Nixon Peabody LLP

Benefits Briefs®

Legal developments affecting employee benefits

A Nixon Peabody LLP Publication

Volume 18, No. 2 • March 2005

Automatic IRA Rollover Rules

New Rules May Result in Fewer Cashouts. Here's Why: Although qualified retirement plans may permit participants to receive their benefits upon termination of employment or another triggering event, the general rule is that plans cannot require payment prior to the later of age 62 or normal retirement age. However, to save employers the expense and burden of administering inactive small amounts, Congress permitted plans to cash out benefits of $5,000 or less without a participant's consent. Then Congress became troubled by the fact that the majority of mandatory cash outs were being spent rather than saved or rolled over, a result that exacerbates our abysmally low rates of retirement savings. As a consequence, EGTRRA requires plans to transfer mandatory cashouts of between $1,000 and $5,000 to an IRA opened in the participant's name. This rule does not prevent an employee from asking for a cash distribution or from rolling a distribution into an IRA of his own choice, but if he fails to make an election, a plan can't simply write him a check. It must instead send the money to the employer-designated IRA.

One would have thought that by now employers would be scurrying around to amend plans and select IRAs in order to implement the automatic rollover rules for distributions between $1,000 and $5,000. Instead, a substantial percentage seem ready to limit mandatory distributions to $1,000 and under and to pay this amount in cash. The thinking is that most participants with benefits of between $1,000 and $5,000 will take their money anyway and if they don't, it is less of a cost and burden to retain the funds than it is to set up the IRAs. Despite the DOL's safe harbor that eases fiduciary liability concerns, there is also a lingering fear about liability if an employer chooses an IRA that performs poorly.

Restricting cashouts to amounts of $1,000 and less should not bother Congress or the regulators since the goal of preserving retirement savings is at least as well served if the funds are retained in the plan as if they are rolled to an IRA. The decision to lower the mandatory cashout amount to $1,000 may be easier for 401(k) and other defined contribution plans than it is for defined benefit plans where administrative costs are higher (PBGC premiums, actuarial fees and so forth). *Caution:* If you amend a plan to provide for $1,000 mandatory cashouts, you need to consider that the IRS position is, contrary to its rule for determining $5,000 cashouts, rollover contributions must be considered in determining whether a participant's account is $1,000 or less.

Time for Action: or What is the Effective Date? Whatever decision you make on cashouts, almost certainly you will need a plan amendment since most plans now have provisions stating that a cash payment will automatically be made to persons with benefits of $5,000 or less—provisions that are no longer in compliance with the law. Since the effective date of the new rules is March 28, 2005, imminent action appears to be required. But this is deceiving. First, the IRS guidance says that while plan operations must satisfy the new rules by March 28, plan amendments need not be made until the last day of the first plan year ending after March 28, or December 31, 2005, for calendar year plans. But, you ask, even if we wait to amend the plan, don't we need to decide what path we will take by March 28 (i.e., limiting cashouts to $1,000 or less, or making rollovers of all distributions of $5,000 or less, or making mandatory rollovers of distributions of between $1,000 and $5,000 and cash for amounts of $1,000 or less)? Not necessarily. The IRS guidance observes that the new rules apply to cashout distributions after March 28, 2005. It then goes on to observe that if you don't make any distributions after March 28, you can't be in violation of the new rules. They go on to say, however, that this bit of sophistry will work only until December 31, 2005, by which time you must have made a choice, set up the employer-selected IRAs—if that is the route you take—amended your plan and made the payments. Hence, if you know where you are going, you can proceed to make distributions in accordance with your game plan by the March 28 effective date; but if you don't, simply stop making any mandatory cashouts until you make up your mind between now and year end.

DOL Guidance on the Fiduciary Responsibilities of Directed Trustees

In marked contrast with the cheerleading it provided for the Enron litigation, the DOL, in a recent release, is apparently trying to soothe more than threaten directed trustees who follow participant directions to invest in company stock.

Field Assistance Bulletin, 2004-03 (EBSA 12/17/04). Enron's 401(k) plan was heavily invested in Enron stock, most of it participant-directed. When the stock became worthless, the participants, with the assistance and encouragement of the DOL, sued a variety of plan fiduciaries and service providers, including the plan's directed trustee, in an effort to recoup losses. Now, a directed trustee is someone who, by definition, has a contractual obligation to carry out directions provided by others—in this case directions from the plan participants and the Enron 401(k) plan administrator. In their lawsuit, the participants persuaded the court that the directed trustee could not automatically be immune from liability just because it was following orders and the terms of the plan document. The court's reasoning? The trustee was a big, sophisticated institution that should have known that investing in Enron stock was too risky. It should, it was argued, have seen the red flags of a company in financial distress and protected the employees by refusing to follow their buy orders.

