New York Law Journal

NEW YORK, FRIDAY, JUNE 27, 1997

OUTSIDE COUNSEL

By Scott M. Riemer

Corporate Outsourcing And ERISA §510

SINCE the late 1980's, companies have been controlling costs by turning over corporate functions, such as accounting, human resources, training and other back office work, to outside specialists. This is called "outsourcing." In a landmark case, *Inter-Modal Rail Employees Association v. Atchison, Topeka and Santa Fe Railway Company,* [1] a unanimous U.S. Supreme Court may have put a brake on this practice or, at least cause companies to restructure future outsourcing. In addition, the ruling may create a backlash of class actions against companies that have outsourced.

Inter-Modal clarified the applicability of §510 of ERISA [2] and its relationship with other sections of the Act. Section 510 provides, "[i]t shall be unlawful for any person to discharge, fine, suspend, expel, discipline or discriminate against a participant or beneficiary ... for the purpose of interfering with the attainment of any right to which such participant may become entitled under the plan ...."

First, *Inter-Modal* held that §510 applies not only to vested benefits, such as those under a pension plan, but also to nonvested benefits, such as an employee welfare benefit plan, [3] which includes medical, dental, disability and other similar plans.

Second, the *Inter-Modal* decision held that §510 applies not only to individual discharges of employees, but to corporate events such as outsourcing. Prior to *Inter-Modal*, most courts declined to find a §510 violation in the context of a corporate transaction, whether the claim was for vested pension benefits or nonvested welfare benefits. [4]

Third, *Inter-Modal* has resolved the tension within ERISA between an employer's unfettered right to amend or terminate a plan and §510's proscription against interference with benefits. The case has set up a kind of Simon Says. Employers may reduce or termi-

Continued on page 32, column 4

Scott M. Riemer *is a solo practitioner in Manhattan.*

Continued from page 1, column 2

nate nonvested benefits for groups of employees provided the employers first amend their plans in accordance with the amendment procedure. They cannot, however, avoid paying these same benefits by discharging employees.

Except for the involvement of collective bargaining agreements, *Inter-Modal* arose from a classic outsourcing. The individual plaintiffs[5] were former employees of Santa Fe Terminal Services Inc. (the subsidiary), which was a wholly owned subsidiary of The Atchison, Topeka and Santa Fe Railway Co.

For approximately 15 years, without a contract, the subsidiary transferred cargo between railcars and trucks at the parent's Hobart Yard in Los Angeles. As employees of the subsidiary, plaintiffs were entitled to pension and welfare benefits under employee benefit plans maintained by the subsidiary pursuant to a collective bargaining agreement with the teamsters union.

All of this changed in January 1990, when the parent entered into a formal service agreement with the subsidiary to have it continue to do the same work at the Hobart Yard. Seven weeks later, however, the parent exercised its right to terminate the newly formed agreement and opened the Hobart Yard work for competitive bidding. In-Terminal Services had the winning bid.

As part of the transaction, the employees of the subsidiary were given the opportunity to transfer their employment to In-Terminal, the outsourcing company. Those who declined were terminated. Employees who transferred were provided diminished employee benefits because the collective bargaining agreement between the outsourcing company and the teamsters provided for fewer pension and welfare benefits than the agreement between the subsidiary and the teamsters.

The plaintiffs sued the parent, the subsidiary and the outsourcing company alleging that defendants violated §510 by conspiring to transfer the Hobart Yard work from the subsidiary to the outsourcing company for the express purpose of depriving plaintiffs of pension and welfare benefits.

The district court for the Central District of California dismissed the complaint for failure to state a claim on which relief could be granted. The Ninth Circuit affirmed in part and reversed in part. The appellate panel reversed the dismissal of plaintiffs' §510 claim for interference with pension benefits, but dismissed their claim for interference with welfare benefits. The court held that §510 applies only to benefits that can vest.

