discourage disfavored conduct.<sup>218</sup> Under labor law, Congress compelled compliance with rules protecting participant rights by imposing sanctions through civil enforcement.<sup>219</sup> The imposition of both sanctions and incentives formed the bedrock of Congress's approach to regulating employer-provided retirement and health plans.

This Part explains the regulatory system for employer-provided retirement plans and health and welfare plans. Much of the difficulty with understanding employee benefits manifests from the relationship between labor law and tax law, and the relationship between the sanctions that protect participant rights and the incentives that promote the provision of employer-provided benefits. To understand the interconnectedness of the law, one must understand the structure of the system and how different types of rules function within it. The structure of the system is formed by overlapping labor law and tax law. Within the structure, two rule formulations—the incentive formulation and the sanction formulation—function to regulate employee benefit plans.

### A. *The Overlapping System of Laws*

Understanding the regulatory approach to employee benefits law requires an appreciation of its historical development. The following is a reprisal of Part II of this Article. In the beginning, there was no regulation.<sup>220</sup> Then, Congress created incentives under the Code for employer-provided retirement plans and health and welfare plans.<sup>221</sup> Next, tax qualification requirements for retirement plans were added to the Code.<sup>222</sup> After that, Congress enacted ERISA, which added additional qualification requirements for retirement plans,<sup>223</sup> and substantive regulation for all employee benefit plans.<sup>224</sup> Post-ERISA, the

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<sup>216</sup> See discussion *infra* Part III.A.

<sup>217</sup> See, e.g., I.R.C. § 401(a).

<sup>218</sup> See, e.g., I.R.C. § 4975.

<sup>219</sup> ERISA § 502, 29 U.S.C. § 1132 (2006).

<sup>220</sup> See discussion *supra* Part II.A.

<sup>221</sup> See discussion *supra* Part II.B.

<sup>222</sup> See discussion *supra* Part II.B.2.

<sup>223</sup> See discussion *supra* Part II.C.2.

<sup>224</sup> See discussion *supra* Part II.C.1.

law for retirement plans and health and welfare plans evolved differently.<sup>225</sup>

To facilitate the explanation of the overlapping system of laws, assume that an ERISA employee benefit plan<sup>226</sup> is at issue. Where an ERISA plan is at issue, the provisions under ERISA Title I apply.<sup>227</sup> Of particular note, ERISA Title I preempts all state laws that relate to the plan.<sup>228</sup> In other words, federal laws regulating employer-provided benefit plans are the only concern.

### 1. *The Overlapping System for Retirement Benefits*

Explaining the overlapping system of regulation for retirement plans under Title I of ERISA and the Code is most efficient with the aid of a mental image. For retirement plans, think of a blank sheet of paper. It is the world of employer-provided retirement plans without regulation—existing in a state of nature, anything goes. Now, imagine that a dot is placed on the clean, white sheet of paper. The dot signifies an employer-provided retirement plan that is about to be regulated by the federal government.

Next, imagine that a circle appears around the dot. It symbolizes that the retirement plan must comply with the substantive requirements under Title I of ERISA. As a retirement plan within the scope of Title I, it must comply with the reporting and disclosure provisions,<sup>229</sup> participation and vesting rules,<sup>230</sup> minimum funding standards,<sup>231</sup> fiduciary requirements,<sup>232</sup> and the plan administration provisions.<sup>233</sup> Failure to comply with these requirements prompts the application of the ERISA enforcement provisions.<sup>234</sup> Further, ERISA preempts all state laws that relate to employer-provided retirement plan.<sup>235</sup> When taken together, the substantive provisions of ERISA Title I and ERISA preemption create a comprehensive system that substantively regulates employer-provided retirement plans.

Next, imagine that a concentric circle surrounds both the retirement plan dot and the ERISA Title I circle. This circle signifies the legal requirements under the Code. The requirements under the Code primarily relate to plan qualification, whereby receipt of tax benefits is conditioned on compliance.<sup>236</sup>

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<sup>225</sup> See discussion *supra* Part II.D.

<sup>226</sup> As defined in ERISA section 3(3), 29 U.S.C. § 1002(3) (2006).

<sup>227</sup> ERISA § 4(a), 29 U.S.C. § 1003 (2006).

<sup>228</sup> ERISA § 514(a), 29 U.S.C. § 1144 (2006). The exceptions to this rule are those state laws that regulate insurance, banking, or securities. ERISA § 514(b), 29 U.S.C. § 1144(b) (2006).

<sup>229</sup> ERISA tit. I, pt. 1, 29 U.S.C. §§ 1021–1031 (2006).

<sup>230</sup> ERISA tit. I, pt. 2, 29 U.S.C. §§ 1051–1061 (2006).

<sup>231</sup> ERISA tit. I, pt. 3, 29 U.S.C. §§ 1081–1086 (2006).

<sup>232</sup> ERISA tit. I, pt. 4, 29 U.S.C. §§ 1101–1114 (2006).

<sup>233</sup> ERISA tit. I, pt. 5, 29 U.S.C. §§ 1131–1147 (2006).

<sup>234</sup> ERISA §§ 501–502, 29 U.S.C. §§ 1131–1132 (2006).

<sup>235</sup> ERISA § 514(a), 29 U.S.C. § 1144(a) (2006). The exceptions to this rule are those state laws that regulate insurance, banking, or securities. ERISA § 514(b)(2), 29 U.S.C. § 1144(b) (2) (2006).

<sup>236</sup> I.R.C. § 401(a).

A plan does not need to comply with all of these rules if it is not designed to be a qualified plan because only some rules apply under both ERISA Title I and the qualification requirements.<sup>237</sup> Where a plan is designed to be a qualified plan, there are substantial additional requirements because some of the qualification rules do not appear in ERISA Title I. Among the most important of these are the nondiscrimination requirements under section 401(a)(4) and the coverage test under section 410(b). In addition to the qualification requirements, some rules must be complied with in order to avoid the imposition of excise taxes.<sup>238</sup>

The rules within the two circles that surround the dot are not mutually exclusive. In other words, if a plan complies with all of the ERISA Title I rules, it has already complied with some of the qualifications requirements under the Code. The repeated rules include plan participation provisions,<sup>239</sup> vesting rules,<sup>240</sup> and the minimum funding standards.<sup>241</sup>

## 2. *The Overlapping System for Health and Welfare Benefits*

Health and welfare plans have a different regulatory structure even though both ERISA Title I and the Code regulate plans. Once again, imagine a blank sheet of white paper. The sheet of paper is the world of employer-provided health and welfare plans without regulation. Now, imagine that a dot is placed on the clean, white sheet of paper. The dot represents an employer-provided health and welfare plan that is about to be regulated by the federal government.

