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Legal developments affecting employee benefits

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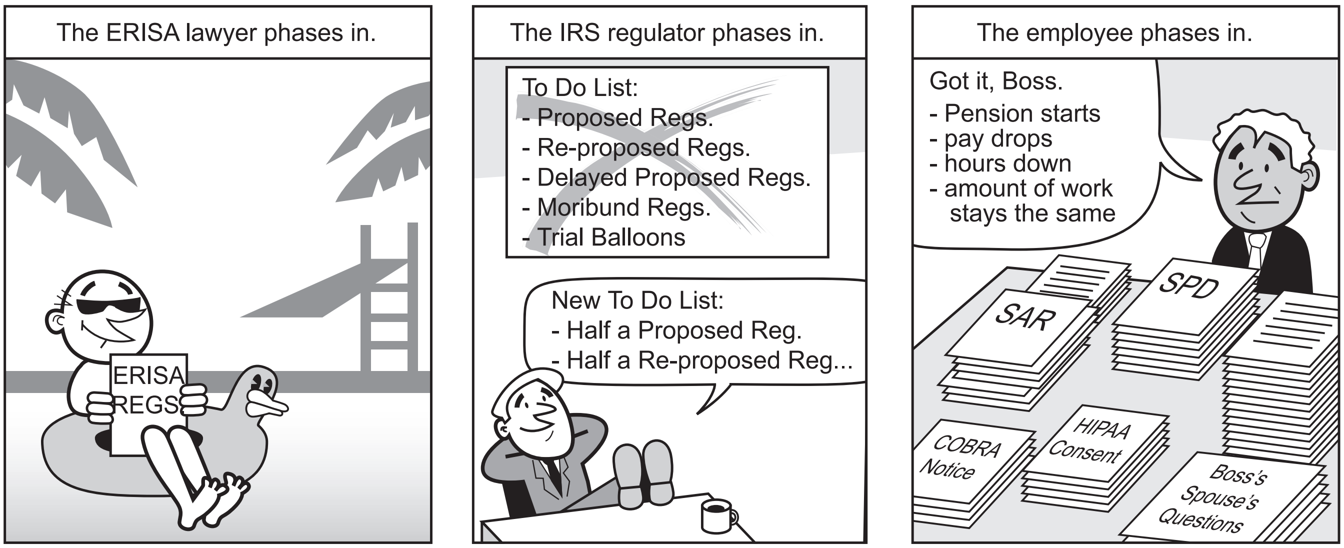

IRS Proposes Phased-Relief in Response to Phased-Retirement Pressures

Regulations in effect for decades define a tax-qualified pension plan as one that provides benefits "after" retirement. And the IRS has for decades construed these regulations as preventing pension distributions before an employee reaches normal retirement age, typically age 65, unless he terminates employment. Until now, this restriction has been only an irritant. Now it is seen as an impediment to one of the latest new things: phased-retirement. In case you missed it, we are apparently in a paradigm shift where we are supposed to stop thinking of retiring early (or maybe even retiring at all) and instead plan to keep slogging it out because (pick one or more): we haven't saved enough; we lost what we had saved in the "dot-com" bust; employers can't replace the boomers if they were to leave the workforce; boomers need to keep working and paying taxes to enable politicians to spend money on governmental things; boomers need to keep working because they want to; and so on. At the same time, continuing to work at the same insane pace we've worked ourselves into is not practicable for aging bodies. Ergo, we will work but at a lesser pace, phasing into retirement by degrees. The no retire/no pension rule is an obstacle to this paradigm because employees say they can't live on reduced earnings and would just as soon quit if that's what it takes to get their pensions.

The IRS has proposed a fix that would permit a partial pension distribution proportional to an employee's reduction in his workload. Prop. Treas. Reg. §1.401(a)-3. For example, if an employee has an accrued benefit of $2,000 per month and agrees to reduce his working hours by 25%, he or she could collect 25% of $2,000, or $500 per month in pension benefits while continuing to work. Because the employee would have a dual status of retiree and active participant, he or she would be eligible for all retiree enhancements (subsidized early retirement) and continue to accrue a pension benefit. Some of the key requirements for taking advantage of this benefit: the employer must establish a written phased-retirement policy; an employee will be eligible only after reaching age 59½; the employee must agree to reduce his or her workload by at least 20%; the employer must monitor the employee's workload to make sure his or her hours stay reduced: a highly compensated employee (HCE) at the outset must continue to be treated as an HCE through the phased-retirement period; the benefit payment cannot be a lump sum or any other type of distribution that is eligible to be rolled over to an IRA or other plan. These proposed rules cannot be relied upon currently; they will be effective only when final regulations are issued.