The U.S. Supreme Court reversed, finding that the plain language of §510 requires application to both vested pension benefits and nonvested welfare benefits. ERISA defines a "plan" to include both employee welfare and employee pension benefit plans. The Court stated that:

> had Congress intended to confine §510's protections to "vested" rights, it could have easily substituted the term "pension plan" [cite omitted] for "plan," or the term "nonforfeitable" right [cite omitted] for "any right." But §510 draws no distinction between those rights that "vest" under ERISA and those that do not.[6]

The Supreme Court also addressed the tension between an employer's right to amend and/or terminate welfare plans and the requirements of §510. It affirmed that employers are generally free under ERISA to adopt, modify or terminate their welfare plans for any reason and at any time.

However, "§510 counterbalances this flexibility by ensuring that employers do not circumvent the provision of promised benefits."[7]

Thus, an employer may retain the unfettered right to alter its promises, but to do so it must follow the formal procedures set forth in the plan. The Supreme Court reasoned that a plan's formal amendment process would be undermined if an employer could informally amend the plan one participant at a time. The power to amend or terminate does not include the power to "discharge ... for purposes of interfering with attainment of rights ... under the plan."

Unfortunately, however, the Court created a measure of uncertainty by remanding for further consideration respondents' argument concerning the "attainment of any right" clause.

Respondents argued that §510 is inapplicable to welfare plans because participants already have "attained" their rights under the plan. As a result, any subsequent actions taken by an employer cannot by definition interfere with the "attainment of any right."

Class Actions

In New York State, §510 has a two-year statute of limitations.[8] Therefore, any outsourcing that occurred after July 1995 may still be subject to legal action.

Many companies are vulnerable to these class actions because they outsourced whole departments but made no amendment to their employee benefit plans.

In many such transactions, a department was divested by the company, made into a separate company and given a contract to provide the department's function. Employees often remained at the same desk and performed the same functions. The only difference was that they had diminished or no employee benefits with the new company.

In these class actions, it is likely the plaintiffs easily will be able to prove specific intent. Under §510, a plaintiff must show that his or her discharge was at least in part motivated by the specific intent to eliminate or diminish employee benefits.[9] It is not sufficient for a plaintiff to establish that the loss of benefits was a consequence of his termination of employment.[10]

In most §510 cases, specific intent must be demonstrated by means of the same three-step analytic framework for indirect proof applied to Title VII cases in *McDonnell Douglas v. Green*, 411 U.S. 792, 802-805 (1973).[11] First, the plaintiff has the burden of proving a prima facie case of discrimination (i.e. that he or she belongs to a protected group (member of a plan), was qualified for the position, and was discharged under circumstances that give rise to an inference of discrimination).

Second, if the plaintiff succeeds, the burden then shifts to the defendant to articulate a legitimate nondiscriminatory reason for the termination. Third, if the defendant establishes its burden, the plaintiff must establish that the reasons offered by the defendant were pretextual.

In the case of outsourcing, however, there are often smoking guns or their equivalent. Specific intent has been admitted in some manner or is apparent by the nature and effect of the transaction. Indeed, there are discoverable internal memorandums discussing the employee benefit cost/benefits of the outsourcing. Corporate motivations often were not concealed because there was no belief prior to *Inter-Modal* that cutting welfare benefits could violate §510.

Moreover, defendants are not likely to find solace in arguing the "attainment" issue remanded by the Supreme Court to the Ninth Circuit.[12] Despite the remand, the "attainment of any right" clause has already been effectively and convincingly interpreted in *McGann v. H&H Music Company*.[13] According to the Fifth Circuit, the clause means "any right to which an employee may become entitled pursuant to an existing, enforceable obligation assumed by the employer." [14]

Accordingly, if after an outsourcing, a company continues to maintain its plans for non-outsourced current employees, then the discharge of outsourced employees would have interfered with their attainment of benefits. But for the discharge, such employees would have attained such benefits.

On the other hand, if a company terminated the plan or otherwise amended the plan to remove an outsourced employee's coverage, the discharge of employees would not have interfered with attainment of benefits. No benefits could have been attained because outsourced employees would not have been eligible to receive benefits even without the discharge.

The Future

As for future outsourcing, *Inter-Modal* is likely to serve as both a shield and a deterrent. The decision made it perfectly clear that employers could reduce or eliminate nonvested employee benefits merely by amending the plan. Therefore, as a preliminary step of outsourcing, an employer could amend its benefit plans (both pension and welfare) to exclude the employees in accounting, human resources, etc., as of the effective date of the outsourcing. Even though one of the employer's motivations is to cut employee benefit costs, the Supreme Court has deemed that such an amendment would not be prohibited by §510.