Next, imagine that a circle surrounds the dot. This circle represents that the health and welfare plan was structured to take advantage of certain tax preferences applicable to employer-provided health and welfare benefits under the Code. In addition, although there are generally not many conditions for receiving the tax preference, the plan must meet certain requirements in order to avoid an excise tax.<sup>242</sup> The requirements include limitations on preexisting condition exclusions,<sup>243</sup> prohibitions against discriminating based on an individual's health status,<sup>244</sup> standards relating to benefits for new mothers and newborns,<sup>245</sup> the mental health parity act,<sup>246</sup> and others.<sup>247</sup>

Next, imagine that a concentric circle surrounds the plan dot and the Code circle. This circle signifies the requirements under ERISA Title I with

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<sup>237</sup> See discussion *supra* Part II.C.2.

<sup>238</sup> *E.g.*, I.R.C. § 4975.

<sup>239</sup> ERISA § 202, 29 U.S.C. § 1052 (2006); I.R.C. § 410(a).

<sup>240</sup> ERISA § 203, 29 U.S.C. § 1053 (2006); I.R.C. § 411(a).

<sup>241</sup> ERISA § 301, 29 U.S.C. § 1082 (2006); I.R.C. § 412.

<sup>242</sup> I.R.C. § 4980D. The excise tax applies where a group health plan fails to comply with chapter 100 of the Code. I.R.C. § 4980D(a).

<sup>243</sup> I.R.C. § 9801.

<sup>244</sup> I.R.C. § 9802.

<sup>245</sup> I.R.C. § 9811.

<sup>246</sup> I.R.C. § 9812.

<sup>247</sup> All of the requirements are contained in chapter 100 of the IRC.

which the health and welfare plan must comply. A health and welfare plan that is a welfare benefit plan that is within the scope of ERISA Title I must comply with numerous requirements. These include the reporting and disclosure requirements,<sup>248</sup> fiduciary responsibilities,<sup>249</sup> plan administration requirements,<sup>250</sup> continuation coverage rules,<sup>251</sup> and the preexisting condition provisions,<sup>252</sup> among others. Noncompliance with these requirements generally triggers the application of the civil enforcement provisions.<sup>253</sup> Also, ERISA Title I preempts all state laws that relate to employer-provided health and welfare plans.<sup>254</sup> The preemption clause, however, provides an exception for state laws that regulate insurance.<sup>255</sup> Thus, the substantive provisions of ERISA Title I and the ERISA preemption provision, when taken together, generally create a comprehensive system that substantively regulates employer-provided benefit plans.

### B. *The Two Rule Formulations*

Within the overlapping system of laws, ERISA Title I and the Code provide the rules for regulating employee benefits. Each rule is either linked to the receipt of a benefit for compliance or the imposition of a sanction for non-compliance. To help understand how these rules are used within the overlapping system, the rules can be classified using two rule formulations: the incentive formulation and the sanction formulation. Congress used these rule formulations differently under tax law and labor law. In addition, Congress applied these rule formulations differently to retirement benefits and health and welfare benefits.

#### 1. *The Sanction Formulation and the Incentive Formulation*

ERISA Title I and the Code use two rule formulations to regulate employer-provided benefit plans: the sanction formulation and the incentive formulation.

The first rule formulation is the sanction formulation. This rule formulation states the following: *noncompliance with X rule causes the imposition of Y sanction*. In other words, Y sanction is imposed upon a plan if it fails to comply with X rule. Both ERISA Title I and the Code use the sanction formulation. Each, however, uses a different sanction mechanism. Under Title I of ERISA, the civil enforcement provisions are the mechanism for imposing

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<sup>248</sup>ERISA tit. I, pt. 1, 29 U.S.C. §§ 1021–1031 (2006).

<sup>249</sup>ERISA tit. I, pt. 4, 29 U.S.C. §§ 1101–1114 (2006).

<sup>250</sup>ERISA tit. I, pt. 5, 29 U.S.C. §§ 1131–1147 (2006).

<sup>251</sup>ERISA tit. I, pt. 6, 29 U.S.C. §§ 1162–1169 (2006).

<sup>252</sup>ERISA tit. I, pt. 7, 29 U.S.C. §§ 1181–1183 (2006).

<sup>253</sup>ERISA § 502, 29 U.S.C. § 1132 (2006).

<sup>254</sup>ERISA § 514(a), 29 U.S.C. § 1144(a) (2006). The exceptions to this rule are those state laws that regulate insurance, banking, or securities. ERISA § 514(b)(2), 29 U.S.C. § 1144(b)(2) (2006).

<sup>255</sup>ERISA § 514(b)(2), 29 U.S.C. § 1144(b)(2) (2006).

sanctions.<sup>256</sup> Noncompliance with a rule causes the potential for the imposition of civil sanctions, and the potential for equitable relief.<sup>257</sup> Under the Code, an excise tax is the sanction mechanism.<sup>258</sup> Noncompliance with a rule causes the imposition of an excise tax.<sup>259</sup>

The second rule formulation is the incentive formulation. This rule formulation states the following: *noncompliance with X rule causes the loss of the right to receive Y benefit*. In other words, a plan does not have a right to receive Y benefit unless it complies with X rule. The incentive formulation is only used in the Code. The incentives provided under the Code are the tax preferences for providing the benefit. Sometimes the Code offers a tax preference merely for providing a benefit. At other times, receipt of the tax preference is conditioned upon satisfying certain requirements.<sup>260</sup> In the event the plan does not comply with the requirements, it loses the tax preference.

## 2. *Applying the Two Rule Formulations to Labor Law and Tax Law*

In creating the regulatory system for employer-provided benefit plans, Congress has passed laws using the sanction formulation and the incentive formulation. The two rule formulations have been used to change and amend ERISA Title I and the Code. Given that one is a labor law and the other is a tax law, the type of rule formulation used has differed. Thus, in developing the overlapping system of laws to regulate benefit plans, Congress crafted rules for each part of the system using different rule formulations.