The consequence of this holding was to force the directed trustee to defend the allegations it breached its fiduciary duties by blindly adhering to its contractual obligations and by following participant directions. It is fair to say that this decision was something of a shock—to both employers and directed trustees. Employers appoint directed trustees for the very purpose of making sure they take direction, not to have them question it; and directed trustees expect they can take such direction without needing to engage in the same depth of investigation that a discretionary trustee would undertake before making a plan investment. Because of the lower expectations, and presumably lower legal risks, directed trustees charge plans substantially lower fees than discretionary trustees. Following *Enron,* there was considerable concern that directed trustees would exit the business or charge huge fees for their services or perhaps that plan investment policies would become dysfunctional. ("I know," sayeth the directed trustee to the plan participant, "that your plan permits you to select an investment fund, that you have determined to invest in company stock, that you have directed us to invest in company stock, and that we have a contractual obligation to follow your directions, but we don't think this is a good choice, so pick another fund, and we'll see if we like that choice.")

The new Field Assistance Bulletin is designed to put the worst fears to rest. The highlights of the guidance are as follows:

- A directed trustee is a fiduciary.
- Its fiduciary responsibilities under the plan and ERISA are, however, substantially less than those of a discretionary trustee.
- In most cases, a directed trustee may follow another plan fiduciary's directions without fear of violating the prudence standard or other ERISA fiduciary standards.
- One exception is that a directed trustee cannot follow a direction that it knows or should know is inconsistent with the plan's documents. In this context, the DOL construes the term "plan documents" broadly to include not only the official plan document but also such ancillary documents as the plan's investment policy.
- A second exception is that a trustee cannot follow directions without having in place a plan or procedure to avoid a prohibited transaction. In this context, the procedure can simply allow a directed trustee to rely on a plan fiduciary's representation that the direction would not cause a prohibited transaction.
- In terms of company stock, a directed trustee will not be protected from liability under ERISA's prudence standard if it possesses material non-public information (e.g., knowledge of material misrepresentations on a company's financial statements that inflate company earnings) unless it discloses the information to a named fiduciary before blindly following directions.
- Finally, while a directed trustee will almost never be liable just because it knows about adverse "public" information (on the theory that all information that is public is already factored into the value of the stock), in the case of company stock, a directed trustee can be liable for following directions when the public information raises a serious question regarding the company's viability as a going concern.

While this guidance is obviously directed at the Enron situation (i.e., the role of a directed trustee in following directions to purchase publicly-traded employer stock), its terms should provide some comfort to all directed trustee arrangements. At the same time, it appears that one should not have illusions that a directed trustee can always act blindly with respect to all directions. The trustee has some duty to question directions that appear to conflict with the terms of plan documents or the law. Plan sponsors will need to be prepared for a directed trustee to say that a direction is not sufficient, or that it needs an opinion of legality in addition to a direction, or that it will not take the directed action even if an opinion is proffered because in its judgment the action violates the plan or the law.

A DOL Believer—The *WorldCom* Case

WorldCom's demise was almost a carbon copy of Enron's death spiral—accounting irregularities, deception by corporate officers, adverse publicity appearing in the press with increasing frequency, a plunging stock value, 401(k) plan accounts heavily invested in company stock and bankruptcy, all resulting in angry employees linking up with an ambitious pack of plaintiffs' attorneys. The lawsuits that followed named scores of defendants, including Merrill Lynch Trust

Company, the WorldCom 401(k) plan's directed trustee which had dutifully followed participant and company directions to invest participant accounts in company stock. The script included arguments lifted almost verbatim from the *Enron* opinion. *In re WorldCom, Inc. ERISA Litigation,* 2005 U.S. Dist. LEXIS 1218 (S.D.N.Y. 2/1/05).

There is only one significant difference between the *Enron* and *WorldCom* cases. The *WorldCom* judge had the benefit of the DOL's guidance discussed above while the *Enron* judge did not. This difference obviously was *the* difference because Merrill Lynch was dismissed from the case, while the Enron trustee was not. The principal issue in *WorldCom* was whether Merrill Lynch had a duty to act on the basis of all the adverse public information circulating about WorldCom. The plaintiffs certainly introduced an impressive list of adverse information, which they dutifully termed "red flags," to hang tight to the *Enron* opinion: news articles on the decline in WorldCom's stock price, concerns about accounting, concerns about management, requests from the SEC seeking the production of documents, etc. Instead of following the Enron decision, the *WorldCom* judge looked at the new DOL release, labeled its guidance "well-reasoned and flow[ing] from a careful analysis of complex issues and concluded that such "persuasive guidance" by the agency charged with enforcing ERISA must be given substantial weight. The court then noted that with respect to public information, a directed trustee must act only when such public information raises a "serious" question regarding a company's "short term viability as a going concern." The court concluded that even though it was clear WorldCom's fortunes were declining during the period in question, Merrill Lynch simply did not have enough information to conclude there was a serious question about WorldCom's short-term viability as a going concern. This case, along with the DOL guidance, should breathe new life into the institution of directed trustees whose own short-term viability was in serious doubt following the *Enron* decision.