It will also serve as a deterrent because amendments to most employee benefit plans are subject to other more problematic requirements of the Internal Revenue Code. Amendments to pension plans, self-insured welfare plans and cafeteria plans (plans where an employee can often chose between cash and certain welfare benefits) are all subject to varying nondiscrimination requirements concerning highly compensated plan participants.[15]

Indeed, the only type of plan that may be amended without nondiscrimination concerns is an insured welfare plan.

However, even where an employer maintains insured welfare plans, it may not escape the nondiscrimination requirements. Many employers maintain both insured welfare plans and pension plans. In such a case, before an employer could outsource, it must nonetheless comply with the nondiscrimination requirements because of the pension plan.

Paradoxically, even in those cases where an employer maintains only insured welfare benefit plans, *Inter-Modal* may also reduce the number of future outsourcings. Instead employers may choose to exclude particular departments from their welfare plans and avoid the other costs of outsourcing. The only countervailing force will be employee morale and employee relations issues in covering some employees and not others.

—

(1) 1997 U.S. LEXIS 2803 (May 12, 1997).

(2) 29 U.S.C. §1140.

(3) Prior to *Inter-Model*, there was a split among the circuits as to whether Section 510 applied to nonvested benefits. The Ninth Circuit in *Inter-Model* held that Section 510 only applied to vested benefits. By contrast, the Fifth, Sixth, Seventh, Eleventh and DC Circuit either held or implied that Section 510 draws no distinction between benefits that vest and those that do not. See *McGann v. H&H Music Co.*, 946 F.2d 401, 408 (5th Cir. 1991); *Shahid v. Ford Motor Co.*, 76 F.3d 1404, 1411 (6th Cir. 1996); *Heath v. Varity Corp.*, 71 F.3d 256, 258 (7th Cir. 1995); *Seaman v. Arvida Realty Sales*, 985 F.2d 543, 546 (11th Cir. 1993), cert. denied, 510 U.S. 916 (1993); *Andes v. Ford Motor Co.*, 70 F.3d 1332, 1336 (D.C. Cir. 1995). The Second Circuit has never ruled on the issue.

(4) See, e.g., *Andes*, 70 F.3d at 1337-1338 (D.C. Circuit drastically proscribed the application of Section 510 to corporate events. The D.C. Circuit stated, "[i]f Congress had wished for §510 to apply routinely to such decisions, which are virtually always based, at least in part, on labor costs, it would surely have included the terms 'layoff' and 'termination.' "). But See, *Gavalik v. Continental Can Co.*, 812 F.2d 834 (3d Cir.), cert. denied, 484 U.S. 979 (1987) (Third Circuit found a company's decision to close down a production line to constitute a Section 510 violation).

(5) Plaintiff Inter-Modal Rail Employees Association is an employee association representing former employees of Santa Fe Terminal Services, Inc.

(6) 1997 U.S. LEXIS 2803, 9-10.

(7) Id., at 11.

(8) Because ERISA itself contains no statute of limitations for Section 510 claims, the courts have borrowed the analogous state statute of limitations. See *Sandberg v. KPMG Peat Marwick, LLP.*, 111 F.3d 331 (2d Cir. 1997)(Second Circuit applied the two-year limitations period of New York's Workers' Compensation Law).

(9) *Dister v. Continental Group*, 859 F.2d 1108, 1111 (2d Cir. 1988).

(10) Id.

(11) Id. at 1112.

(12) 1997 U.S. LEXIS 2803, 13.

(13) 946 F.2d 401 (5th Cir. 1991).

(14) Id. at 405.

(15) Pension Plans are subject to the coverage and nondiscrimination requirements of §410 of the Internal Revenue Code. Therefore, any amendment to a pension plan can only be made provided the plan as amended continues to satisfy the requirements of §410. The same is true for self-insured welfare plans and cafeteria plans which are subject respectively to the nondiscrimination requirements of §§105(h) and 125 of the Internal Revenue Code.