While the Service is to be commended for being responsive to a paradigm shift, one wonders whether this is the best it can do. For one, the benefit is fairly modest compared to the complexity and attendant administrative costs of satisfying these requirements. For another, the rules aren't consistent with the 401(k) plan rules on which more and more employees rely for their retirement income. In a 401(k) plan, an employee can receive his entire benefit at age 59½ while still working. Why not just adopt the same rule for pension plans? It is a simple rule, it would put employees under both types of plans on the same footing, and would not appear to be an impossible intellectual challenge for the IRS to redefine retirement as reaching age 59½ instead of age 65. Finally, this is not the rule that employees really want. Many feel that they have earned a pension benefit by the time they reach their mid-to-late 50s and are impatient to reap the rewards. Since they can receive a benefit if they quit, many do resign, commence their pension and take a job with another employer—a very inefficient process since the first employer loses the employee's long-term experience and in many cases it has lost that employee to a competitor, and the employee is stuck learning a new job. This is not to say the IRS does not have a legitimate concern. If taxpayers provide tax subsidies to provide for retirement benefits, then we ought to ensure that benefits will be there for retirement. But if that is the policy, then it ought to apply to all taxpayer-subsidized benefits from pension plans to 401(k)s and 403(b)s to IRAs. Having a different rule for pension plans betrays a lack of a consistent policy. Moreover, a unique, complex rule for pension plans simply gives employers one or more reasons to get rid of them in favor of plans that are more user-friendly.

Automatic IRA Rollovers for Distributions Under $5,000

If someone ceases plan participation with an account balance of less than $5,000, the plan can automatically cash out the benefit without the participant's consent. Typically, the employee is given a check for the cashout amount, and typically he or she spends it. In a modest attempt to try and preserve retirement benefits until retirement, EGTRRA contains a requirement that if a participant fails to ask for a cash distribution or to have the distribution rolled into an IRA of his or her own choice, then the employer must deposit the money in an IRA chosen by the employer, if the distribution is between $1,000 and $5,000. The cash payment, in other words, can no longer be the plan's default option for distribution in this range. The rule will go into effect March 28, 2005 by which time the IRS will have issued model plan amendments and by which time you must select both the default IRA vendor for your plan and the investment fund for the IRA.

The choice of an IRA vendor and of an IRA investment are fiduciary functions for which you could normally be held personally liable if your selections were imprudent. However, the DOL has now issued safe harbor regulations which, if followed, will relieve you of your fiduciary liability. *See* 29 CFR § 2550.404a-2. To fall within the safe harbor you must, in principal part:

1. Select as an IRA provider an established financial institution (bank, brokerage firm, mutual fund firm, insurance company) that satisfies prescribed IRA standards.
2. Give a participant an SPD or SMM which describes the automatic rollover, the reason for it, the reason for the investment you've chosen for the IRA, the fees and expenses that will be charged to the IRA, the name of the IRA provider, the name of the plan's representative who can answer questions, and certain other details.
3. Your agreement with your selected IRA provider must contain the following terms and conditions:
   - the IRA investment must be a money market fund, CD, stable value fund, or similar investment that preserves the dollar value of the amount rolled over.
   - The investment product you select must be offered only by certain regulated banks, credit unions, insurance companies, or mutual fund companies.
   - The fees charged against the IRA cannot exceed the fees charged for comparable IRAs used for purposes other than mandatory rollovers.
   - The IRA participant must have the legal right to enforce the terms of the IRA against the IRA provider.