Court Upholds IRS in Taxing Employee/ Plaintiff on Attorneys' Fees

Here's a Supreme Court decision that might have been significant (and distressing) but for a recent change in the law. *Commissioner v. Banks,* 125 S. Ct. 826, 2005 U.S. LEXIS 1370 (1/24/05). The generic facts are as follows: an employee brings an employment discrimination lawsuit against his employer after being fired, seeking lost pay and other damages. Because he can't afford to pay a lawyer unless he wins, the employee agrees to pay his lawyer a contingency fee of 30% of any recovery. The case later settles or is decided by a court with the employee winning \$100x, of which the employer pays \$70x to the employee and \$30x to his lawyer. The employee pays tax on his \$70x, the lawyer pays tax on his \$30x and everyone seems happy—except for the IRS, which comes after the former employee saying he owes tax on the full \$100x award. Because of peculiarities in the tax law, the former employee is not allowed to deduct the \$30x paid to his lawyer and is pretty upset with the meager leftovers from his legal triumph after paying his lawyer \$30x and the IRS probably another \$30x to \$40x.

The double tax on the \$30x in attorney fees was eliminated by Congress last year when it amended the Code to permit a victorious employee to deduct the attorney fees he incurred in prosecuting his employment discrimination suit, thus leaving him to pay tax only on the \$70x he actually receives. But justice grinds on and *Banks* provides precedent for settlement payments prior to October 22, 2004 when the law changed. Not surprisingly, the Court unanimously upheld the Service's position that the employee must include the full \$100x in his income. The case was decided upon what is known as the "anticipatory assignment of income" doctrine, which basically says that he who earns or has control of income cannot escape being taxed on that income even if he assigns it to someone else. The reason for the doctrine is most easily understood in the context of a high income taxpayer who is not too pleased with his high income tax rate and assigns his income to a lower tax rate relative (a spouse or child, for example). But the IRS applies this doctrine in all cases, not just where assignments are intended to cheat the Service. In the *Banks* scenario, specifically, the Service's position is that because the right to sue and to recover damages belong to the employee, the employee is taxed—period. There is no need to consider that the attorney is paying tax on the same dollars, that the employee gets no offsetting deduction, and that the result hinders settlement of lawsuits.

The taxpayer in the *Banks* case made an argument before the Court that had been successful in many of the lower courts: namely, that he was not really entitled to the 30% contingent attorney fee in the first place and, therefore, it was not assigned. He noted that when he entered the contingent fee agreement, he had no idea whether he would win, or even if he did, how much he would win, and thus had nothing of value to assign. He also argued that the fee agreement effectively turned the case into a joint enterprise or partnership between himself and his attorney with the attorney performing services to earn his 30%. Thus, he concluded, the attorney wasn't just the passive recipient of someone else's money but was earning it by the sweat of his brow, or whatever. The Court did not bite. The lawsuit and any award stemming from it belonged wholly to the employee. His lawyer was only acting as the employee's agent—doing his bidding as it were. The lawyer may have brought some expertise or special skill to the enterprise, but ultimately the employee was in control of all the important decisions such as whether to settle or to press on to judgment. And whenever there exists a principal/agent relationship of this nature, the principal is entitled to all of the income of the enterprise, and the agent gets paid by the principal for services rendered—in other words, the attorney is like an employee working for a corporation.

The decision is a huge win for the IRS because it endorses wholeheartedly the assignment of income doctrine. On the other hand, future settlements are not impacted by the decision. With the amendment to the Code, although employees must report as income the full amount of the award, they can deduct the full amount paid to their attorneys. Employers also win under the new law because settlements in these cases will go easier—and cheaper. In the past, if an employee knew about the disastrous tax consequences, he would typically ask for more money or refuse to settle.