The rules under ERISA Title I use the sanction formulation. ERISA Title I provides rules that protect participant rights.<sup>261</sup> Employee benefit plans that do not comply with these rules under ERISA Title I are subject to the imposition of sanctions under the civil enforcement provisions or other sanction mechanisms.<sup>262</sup> Many different parties are permitted to bring an action, including participants, beneficiaries, the Secretary of Labor, and fiduciaries.<sup>263</sup> These parties are able to gain relief through the imposition of civil sanctions imposed on the party against whom the civil action is brought.<sup>264</sup> Some of the rules permit a party to attain relief from the benefit plan.<sup>265</sup> Also, other rules permit a party to attain relief directly from the fiduciary or other party responsible for noncompliance.<sup>266</sup> Further, some rules permit the Secretary of

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<sup>256</sup> See, e.g., ERISA § 502(a)(5), 29 U.S.C. § 1132(a)(5) (2006) (permitting, among other things, the Secretary of Labor to bring a civil action to enjoin any act or practice in violation of any provision under Title I of ERISA).

<sup>257</sup> ERISA § 502 (a)(3), 29 U.S.C. § 1132(a)(3) (2006).

<sup>258</sup> See, e.g., I.R.C. § 4980B(a).

<sup>259</sup> See I.R.C. § 4980D.

<sup>260</sup> See, e.g., I.R.C. § 401(a).

<sup>261</sup> ERISA tit. I, 29 U.S.C. §§ 1001–1191c (2006).

<sup>262</sup> See, e.g., ERISA § 502, 29 U.S.C. § 1132 (2006).

<sup>263</sup> See *id.*

<sup>264</sup> See *id.*

<sup>265</sup> See ERISA § 502(d), 29 U.S.C. § 1132(d) (2006).

<sup>266</sup> See, e.g., ERISA § 405, 29 U.S.C. § 1105 (2006).

Labor to impose sanctions for noncompliance with the rules.<sup>267</sup> For each of these cases, Congress prescribed specific sanctions, which were not the same for all rules.<sup>268</sup> Depending on which rule a party failed to comply with, the sanction imposed on a particular party is a statutorily specified amount or other relief.<sup>269</sup> In addition, criminal penalties may apply where a person willfully violates certain rules under ERISA Title I.<sup>270</sup> Thus, under ERISA Title I, Congress passed laws to protect participant rights that imposed civil sanctions for noncompliance.

The following are some examples of the application of the sanction formulation under ERISA Title I. First, an employee benefit plan must comply with the reporting and disclosure requirements, or else it may suffer a sanction in the form of a monetary fine.<sup>271</sup> Second, a pension benefit plan must comply with the fiduciary responsibilities, or else sanctions may be imposed under the enforcement provisions.<sup>272</sup> Third, a health plan must provide continuation coverage, or else it may suffer sanctions under the enforcement provisions.<sup>273</sup>

The Code uses both the sanction formulation and the incentive formulation to regulate benefit plans. The incentive formulation is applied a few different ways under the Code. First, the incentive formulation is used where a tax preference is given for the provision of a benefit.<sup>274</sup> For example, an employee receives the exclusion for employer contributions under section 105 so long as a qualifying benefit is provided. Second, the incentive formulation is used where Congress provides a tax preference so long as certain requirements are met in providing a benefit.<sup>275</sup> In these instances, Congress offers tax preferences so long as a certain type of benefit is provided, and so long as certain requirements are satisfied when the benefit is provided. For example, a retirement plan is qualified, and thus receives several tax preferences, so long as the plan complies with the requirements under section 401(a).

In addition to the incentive formulation, the Code provides rules regulating benefit plans stated in the sanction formulation. Rules in the sanction formulation provide that noncompliance with a requirement that is related to the provision of the benefit causes the imposition of an excise tax.<sup>276</sup> The excise tax may be assessed against different parties, including the employer

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<sup>267</sup> See, e.g., ERISA § 502(c), 29 U.S.C. § 1132(c) (2006).

<sup>268</sup> See ERISA § 502, 29 U.S.C. § 1132 (2006).

<sup>269</sup> See ERISA § 502(a), 29 U.S.C. § 1132(a) (2006).

<sup>270</sup> ERISA § 501, 29 U.S.C. § 1131 (2006).

<sup>271</sup> ERISA § 502(c), 29 U.S.C. § 1132(c) (2006).

<sup>272</sup> ERISA §§ 405, 409, 502(a)(2), 29 U.S.C. §§ 1105, 1109, 1132(a)(2) (2006).

<sup>273</sup> ERISA § 502, 29 U.S.C. § 1132 (2006).

<sup>274</sup> See, e.g., I.R.C. § 105.

<sup>275</sup> See, e.g., I.R.C. §§ 105(h), 401(a).

<sup>276</sup> See, e.g., I.R.C. § 4975.

maintaining the plan<sup>277</sup> and a party involved in the event that resulted in the violation of a rule.<sup>278</sup>

### 3. *Regulating Employee Benefits with Two Rule Formulations*

Congress created an overlapping system of laws to regulate retirement plans and health and welfare plans. Although the system developed differently for retirement plans and health and welfare plans, the rules that regulate both types of plans are provided under ERISA Title I and the Code. In addition, Congress used both the incentive formulation and the sanction formulation to regulate retirement plans and health and welfare plans. Yet, even though the rules for both types of plans are stated in ERISA Title I and the Code, and the rules regulating the plans used both rule formulations, the overlapping system of laws for retirement plans and health and welfare plans developed differently because each uses the two rule formulations differently.

As Congress developed the regulatory system for retirement plans, the system used both the sanction formulation and the incentive formulation. First, the rules under ERISA Title I are stated in the sanction formulation. As previously discussed, the rules under ERISA Title I protect participant rights, including compliance with the reporting and disclosure provisions,<sup>279</sup> participation and vesting rules,<sup>280</sup> minimum funding standards,<sup>281</sup> fiduciary requirements,<sup>282</sup> and plan administration provisions.<sup>283</sup> With these rules, Congress created rules that protected retirement security. To facilitate compliance, Congress developed a system for compelling compliance with civil enforcement. Thus, Congress enacted laws using the sanction formulation to protect participant rights.

Second, the rules regulating retirement plans under the Code are stated in both the incentive formulation and the sanction formulation. The incentive formulation is used to create the system for tax-qualified plans. Numerous requirements under section 401(a) must be complied with in order to receive the benefit of tax qualification, which is a significant tax preference. In addition, the sanction formulation is used to regulate certain parts of retirement plan operation. In certain instances, the rules under the Code impose an excise tax for noncompliance with a plan requirement. Thus, to regulate retirement plans under the Code, Congress used both the incentive formulation and the sanction formulation to regulate employer-provided retirement plans.