You are not required to follow this safe harbor, but if you do not, you face potential fiduciary liability for your choices. The principal question about whether to use the safe harbor, we feel, is whether it is fair to participants to dump their money into the extraordinarily conservative investments required by the DOL because they stand little chance of having any significant returns over the level of inflation. This question is particularly apt where a plan itself has a default option for those who make investment elections that is more liberal, e.g., an age-specific lifestyle fund or a balanced fund. On the other hand, is there any reason for you to take any risk when the DOL has given you the means to avoid it and participants can still be given the option to take cash or to roll their funds to an IRA of their own choosing and thereby avoid the default IRA rollover? Another question that crops up is how much searching is required to find an IRA rollover provider. Well, if your current plan provider is also an IRA provider, then you should probably stick with that provider. After all, you presumably have already determined that you made a prudent selection and both the institution and its investments and procedures are the ones most familiar to your participants. Of course, you need to pay attention to fees, and if your fund sponsor's IRA fees are out of whack, in this era of fee sensitivity you should look around. The problem is whether anyone other than your current fund provider will want to have anything to do with small accounts of participants whose very presence in the default pool demonstrates a lack of interest in retirement savings, presumably including a lack of interest in contributing to the IRA and thereby helping to enrich the IRA sponsor.

Missing Participants

Most of us encounter the problem some time: a benefit of some sort is clearly payable but the participant or beneficiary can't be found. Many times, you can just sit still and wait for the person to submit a claim; but sometimes you can't — as when you wish to terminate a retirement plan and the IRS will not let you until all the participants and beneficiaries have been paid out. Plan administrators have done many things to get rid of the benefits of the missing — send them to the state as unclaimed property, send them to the IRS as withheld taxes, put them in a bank account in the participant's name, etc. Of no little concern in this effort to get rid of the money is that the action one takes is a fiduciary action in which one is potentially liable for making the wrong choice, i.e., a choice that is imprudent or not in the best interests of the participant.

The Department of Labor has recently issued a nifty guideline that not only makes abundant good sense but also should relieve one who adheres to its terms from fiduciary liability. *DOL Field Assistance Bulletin 2004-02* (9/30/04). The guideline contains a roadmap on the steps you need to take to find a missing participant. It also tells you how to dispose of the benefit if your search is unsuccessful. Finally, the disposition rules apply not only to missing participants but also to participants who are not missing but who refuse to fill out forms, make payment elections or otherwise fail to cooperate in taking the steps necessary to receive a payment.

First, the DOL says that in determining your search techniques for the missing you are allowed to balance the expenses for a particular search with the size of the benefit. This leads the DOL to say that the following basic search methods must always be used because they are so cheap there is no excuse for overlooking them: first class mail, certified mail, electronic notification, reviewing the records of other plans in which the employee participated to see if they provide a contact, identifying and contacting beneficiaries the participant has designated to see if they know the participant's whereabouts, and using the letter forwarding services of the IRS or the SSA. If these methods do not work, then you should proceed to use the following methods, taking into account their cost in relation to the benefit amount: internet searches, commercial locator services, and credit reporting agencies.

If you remain unsuccessful in locating the missing participant or in convincing him or her to cooperate in taking the steps required to receive a distribution, your first option must be to open an IRA and roll the benefit into it. The DOL requires this first step because it is the one that has the best chance of preserving the benefit for its intended purpose, namely, retirement income and has no adverse tax consequences to the participant. Although the DOL does not say so, the safe harbor IRA rollover rules discussed above seem to offer the best guide for selecting an IRA provider and an investment. Only if you cannot open an IRA (in most cases because the amount is so small that no IRA sponsor will be willing to open the account), are you allowed to take an alternative route: put the money either in a federally insured bank account or in a state's unclaimed property fund. Significantly, the DOL says that paying the funds to the IRS as withheld taxes is unacceptable. Although the IRS can't be happy that the DOL has released the following bit of intelligence, here it is: the IRS does not think its program for matching reported income to taxpayers who received it is good enough to ensure that the withheld funds will eventually be credited to the individual.

Although the DOL guidance applies directly only in the context of terminating defined contribution retirement plans, the advice is so sensible that it makes sense to apply this roadmap to locating missing participants and beneficiaries in all types of employee benefit plans.

Miscellaneous Curiosities

No Fiduciary Duty to Fire an Employee. Joseph Ferrer retired from Chevron shortly before reaching normal retirement age. Had he been fired he would have received an enhanced retirement benefit. Instead, because he quit he received only a normal benefit. In order to correct this injustice, he sued Chevron alleging that the Company's refusal to fire him was a breach of the fiduciary duty it owed Ferrar under the plan. Honest! *Ferrer v. Chevron Corp.*, unpublished opinion reported in 31 Pens. & Benefits Rep. (BNA) 2570 (S.D. Miss. 11/5/04). Fortunately, the court held that Chevron's decision to withhold the axe was made in its role as an employer; not as an ERISA fiduciary.