There is even one twist to the *Banks* case that may be helpful with respect to settlements under old law. One argument raised in *Banks* was that the assignment of income doctrine should not apply where the antidiscrimination law in question has a "fee shifting" provision. Fee shifting is an exception to the normal practice that each party to a lawsuit must pay for his own lawyer. A fee shifting provision permits a court to require the employer, or other defendant, to pay the plaintiff's attorney fees if the plaintiff wins. The tax argument arising from fee shifting provisions is that they reflect a congressional decision that the attorney is working not as an agent for the plaintiff but for the public good, i.e., that the enforcement of employment laws is more effectively handled through litigation than by administrative agencies. In any event, the Court held that because the *Banks* fees were paid to the attorney under a contingent fee agreement and were not awarded by the court, it need not consider this argument for the moment. Thus, if you have an old settlement or judgment where attorney fees were blessed by the court, you are at least not precluded from arguing that the fees are not your tax burden.

Equitable Relief Versus Legal Relief

Equitable Relief is the Sole Remedy for Unsportsmanlike Conduct. Roth's former wife obtained a QDRO awarding her 65% of Roth's 401(k) account. Roth informed the plan of this order but about two months later, and before the plan had paid out his former "Mrs.," he applied for a distribution of his full account balance. The plan mistakenly sent him a check for the full amount, and he endorsed it over to Schlaht. Upon realizing its error, the plan's fiduciary sued Roth and Schlaht seeking a return of the excess distribution. The district court was not amused by Roth's lack of chivalry and gave a whole bunch of relief to the plan: a constructive trust was imposed on the funds in his and Schlaht's possession, meaning they had a legal duty to hold the funds in trust for the former Mrs. Roth, they were personally enjoined from using or spending the funds in the trust, and they were ordered to return the funds to the plan. So far, so good, but the court also added for good measure that the two were personally liable to the plan and entered a judgment against them for the exact sum of the excess payment plus interest. What could be wrong with this relief? Well, ERISA allows a plan fiduciary to sue others only to enjoin their violations of ERISA or of the plan or to obtain "other appropriate equitable relief." As we've explained at other times, "equitable" relief allows a court to order a person to do something (return the money in your possession) or not to do something (don't spend the money in your possession). In other words, the court can order actions. However, money damages is legal, not equitable, relief. Thus, the appellate court threw out the legal relief of a fixed sum of money on the grounds it is not authorized by ERISA. *North American Coal Corporation Retirement Savings Plan v. Roth,* 2005 U.S. App. LEXIS 1213 (8th Cir. 1/25/05).

So, if there is a constructive trust and Roth and Schlaht must return the money, what's the problem? The problem is that they may not have some or all the money. Roth has none because he gave it to Schlaht, and one suspects Schlaht may have spent some of it before the culmination of the court proceedings. If the money judgment for the full amount of the erroneous payment were upheld, the plan could have enforced it against any assets Roth and Schlaht may have. With only the constructive trust binding up the money not yet spent, the plan will owe any shortfall to the former Mrs. Roth, in effect having to pay at least some, and perhaps all, of her benefit twice. It seems by now that we have had a sufficient number of cases like this for Congress to amend ERISA by removing the "equitable" relief provision and instead let the courts impose any appropriate relief.

Coming in the Back Door Won't Work. So, what's a lawyer to do if he really wants money, but ERISA permits only equitable relief? Well, of course, he dresses up a claim for bucks to look like equity. *Ramsey v. Formica Corp.,* 2005 U.S. App. LEXIS 2023 (6th Cir 2/9/05). In an effort to reduce its work force, Formica offered an early retirement incentive under its pension plan. After the enhanced payments had been made for a period of 8-17 years, an audit revealed that the plan had been overpaying about 300 participants. The excess amounts were then eliminated, and the retirees responded with a lawsuit seeking to have their benefits restored. The court threw out their state law claim on the grounds of ERISA preemption and then proceeded to examine their ERISA claims. These were cast in terms of a temporary restraining order (a "TRO") asking the court to order the payments be restored. A TRO is clearly an equitable claim since it boils down to an order to do something or not do something. However, the court concluded that while this claim was all dressed up in equity, it was nothing more than a bid for money, i.e., a claim whose only end was to seek an increase in pension dollars. The consequence? No relief. Once again, regardless of how one might feel about whether pensioners should be able to continue receiving erroneous pension benefits, there is something not quite right about a statute intended to protect pension benefits from being interpreted as prohibiting pensioners from even having a cause of action to make their claims.

Granted, ERISA does permit these pensioners to make a claim for benefits under another provision (Section 502(a)(1)). However, there would no relief under this provision since they received the full benefits promised by the plan. Their real complaint is not that they failed to receive the benefits promised by the plan but that they relied on what they were told, had been receiving the mistaken benefits for 8-17 years and, accordingly, had some sort of right to continue receiving the benefits. For this type of claim, ERISA permits actions only under the provision allowing "other appropriate equitable relief" to correct or enforce violations of ERISA or of the plan (Section 502(a)(3)). The term "equitable" sounds like it gives broad authority for the courts to do whatever is right (i.e., "equitable" in the common understanding of the word), but the term is actually quite limiting because of the courts' construing the terms to its narrow, technical meaning.