Similar to the system for regulating retirement plans, Congress used both the incentive formulation and the sanction formulation to regulate health and welfare plans. First, as previously discussed, the rules under ERISA

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<sup>277</sup> See, e.g., I.R.C. § 4980.

<sup>278</sup> See, e.g., I.R.C. § 4975.

<sup>279</sup> ERISA tit. I, pt. 1, 29 U.S.C. §§ 1021–1031 (2006).

<sup>280</sup> ERISA tit. I, pt. 2, 29 U.S.C. §§ 1051–1061 (2006).

<sup>281</sup> ERISA tit. I, pt. 3, 29 U.S.C. §§ 1081–1086 (2006).

<sup>282</sup> ERISA tit. I, pt. 4, 29 U.S.C. §§ 1101–1114 (2006).

<sup>283</sup> ERISA tit. I, pt. 5, 29 U.S.C. §§ 1131–1147 (2006).

Title I protect participant rights, including the reporting and disclosure requirements,<sup>284</sup> fiduciary responsibilities,<sup>285</sup> plan administration,<sup>286</sup> continuation coverage rules,<sup>287</sup> and the preexisting condition provisions,<sup>288</sup> among others. With these rules, Congress created rules to protect certain participant rights under an employer-provided plan. These rights were safeguarded with the civil enforcement provision.

Second, the rules under the Code use both the incentive formulation and the sanction formulation. The incentive formulation is used to regulate employer-provided health and welfare plans by providing a tax preference where an employer provides a certain type of benefit. In general, the tax preference is provided if a certain type of benefit is offered. However, with the exception of the nondiscrimination test under sections 105(h) and 125, and others, health and welfare plans are not required to satisfy a legion of requirements in order to receive a tax preference. The sanction formulation is frequently used to regulate employer-provided health benefits. The Code provides a list of requirements that a plan must comply with. If a plan does not comply with these requirements, then the plan is assessed an excise tax. Thus, similar to the regulation of retirement plans under the Code, Congress used both the incentive formulation and the sanction formulation to regulate health and welfare plans.

### *C. The Two Rule Formulations Within the Overlapping System of Laws*

Understanding how the rule formulations function within the overlapping system of laws is necessary to understanding the regulation of retirement plans and health and welfare plans. Recall the two-dimensional concentric circle diagrams used to explain how the Code and ERISA Title I work in concert to form the overlapping system of laws. Within the systems, Congress used the two rule formulations to impose sanctions for certain conduct and create incentives promoting other conduct.

The regulatory system is different for retirement plans and health and welfare plans. Stated another way, although both retirement plans and health and welfare plans use the overlapping system of laws and the two rule formulations within the system, a unique regulatory system developed for both retirement plans and health and welfare plans. What drove them to develop differently were the decisions for how to use the rule formulations within the system. The net effect of these decisions was to create the regulatory systems for retirement plans and health and welfare plans.

To explain what was created requires an analysis of how the rule formulations function within the overlapping system of laws. This requires an expla-

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<sup>284</sup> ERISA tit. I, pt. 1, 29 U.S.C. §§ 1021–1031 (2006).

<sup>285</sup> ERISA tit. I, pt. 4, 29 U.S.C. §§ 1101–1114 (2006).

<sup>286</sup> ERISA tit. I, pt. 5, 29 U.S.C. §§ 1131–1147 (2006).

<sup>287</sup> ERISA tit. I, pt. 6, 29 U.S.C. §§ 1161–1169 (2006).

<sup>288</sup> ERISA tit. I, pt. 7, 29 U.S.C. §§ 1181–1191c (2006).

nation of the effect of the decisions to use sanctions and incentives to regulate benefit plans within the overlapping system of laws. The examination must proceed by analyzing the systems for retirement benefits and health and welfare benefits separately. Explaining how the rule formulations function within the system is the purpose of this examination. Through this process, it becomes clear that the effect of using the two rule formulations within the overlapping system was the creation of unique regulatory approaches for employer-provided retirement plans and health and welfare plans.

### 1. *The Regulatory System for Retirement Benefits*

For retirement plans, there is an overlapping system of laws—ERISA Title I and the Code—and two different types of rule formulations within the system. The first layer of rules is Title I of ERISA. Its rules use the sanction formulation; rules backed by the sanction of civil enforcement.<sup>289</sup> For example, a violation of the prohibited transaction rules creates the potential for civil enforcement.<sup>290</sup> The Code provides the second layer of rules. It provides some rules under the sanction formulation and others under the incentive formulation. Sanctions are imposed through an excise tax, while the incentive of tax-qualified status is provided for compliance with a legion of requirements. For example, noncompliance with the participation standards under the Code disqualifies a plan and thus results in the loss of the right to the tax benefits.<sup>291</sup>

The structure of the regulatory system for retirement plans developed because of how the sanction formulation and the incentive formulation were used to regulate employer-provided benefit plans. Congress has used several variations of the rule formulations. The first variation is to state a rule using two rule formulations.<sup>292</sup> Put another way, a rule is stated using both the incentive formulation and the sanction formulation. Where both formulations are used to state a rule, a rule is provided under the Code and ERISA Title I. For example, Congress used this approach in 1974 for the participation, vesting, and funding requirements that were contained in both ERISA Title I and ERISA Title II, which amended the Code.<sup>293</sup>

In stating a rule using both rule formulations, the compliance requirements are generally the same but the effect of noncompliance is different. To illustrate, consider the participation rules under ERISA Title I and the Code. The participation rules provide identical requirements under ERISA Title I and the Code.<sup>294</sup> The rules under each part of the overlapping system

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<sup>289</sup>ERISA § 502, 29 U.S.C. § 1132 (2006).

<sup>290</sup>*Id.*

<sup>291</sup>I.R.C. §§ 401(a)(3), 410(a).

<sup>292</sup>*See, e.g.*, I.R.C. §§ 401(a)(3), 410(a); ERISA § 202, 29 U.S.C. § 1052 (2006).

<sup>293</sup>ERISA §§ 202, 203, 302 (1974), 29 U.S.C. §§ 1052, 1053, 1082 (Supp. IV 1975); ERISA §§ 1011, 1012, 1013 (1974), I.R.C. §§ 410, 411, 412 (amending the 1954 Code).