No Duty to Pay Severance if Compensation is not Actually Reduced. It must be a rare employee who hasn't thought there must be some way of quitting work and getting his employer to finance his unemployment. Often it is disability pay or workers' compensation that would-be quitters seek, but in this case it was severance. Brenda Johnson had a golden parachute contract that promised severance pay if, following a change in control, she quit work due to a reduction of more than 10% in her pay. Well, there was a change in control and her new employer did propose to reduce her pay but before it implemented its proposed compensation plan the company reversed itself and kept her pay intact albeit under the new plan. Johnson quit anyway and claimed entitlement to severance pay because the proposed pay change triggered the golden parachute contract. The court concluded that there was no gold in this claim because Johnson's pay was never actually reduced, i.e., nothing occurred, therefore, nothing gained. *Johnson v. U.S. Bancorp., 387 F.3d 939,* (8th Cir. 11/2/04).

Partial Termination Calculations. If a retirement plan is partially terminated, all affected participants must be fully vested. To the delight of lawyers, the standard for determining whether a partial termination has occurred is full of ambiguity. Here's a case in which the legal fees expended in fighting over the issue almost certainly far outweighed the amount of benefits that were subject to the squabbling: *Matz v. Household Int'l. Tax Reduction Investment Plan*, 388 F.3d 570 (7th Cir. 11/5/04). The case began nine years ago when Household sold the line of business employing Matz, and he thereupon dropped out of Household's employment and 401(k) plan, thereby forfeiting 40% of his 401(k) account balance. Now, the IRS has an administrative rule that a partial termination will be presumed if there is a 20% or more reduction in plan participation. For example, if a plan has 100 participants at the beginning of the year but only 75 at the end of the year, there is a presumption the plan partially terminated and that any of the 25 terminated participants who were not fully vested must become fully vested. The problem is that this court, along with many others, has frequently found many alternative ways of applying the rule. This court first adopted the IRS position of looking at all participants, vested and non-vested, in calculating whether the reduction reached the 20%. Then, when the case came up a second time, it decided that the proper approach was to look at only non-vested participants (apparently on the theory that the vesting rule impacts only the non-vested participants). On this, its third try, the court went back to its original position of looking at all participants. ("The natural way to decide whether a partial termination has occurred is to see how close it is to a complete termination.") So after nine years and three full decisions by the lower court and three by this court, Matz now knows whether he was supposed to have been fully vested, right? Not exactly. Although the court came out with a clear holding that one must look at all participants, both vested and non-vested, when doing the calculations, it found another issue to noodle on, namely, what period of time does one look at when calculating the percentage drop: one calendar year, one transaction (i.e., the one transaction involving Matz) or several transactions that properly should be aggregated and treated as one because they are part of an overall plan of shrinking the company? The court determined the last was appropriate but did not determine which corporate transactions should be aggregated with this one, saying the percentage reduction could fall anywhere between 15.4 and 35.8 percent depending on one's choices. Hence, it remanded the matter to the lower court to make the decision and do the math. It also noted that even if the percentage drop is more than 20%, this results only in a rebuttable presumption of a partial termination. Therefore, the lower court must also look at all the other facts and circumstances of Household's transactions to see if the presumption can be rebutted. No doubt, unless the parties settle once the lower court has examined all these factors, the case will pop back up to the appellate court for yet another review. If you still haven't got the message, here it is: When in doubt, vest. There is usually not a lot of money in partially vested accounts (by definition, we are looking at short-term employees whose account balances will not be very high). Also, there is usually enough anger in short-term employees who lose a portion of their accounts through no fault of their own, particularly if they've also lost their jobs, to give them an incentive to sue and enough issues they can raise over how one properly determines whether a partial termination took place that lengthy litigation is a big risk. So, unless you wish to spend a lot of time with your lawyers, if there is any question that your actions may have caused a partial termination, you should think seriously about vesting all the non-vested employees you drop from your plan.