Severance Plan?

Here's an example of a court interpreting ERISA to expand relief options for employees rather than to restrict them as discussed above. *Emery v. Bay Capital Corporation,* 2005 U.S. Dist. LEXIS 1649 (D. Md. 1/25/03). Emery received an offer of employment by e-mail; one of the offered terms was a promise of six months' severance pay if he were fired for any reason other than fraud or misrepresentation. About a year after he was hired, Emery was laid off not because of anything he did but because his job was eliminated. He sued to receive his pay under various state law causes of action that presumably offered more, or at least easier, relief than ERISA. His employer argued that because ERISA covers severance benefits and preempts state law, his sole remedy fell under ERISA. The employer was right that ERISA applies to severance plans, but, as the court observed, only if the severance benefits are provided by employer "plans." Was the e-mail message a plan?

There is history behind this issue. Several years ago, the State of Maine passed a law requiring any employer who shut down a plant in the state to pay a specified lump sum benefit to terminated employees. An employer shuttered a plant, refused to pay the required benefit, and the employees sued. The employer justified its actions by saying that ERISA covers severance benefits and accordingly preempts Maine from enacting any law regulating these benefits. The lower federal courts agreed. When the case reached the Supreme Court, it apparently was unable to let an employer be so brazen as to simply brush off state law. It concluded that the state law was not a "plan" because it didn't require an ongoing administrative scheme and hence was not governed by ERISA. Since it was not a plan, ERISA does not preempt state law and the plaintiffs could sue for their state-mandated benefits. *Fort Halifax v. Coyne*, 482 U.S. 1 (1987).

Ever since *Fort Halifax,* courts have relied on it when they wish to avoid ERISA for one reason or another, usually not because ERISA regulation would achieve a "just" result but because, as in *Fort Halifax,* it actually fails to regulate at all and they wish to open the matter to state justice. As a general rule, the factors they use to determine whether a severance "plan" exists or not are: (1) whether payments are lump sum or continuous; (2) whether the employer's promise is a long-term commitment; (3) whether the payments are triggered by a single unique event or occur with any termination of employment; and (4) whether the payment is automatic on the one hand or, on the other, the employer needs to use its discretion or undertake a review of facts to determine if a benefit is payable. All of these factors are intended to ferret out whether the severance benefits will require an ongoing administrative program to meet the employer's obligation. While the court here paid lip service to these factors, it held that it stretches the common meaning of the word "plan" beyond recognition to find that a single e-mail to the plaintiff employee constitutes an ERISA plan. This decision successfully lifted the employee out of ERISA and into the favorable arms of state law to press his claim for benefits.

IRS to Employees—Everything's Taxable

"Wages" paid to employees are subject to income taxes at ordinary income rates instead of lower capital gains rates, are subject to FICA and Medicare taxes, and are subject to withholding. If only payments related to property rights, they would be considered as capital in nature and the foregoing consequences could be avoided. Well, many years (really decades) ago, the IRS did in fact hold that certain payments to employees might be capital in nature. Unfortunately, as the years went by these rulings were undermined by subsequent rulings and court cases. More unfortunately, the IRS has recently decided to pull the rug out of the capital argument entirely by holding the older rulings to be obsolete. *Rev. Rul.* 2004-109, 2004 IRB LEXIS 488; *Rev. Rul,* 2004-110, 2004 IRB LEXIS 489. Here are the scenarios:

Sign-on bonus for baseball player:

Old Ruling:	*New Ruling:*
not ordinary income because paid for signing and not contingent on the performance of either past or future services	ordinary income because payable in connection with establishing an employment relationship

Ratification bonus to union members when CBA is ratified:

Old Ruling:	*New Ruling:*
not ordinary income because not contingent on performing services but paid simply for being a member of the union on the ratification date	ordinary income because payable in connection with establishing an employment relationship

Negotiated payment to employee with employment contract to relinquish the contract:

Old Ruling:	*New Ruling:*
not ordinary income because the transaction relates to property rights (the employment contract) which is capital in nature	ordinary income because payment is a substitute for compensation the employee would otherwise have received had the contract not been terminated.

It hardly seems stretching it to conclude that the IRS sees "wages" in any payment made in connection with every employment relationship which is to come, which is or which has been. Other than that, maybe you have an argument.

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