<sup>294</sup>I.R.C. § 410(a); ERISA § 202, 29 U.S.C. § 1052 (2006).

of laws are stated using different rule formulations.<sup>295</sup> Under ERISA Title I, noncompliance with the participation requirements creates the potential for sanctions through civil enforcement.<sup>296</sup> Dissimilarly, noncompliance with the participation requirements under the Code causes the plan to become disqualified.<sup>297</sup>

The second variation used by Congress is to state a rule using only one of the two rule formulations. If the retirement plan requirement is only stated in the incentive formulation, then the failure to comply causes the loss of tax-qualified status. The limitations on contributions and benefits are an example of a rule that is only stated using the incentive formulation.<sup>298</sup> Other examples include the nondiscrimination test and the coverage test.<sup>299</sup> Compliance results in receiving the benefit of qualified status, while noncompliance results in disqualification, the loss of the right to receive a benefit.<sup>300</sup>

On the other hand, if a rule is only stated using the sanction formulation, there are a few consequences for failing to comply, depending on whether the sanction formulation is used under the Code or ERISA Title I. If the rule is only stated under ERISA Title I, then the sanction of civil enforcement applies for noncompliance.<sup>301</sup> And if the rule is only stated in the Code using the sanction formulation, then noncompliance results in the imposition of an excise tax.<sup>302</sup> Finally, if a rule is stated using the sanction formulation under both ERISA Title I and the Code, then noncompliance results in the imposition of civil enforcement and an excise tax. For example, the prohibited transaction rules are in ERISA Title I and the Code, and different sanctions are imposed for noncompliance.<sup>303</sup> Noncompliance with the ERISA Title I rule causes the imposition of civil enforcement,<sup>304</sup> while noncompliance with the rules under the Code result in the imposition of an excise tax.<sup>305</sup> Even though the types of sanctions differ, the formulation of the rule is still the same.

As a result of using different methods for stating rules, Congress created a unique approach for regulating employer-provided retirement plans.

Congress used a multi-part approach for passing laws under ERISA Title I and the Code. First, there is the tax-qualified system and the rules for imposing an excise tax. For the rules that impose an excise tax for noncompliance, Congress used the sanction formulation. As for the tax-qualified system, Congress used the incentive formulation. In doing so, employers who decide to offer a

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<sup>295</sup> See *supra* Part III.B.

<sup>296</sup> ERISA § 502, 29 U.S.C. § 1132 (2006).

<sup>297</sup> I.R.C. §§ 401(a), 410(a).

<sup>298</sup> I.R.C. §§ 401(a)(16), 415.

<sup>299</sup> I.R.C. §§ 401(a)(4), 410(b).

<sup>300</sup> See I.R.C. § 401(a).

<sup>301</sup> See ERISA § 502, 29 U.S.C. § 1132 (2006).

<sup>302</sup> See I.R.C. subtit. D, ch. 43.

<sup>303</sup> I.R.C. § 4975; ERISA § 406, 29 U.S.C. § 1106 (2006).

<sup>304</sup> ERISA § 502, 29 U.S.C. § 1132 (2006).

<sup>305</sup> *E.g.*, I.R.C. § 4975.

retirement plan to employees may receive tax-preferred status, on condition that the several rules are satisfied. In the event the employer provides a plan intended to be tax qualified but fails to satisfy the requirements, then the tax preference is lost.<sup>306</sup> However, the employer has no legal obligation to comply with the qualification requirements so long as the employer has no expectation of receiving a tax preference for the provision of an employer-provided retirement plan. This is the effect of the voluntary system.

Second, ERISA Title I protects participant rights. Here Congress used the sanction formulation. If an employer provides an ERISA Title I covered retirement plan, then the plan must comply with the rules thereunder. A failure to comply with these rules creates the potential for civil enforcement. By providing a retirement plan to employees, an employer accepts the legal obligation to satisfy numerous substantive requirements. Put another way, an employer may not provide a retirement plan to employees and choose not to comply with the ERISA Title I requirements.

Third, there is the overlap. Here Congress stated the same rule twice, once in ERISA Title I and once in the Code. There are two ways Congress used this approach: (1) the incentive formulation under the Code and the sanction formulation under ERISA Title I, or (2) the sanction formulation under ERISA Title I and the sanction formulation under the Code. Where the sanction formulation is used twice, Congress substantively protects participant rights under ERISA Title I and imposes an excise tax for not protecting participant rights. The other option is to state the same rule using both rule formulations. The use of both rule formulations creates a two-tiered system of compliance for certain requirements. ERISA is the first tier. Compliance with the requirement is required if the employer provides a retirement plan. The Code qualification requirements form the second tier. Given that the employer must comply with the rule under ERISA Title I, the plan has already satisfied those qualification requirements that are duplicated in both ERISA Title I and the Code.

Ultimately, the interaction between ERISA and the Code facilitates additional regulation and complexity. Although compliance with ERISA and the Code are not mutually exclusive, compliance with each is distinct and separate. The systems facilitate additional regulation by providing two areas of law that operate independently—each of which implements the rule formulations differently. As a consequence, Congress effectively created a system of laws for plan qualification whereby an employer providing a retirement plan to employees may choose whether to comply with certain rules—rules not contained in or enforced by ERISA Title I. The employer's ultimate decision depends on whether it wishes to consent to additional regulation, namely all of the provisions under section 401(a) that are not duplicated in ERISA Title

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<sup>306</sup>The Service permits the correction of failures under the Employee Plans Compliance Resolution System (EPCRS) in order to avoid the harsh effect of noncompliance. Rev. Proc. 2008-50, 2008-35 I.R.B. 464.

I. Compliance with those rules is necessary to get the tax preference afforded to qualified plans. Employers are likely to comply with the additional requirements because of the interest in attracting and retaining employees. But the employer still must comply with the ERISA Title I requirements regardless of the final decision.

The interesting part about the system is that the overlapping system depends upon the two types of rule formulations to exist. Escaping the compliance burden under ERISA Title I or the Code is usually not the reality. Theoretically, an employer could create a plan that does not receive the tax preference but must comply with ERISA Title I. The reality is that, among other reasons, such as employee retention, the tax preferences afforded to tax-qualified plans drives employers to provide them. Once an employer takes advantage of the tax incentives for providing a plan, compliance with the protections under ERISA Title I is required. The rule formulations drive the system because the incentive formulation under the Code promotes the provision of employer-provided retirement plans, while the sanction formulation under ERISA Title I protects participant rights.