Misleading Statements Not Actionable. It is no surprise that lawyers make nitpicking technical arguments in support of their clients' claims. It is surprising when courts embrace them. One example: an obviously eligible employee is denied participation in a plan. He sues, and the court throws out his complaint because ERISA permits suits only by "participants" and because he was denied participation he is, by definition, not a participant (most courts now reject this particular "reasoning" by holding that anyone with a colorable claim to being a participant is a participant for purposes of entitlement to bring a lawsuit). But here's a new example: *Beach v. Commonwealth Edison Co.*, 382 F.3d 656 (7th Cir. 8/24/04). Randall Beach retired from Commonwealth Edison when he was 52 years old, three years before he would have been able to receive retiree health benefits. Since he knew that the ComEd had a history of offering voluntary early retirement programs that included health coverage for persons his age, he asked both his supervisor and the company's HR staff if such a program was in the planning stage. He was told there was no such planning and even if a plan were offered, it would not be offered to employees retiring from his department. Six months after Beach retired, a program was offered — it covered employees in his department and if he were still employed, he would have received the benefit. He was not pleased, and he sued ComEd for a breach of its fiduciary duty based on the misleading statements. While the court said that Beach would have lost if it were to apply the "serious consideration" standard typical of these cases (the employer is not liable for misleading statements about early retirement programs until after it has given serious consideration to implementing a program), the court eschewed that approach to hold that ComEd employees were not acting in a fiduciary capacity when they made the misleading statements. Why? The court observed that the serious consideration test had only been applied in cases where a company lied about whether there might be amendments to existing plans. Despite the fact that Beach was a participant in the company's pension and health plans for 31 years, this court concluded that the enhanced health benefits were offered under a new plan, not an existing plan. Since the new plan was not in existence when the company lied, the company could not have yet been a fiduciary with respect to the plan. This holding is breathtaking in the context of at least the *Varity* and *Enron* cases where the courts have held company employees and directors liable if they owe a fiduciary obligation under the company's benefit program in general whether or not they happen to be fiduciaries with respect to a participant or plan. This case seems even easier because, retiree health benefits are really nothing more than one component of a company's existing health benefits package. Moreover, even if the plan were a new type of plan, what justification can there be for a company lying to its employees about a plan about to be borne but not about an existing plan about to be amended? One would have expected a court to find some way of concluding that a company simply can't lie about impending changes to its benefit program.

Never Mind. The IRS has saved you from a problem you may not have known you faced. Earlier this year Congress passed something called the Working Families Tax Relief Act of 2004. Among other things, it rewrote the rules on who qualifies as a "dependent" under Code Section 152. One modest change added a gross income limitation on relatives other than minor children who can qualify as dependents, meaning that certain relatives now treated as dependents no longer will be. This is all well and good for general tax purposes but since the term dependent is used in various employee benefit sections of the Code, including the income exclusion for employer-provided medical benefits under Code Section 106, it would mean that some people now treated as dependents by health plans would no longer be so treated for tax purposes, which means that the value of their medical benefits would need to be added back into the employee's income. The Service has just saved us all from this potential employee relations and tax reporting fiasco by issuing a notice saying that it will draft regulations that permit health plans to ignore the new definition of a dependent and to continue using the old definition. IRS Notice 2004-79. What about other plans that cover dependents, such as dependent care or group term life insurance? The Service was silent which means that there may be a tax problem, e.g., an employee who uses a dependent care FSA to pay for the care of parents who may earn more than the now-allotted $3,200 per year. On the other hand, maybe Congress will correct the whole merit credit.

No ERISA Preemption of Stop/Loss Coverage Claim. Many an employer has benefited from ERISA's preemption of state laws when a court has thrown out a state law contract or tort claim, such as wrongful interference with employment rights, holding that the employee's only recourse is to bring an ERISA claim for benefits. A stop/loss carrier recently tried to turn the tables. *Northern Kare Facilities v. Benefirst LLC*, 2004 U.S. Dist. LEXIS 21963 (D. Mass. 11/1/04). Northern Kare sponsored a self-insured health plan that included stop/loss coverage to protect it against employee health claims above a specified dollar level. The stop/loss carrier denied coverage for one of these very high claims. Northern Kare brought a state law action against the carrier, and the carrier attempted to have it thrown out on the grounds of ERISA preemption. However, the court held that the action was not an ERISA claim because it did not relate to the plan in the sense that neither the plan's benefits nor the plan's participants were implicated. The insurance was intended only for the protection of the employer, i.e., to limit its liability, not for the benefit of the employees. Why is any of this important? Well, usually because state law provides more potential claims, the possibility for jury trials (unlike ERISA), and more varied and generous forms of relief. Since this combination improves employees' chances, it is not for nothing that employers call for ERISA to preempt state law.

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