In addition to the regulation under ERISA Title I, the two-tiered overlapping system facilitates greater regulation by creating a forum for additional regulations under section 401(a). The qualification requirements act as a vessel for additional rules. The qualification requirements contain many rules that do not rise to the level of a participant right, which would warrant inclusion in ERISA Title I. As a consequence, additional qualification requirements may be enacted to regulate the operation of plans where sanctions are not as appropriate. The ability to provide additional regulation is especially important because ERISA preempts all state laws that relate to retirement plans. The interaction of the system of laws with the preemption provision creates a complete system, foreclosing the potential for additional regulation at the state level.

## *2. The Regulatory System for Health and Welfare Benefits*

The regulatory system for health and welfare plans has a structure similar to the one for retirement plans. The system functions through the overlapping rules of the Code and ERISA Title I. Further, within the overlapping system, the sanction formulation and the incentive formulation are used. Yet, even though the two rule formulations are used within the system for regulating health and welfare plans, they are used in a way that is different from the retirement system. The existence of two methods for using the rule formulations creates a unique system.

Similar to the system for retirement plans, the system for regulating welfare plans developed out of Congress's use of the two rule formulations. In particular, Congress used several variations of the two rule formulations when it enacted health and welfare plan laws. Variations included stating a rule using both types of rule formulations and enacting a rule with the use of only one of the two rule formulations. The uses of the different rule formulations differed

from the retirement plan system.

The first variation of the rule formulations was the use of the same rule formulation twice. In many cases, Congress enacted new legal requirements with identical or similar provisions under both ERISA Title I and the Code. The effect of noncompliance under ERISA Title I is the imposition of civil enforcement, and noncompliance under the Code results in an excise tax. For example, Congress used this variation in enacting the continuation coverage provisions.<sup>307</sup> Both provisions imposed sanctions for noncompliance.<sup>308</sup>

The second variation is to state a rule using one of the two rule formulations. First, Congress has frequently stated rules using the incentive formulation. Where this rule formulation is used, Congress provides a tax preference for the provision of certain benefits.<sup>309</sup> For example, an employer may provide a cafeteria plan that provides certain qualified benefits.<sup>310</sup> In making the deferral election, the employee is treated as not being in constructive receipt of compensation.<sup>311</sup> Second, Congress has also stated rules in the sanction formulation. For example, ERISA Title I requires that a group health plan must cover a child placed with the participant for adoption if the plan covers dependent children.<sup>312</sup> Noncompliance with this rule triggers the enforcement provisions under ERISA Title I.<sup>313</sup>

The common variation of stating a rule in both rule formulations is not used to regulate health and welfare plans. Instead, these plans are regulated using the variations discussed above.

By using the different variations of stating rules, Congress created a unique regulatory approach for employer-provided health and welfare plans. Similar to the system for regulating retirement plans, a multi-layered approach to regulating welfare plans emerged through laws that changed ERISA Title I and the Code. The first layer of the system provides a tax preference for the provision of a plan, and an excise tax for not complying with certain requirements when providing a benefit. For these rules, Congress used the incentive formulation for the rules providing a tax preference, and the sanction formulation for the rules imposing an excise tax for noncompliance. Employers typically structure the plans to take advantage of the tax preferences. In doing so, plans must comply with certain additional rules, noncompliance with which results in the sanction of an excise tax.

The second layer of the system protects participant rights under ERISA Title I. Congress uses the sanction formulation to achieve this end. If an employer provides an ERISA Title I covered plan, then the plan must comply with the applicable rules thereunder. Civil enforcement results upon non-

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<sup>307</sup>ERISA tit. I, pt. 6, 29 U.S.C. § 1161–1169 (2006); I.R.C. § 4980B.

<sup>308</sup>ERISA § 502, 29 U.S.C. § 1132 (2006); I.R.C. § 4980B.

<sup>309</sup>I.R.C. §§ 79, 101, 104, 105, 106, 119(d), 120, 125, 127, 129, 132.

<sup>310</sup>I.R.C. § 125.

<sup>311</sup>I.R.C. § 125(a).

<sup>312</sup>ERISA § 609(c), 29 U.S.C. § 1169(c) (2006).

<sup>313</sup>ERISA § 502(a)(1), 29 U.S.C. § 1132(a)(1) (2006).

compliance. In voluntarily offering a plan, an employer assents to complying with the numerous substantive requirements.

The third layer of the system is the overlap. Here Congress enacts a rule twice. The rule is stated once in ERISA Title I using the sanction formulation, and again using the same rule formulation under the Code. Where the sanction formulation is used twice, Congress substantively protects participant rights under ERISA Title I, and imposes an excise tax for not protecting participant rights. This layer of the system provides for substantive regulation of the benefits where an employer provides a plan.

Congress's use of the two rule formulations within ERISA Title I and the Code is distinct from the system for regulating retirement plans. Congress offered a tax preference for the provision of certain benefits. However, there were very few instances where receipt of the tax preference was conditioned on satisfaction with additional requirements.<sup>314</sup> The Code offered a tax preference to provide an incentive for employers to provide certain types of health and welfare benefits. These incentives drove employers to provide certain types of benefits to their employees.

By deciding to provide a benefit plan, the employer accepts the obligation to comply with substantive requirements. These additional requirements promote a fair system meant to protect the rights of employees. For example, an employer offering a group health plan must provide continuation coverage. For another example, a group health plan is restricted from imposing restrictions on certain preexisting conditions. Under this system, Congress imposes sanctions if an employer does not comply with these requirements, either in the form of an excise tax or through civil enforcement. These rules, however, are not linked to the receipt of the tax preference. They exist wholly separate from the provisions for tax-preferred treatment.

The employer and the employee may agree to certain additional requirements. Beyond the requirements under ERISA Title I and the Code, the parties are free to agree to additional provisions related to the benefits. The enforcement provisions under ERISA Title I act to safeguard these promises.<sup>315</sup>

There is little regulation of health and welfare plans beyond the substantive regulation and sanctions provided under ERISA Title I and the Code. ERISA preempts all state laws related to employee benefit plans, including health plans.<sup>316</sup> There is, however, an exception for state laws that regulate insurance, banking, or securities.<sup>317</sup> This exception is most important for the exception for state laws that regulate insurance. Besides this exception, federal regulation is generally the only means of regulating the provision of employer-provided health and welfare plans.

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<sup>314</sup> Cf. I.R.C. § 105(h).

<sup>315</sup> ERISA § 502(a)(1)(B), 29 U.S.C. § 1132(a)(1)(B) (2006).

<sup>316</sup> ERISA § 514, 29 U.S.C. § 1144 (2006).

<sup>317</sup> ERISA § 514(b)(2)(A), 29 U.S.C. § 1144(b)(2)(A) (2006).

This Part has explained the regulatory system for employer-provided retirement benefits and health and welfare benefits. A systematic approach emphasizes the way a rule functions within the system. To understand the function of a rule within the system, it is necessary to understand the system in which it functions. Understanding the system makes it easier to understand the effect of a change to the system.

#### **IV. The Two Levels of the Regulatory System**

The overlapping system of laws and its two rule formulations evolve to regulate employee benefits. Each time Congress changes a rule within the system, the change has an effect on the system as a whole. The policy or purpose for a change to the system originates from some issue arising with the employer-employee relationship or with an entity that provides services for the provision of benefits. To meet the issues facing the system, rules must be implemented into the system.

Crafting new rules requires a determination of what type of rule formulation to use. How the rule is formulated directly impacts how the system is altered and how it will function in the future. In other words, a change to the system inevitably has an overall effect on the system as a whole. The effect manifests from the overall purposes of the system, namely, among other things, encouraging employers to provide benefits, limiting tax expenditures by only allowing such expenditures where conduct furthers public policy, and protecting the rights and expectations of employees who receive benefits. By changing a rule within the system, these policies will be affected. Typically, more than one of these policies is affected by a change to the system because the new or additional rules affect the relationship between the employer and the employee. Given that a new rule or a change to an old rule will have a systematic effect, the type of rule formulation used will determine its effect on the system as a whole because it will affect the purpose and policy of the system.

A method is needed to guide the development of the system to ensure that changes to the systems do not run astray of its fundamental purpose—to promote the general welfare. To use the system in analyzing policy decisions, the system needs to be broken down from the compact form explained in Part III. The compact, theoretical system is difficult to apply for purposes of policy analysis. The system, however, could impact policy decisions if the effect each change to the system had on the employer-employee relationship and the employer's decision to provide benefits was part of the policy analysis. Before understanding the effect of a change to the system, one must understand and appreciate how the system applies to and affects the employer-employee relationship and the employer's decision to provide benefits.

This Part confronts the issue by isolating specific aspects of the employer-employee relationship that are affected by the regulatory system. The overlapping system of laws with its two rule formulations is explained in terms of how it affects participants in the system. The rules within the system affect the

employer-employee relationship on two different levels: plan formation and plan operation. At these two levels, the rules impact the employer's decision to provide benefits to employees and determine the rights of the participants.

#### *A. Level One: Plan Formation*

The first level of the system is plan formation. There are generally two stages to plan formation. The first stage is the decision making process. During this stage, the regulations within the system affect an employer's decision to provide a benefit plan to employees. The second stage is the plan structuring process. During this stage, the regulations within the system affect, among other things, the type, terms, and administration of the plan.

At the first stage, the rules within the system have an impact on the employer's decision to provide benefits. Many economic and business-related reasons impact the employer's decision to provide benefits, including the employer's ability to attract and retain good employees. These reasons alone give employers a reason to provide benefits, but the systems significantly impact the decision-making process as well. In particular, the tax laws give employers an incentive to offer employee benefits. The tax preferences given to the employer and the employee provide a quantifiable benefit, enticing employers to offer benefits. There is a substantial tax expenditure for trying to get private sector employers to provide benefits.

The tax preference, however, is not the only part of the system that affects the employer's decision to provide benefits. Employers must incur a significant cost to comply with the many rules as a condition of receiving the tax preference. The costs associated with these rules are not restricted to the period before the benefits are provided. Benefit plans must be maintained in accordance with requirements while providing the benefits. In addition to the conditions for receiving a tax preference, employers must also consider the other burdens of the system. By providing a benefit plan, the employer will be required to comply with the ERISA requirements applicable to the plan and additional excise tax rules. These rules create additional compliance costs and potential liability.

An employer who decides to provide a benefit plan enters the second stage of structural plan formation. During this stage, the employer sets the terms of the plan and establishes administrative and maintenance procedures. Plan structures vary widely, due to the different types of employee benefits, but there is a constant among all plans. Each plan must comply with all applicable rules, irrespective of whether the failure to comply results in the loss of a tax preference, civil sanctions, or an excise tax. Thus, the structural formation of the plan will take account of all different rule formulations within the system.

#### *B. Level Two: Plan Operation*

The second level of the system is plan operation. At this level, benefits are provided through the plan, and the plan must be operated in accordance with

its terms and the rules within the system. Operating in accordance with the rules means not incurring the consequences associated with violating a rule. The effort expended to comply with the rules during the administration of the plan is a burden. This burden falls on many parties within the system, and the burden is enhanced by the potential for the loss of the tax preference, the imposition of an excise tax, or the enforcement of civil sanctions. There are additional burdens, such as the burden of amending a plan to comply with new legal requirements, and the burden of operating a plan in accordance with the new requirements.

The burden of compliance that accompanies the rules depends on which type of rule formulation is used. The employer, who became the plan sponsor when it decided to offer the plan, must operate the plan in accordance with the rules on which receipt of the tax preference is conditioned. Satisfying the obligation means not only operating the plan in accordance with those provisions in the plan at the time it was created, it also means adding new requirements to the plan as Congress enacts new laws. This means that the conditions for receiving incentives are constantly in flux.

The rules stated under the sanction formulation place specific burdens on different individuals and entities. Similar to the rules stated using the incentive formulation, these rules require different parties to conform their conduct to certain rules. The parties who are regulated are legion, and the rules diverse. Parties affected by the rules reach broadly so as to affect nearly all parties who provide service to a plan. Regardless of which party is being regulated, however, a rule serves a distinct purpose. If a plan complies with the rule, the purpose for which the rule exists has been accomplished. If the rule has not been followed, then the purpose was thwarted.

The individual rules, however, do not function as a cohesive whole in the sense that noncompliance with one results in the failure of the whole. Instead, if a rule is failed, there are sanctions. Sanctions provide a negative consequence, which encourages compliance. Sanctions operate to force the parties associated with the plan to act in accordance with the rule of law, thus furthering a specific purpose.

In the second level, there are two types of sanctions: excise taxes and civil enforcement. Each type of sanction affects compliance differently. The excise tax is a method of self-regulation. A party that does not act in accordance with a rule must pay a tax to atone for its failure. Although the rules are not necessarily linked to the qualification of a plan, the rules do function to minimize the benefit of the tax preference or impose an outright separate penalty. In contrast, the civil enforcement provisions are not self-regulatory. The law empowers certain parties with the right to enforce their rights or the rights of another. During the course of operating the plan, if a party who is so empowered decides to exercise its right to complain, then it is permitted to use the civil enforcement mechanisms to force the other party to comply with the rules.

## V. The Framework for Analyzing the Regulatory System

With an understanding of the two levels of the system, a new method for analyzing policy decisions can be applied. The analysis needs to consider the effect of a change to the system on the several policies furthered by the system. The broad effects of a change to the system cannot be analyzed in a vacuum where the only concern is the policy furthered by the particular rule. Such an analysis does a disservice to the participants in the system and the effectuation of the goals of the system. The regulatory system is not meant to be an esoteric, theoretical construct without application. Although the system is explained as a cohesive whole, the system can be understood by how it affects the participants in the system, the employer and the employee, as well as those who provide services that allow the system to function.

The regulatory system for employee benefits is unique and comprised of many parts. A maze of tax law, labor law, incentives, and sanctions work together to form the system. These details, when explained in a comprehensible systematic framework, aid in understanding benefits law. The systematic approach reviews the numerous and often incremental legal changes to the system and explains how the rules work together as a whole, at two levels. Throughout history, policies were furthered, laws were enacted, choices were made, and, ultimately, the systems developed. Although it is a complex, complicated, and cumbersome system, it is coherent, even if not easily communicated.

With each change to the system, the relationship between the employer and its employees is altered. The relationship is altered by the substance of the new rule. The relationship is altered based on how a rule is integrated into the system. The relationship is altered based upon how a rule is formulated to fit within the system.

A systematic approach to employee benefits law can help determine the policy for altering the relationship between the employer and its employees through an addition or modification to the law. In general, crafting the substance of a new law involves a narrow policy analysis. Each new rule is drafted for an intended purpose and to help achieve a particular outcome. The policy analysis may evaluate the effects and consequences of a proposed rule. Through this process a rule may be determined to be favorable and thus worthy of being enacted. Yet, although it is necessary to determine whether a policy for a particular rule is favorable, it may not be sufficient for its existence. Given that the rule functions within a greater system, its merits cannot be assessed in isolation. The analysis should consider how the rule will function within the system. An analysis should evaluate the extent to which adding a rule to, or modifying a rule within, the system will affect the employer-employee relationship and the employer's decision to provide benefits. The addition of a rule may negatively interact with the system as a whole. Accordingly, a proposed rule should be analyzed to determine whether its addition to the system will negatively affect the overall purpose of the system. A similar analysis should be conducted with respect to modifications to the system.

In evaluating a proposed rule, the analysis should also consider the effect of using different rule formulations. Each rule can be stated using one or both of the incentive formulation and the two varieties of the sanction formulation. Many different permutations are available when formulating a rule. Each possible permutation has a different function within the system. Consequently, how a rule is formulated will impact the effect of an addition or modification to the system. Furthermore, how a rule is formulated will determine the effect of noncompliance and the mechanisms for encouraging compliance or discouraging noncompliance.

A rule should also use the rule formulation that helps achieve its purpose. Each rule has a purpose, and the type of rule formulation employed will affect it. There are many possible reasons for a rule. For example, a rule may be meant to regulate the provision of a tax expenditure to those cases where doing so would comport with public policy. A rule may be meant to protect plan assets so that they may be used for the benefit of employees. A rule may be meant to enhance transparency, enabling informed decision making. A rule may be meant to raise revenue for the federal government. After ascertaining the purpose of a rule, whatever it may be, each rule formulation should be evaluated. The analysis should review how a rule formulation affects the purpose of the rule. If the incentive formulation is used, every plan that wants to receive the tax preference will be required to comply with it. Thus, the rule will primarily affect the first level, the decision to provide benefits. If the sanction formulation is used, the rule may be enforced with an excise tax, civil sanctions, or an excise tax and civil enforcement. Here, a rule generally covers whether the plan is operated in accordance with certain restrictions and limitations. On the other hand, if the rule is stated using both rule formulations, then the rule will be formulated to function at two levels and serve multiple purposes.

In formulating a rule, the purpose of the regulatory system as a whole should be considered. Benefits law exists in a grand regulatory system that serves a purpose. When a rule is formulated, it is necessary to analyze how a rule, stated in a rule formulation, will affect the purpose of the system. A rule may have a positive effect on the regulatory system. A rule may have a negative effect on the regulatory system. But whether a rule positively or negatively affects the system is determined by the overall affect on employers, employees, and other parties involved with the system.

## **VI. Conclusion**

This Article explored the history of incremental changes to employee benefits law to help understand current law. The Article used the understanding gained from this exploration to provide a simple method to assist those charged with developing the system of the future.

This exploration was necessary because benefits law is headed for a major change. Any time there is a change to something, those responsible for the change must understand what it is they are changing. That is the only way to

understand the effect of actions. Without a sufficient systematic understanding of benefits law, new legislation will add another layer of laws on top of what is already in place. Accordingly, change should consider what is currently in place—cohesive regulatory systems.

To this end, this Article explained the regulatory systems for employee benefits. The structure for regulating benefit plans is an overlapping system of laws that employs incentives and sanctions. Understanding the historical development of benefits law and the current regulatory system allows for a deeper understanding of benefits law, and the effect of changes to it. In addition, and potentially more important, a systematic analysis of benefits law compels all to step away from the particular, technical rules, and consider the impact of the rules on employers, employees, and parties who service the system.

Even though employee benefits law is the compendium of responses to the human experience, the human element is often lost when discussing employee benefits. But sometimes it is necessary to get lost before finding the way. Such was the journey traveled herein. Through abstraction and reasoned analysis, the simple system, which lies beneath the complexity, was revealed. Understanding the regulatory system is the easy part. The regulatory system functions to benefit those affected by it.

The difficult part is creating a better system for the future. A better system is one that more efficiently achieves the ends for which the system was created. Infinite possibilities are available to those charged with this task. In creating the system, one fundamental issue should remain constant. The issue is whether a change to the system will produce the maximum possible benefit for the general welfare.

All of this is important for one simple reason: actions in the present lead to the reality of tomorrow. But an inquiry concerning those actions that will lead to the best of all possible tomorrows must wait for another day.



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