EMPLOYEE BENEFITS DEVELOPMENTS AUGUST 2013

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Practices & Industries

Employee Benefits

RULINGS, OPINIONS, ETC.

IRS Compliance Check Targets Non-Governmental 457(b) Plans. Tax-exempt entities that sponsor Internal Revenue Code Section 457(b) plans may soon find compliance questionnaires from the Internal Revenue Service (IRS) in their mailboxes. The compliance check will be conducted by the IRS Employee Plans Compliance Unit (EPCU). Questionnaires will be sent to approximately 200 non-governmental tax-exempt employers in fiscal year 2013, with an additional 200 employers receiving forms in 2014. According to IRS sources, recipients of the information requests will be randomly selected based on information reported on employers' IRS Forms 990. The goals of the program are to identify noncompliance issues and to develop recommendations for employers on how to ensure plan compliance.

Eligible 457(b) plans, commonly known as "top hat" plans, are designed to provide nonqualified deferred compensation for select groups of highly compensated employees, managers, directors and officers of tax-exempt organizations. To achieve the intended tax deferral for participants, 457(b) plans must satisfy specific documentary and operational requirements. Among the requirements singled out for special attention by the EPCU are the eligibility of a plan's sponsor, whether participant eligibility is properly limited to the select top hat group, whether the plan contains impermissible features, and whether hardship distributions have been made under a plan's "unforeseeable emergency" provisions. If the IRS determines that a plan is not in compliance with the rules, the IRS may conduct a plan audit or recommend correction under its Voluntary Correction Program. The IRS announcement of the compliance review states that submissions relating to correction of these plans will be accepted on a provisional basis outside of the Employee Plans Compliance Resolution System (EPCRS) and will be evaluated on a facts and circumstances basis, employing standards that are similar to EPCRS.

Employers who receive the compliance check letters should respond to the letters promptly, even if they do not maintain a 457(b) plan or otherwise believe they were contacted by mistake. Also, given the IRS scrutiny, all tax-exempt employers with 457(b) plans may wish to review the documentation and operation of their plans, regardless of whether or not they receive a questionnaire. Details of the program may

be found on the "Employee Plans News" page of the IRS website, http://www.irs.gov/Retirement-Plans/Employee-Plans-News.

CASES

Withdrawal Liability From Multiemployer Plan and Alter-Ego Liability. Because of the severe underfunding in many multiemployer defined benefit funds, we are seeing increased collection activities by these funds to collect withdrawal liability. In many situations, the direct contributing employer is unable to pay withdrawal liability. Therefore, multiemployer funds look for other entities that could be liable for such payments. One theory that funds have been pursuing is to claim that other entities are "alter-egos" of the withdrawing employer and thus are liable to the fund. As two recent cases illustrate, this theory is very fact-specific; sometimes funds are successful and other times they are not.

In the first case in the U.S. District Court for the Northern District of Ohio, (*Local 134 Board of Trustees of the Toledo Roofers Pension Plan v. Enterprise Roofing & Sheet Metal*, N.D. Ohio, 2013), the district court found that a related company was an alter-ego. Enterprise Roofing and Sheet Metal (Enterprise) participated in a multiemployer plan and, when it ceased operations, it was subject to withdrawal liability of slightly more than $600,000. Enterprise did not pay the withdrawal liability, and the fund sought payment from an entity owned by family members. Enterprise was a family-owned business and was the party to a collective bargaining agreement. The second company, which had a similar name, Enterprise Roofing and Remodeling Services Inc. (Newco), and was non-union, was founded when the president of Enterprise realized that Enterprise would probably fail financially. The president's wife, who had no experience in the business field, incorporated Newco. The president helped his wife run the company, used the same attorney to form the new company, and two employees from Enterprise served as Newco managers. The president, upon divorcing his wife, received all the shares of the new company. Over the period of operation, there was a substantial overlap in management, shared business facilities and equipment, and shared customers between the two companies. It was also found that there was extensive lending of money between the two companies with no intention to repay. The district court found that the new company was formed to avoid the burden of Enterprise's collective bargaining agreement with the union and, therefore, was liable as an alter-ego.

The second case, in the U.S. District Court for the District of Columbia (*Boland v. Thermal Specialties Inc*., D.D.C., 2013), Thermal Specialties Inc. (TSI) operated for more than 30 years and participated in a multiemployer defined benefit plan. In 2009, one of TSI's former employees purchased all the assets of TSI, and TSI closed. The new company (Newco) encouraged the employees of TSI to apply for work with Newco with the caution that benefits and terms of employment would be changed. The union filed a charge with the National Labor Relations Board (NLRB) alleging that Newco was an alter-ego of TSI. The NLRB dismissed the charge. Subsequently, the fund trustees sued TSI and Newco, claiming them to be jointly and severally liable for deficient pension contributions to the multiemployer plan. The district court found that many of the elements necessary to impose alter-ego liability were present because there was some substantial overlapping of management and business purpose operations and customers. However, the district court did not find the companies were alter-egos because it found they are not essentially the same company. The district court found that the purchase was sufficiently an arm's length transaction with no record of "flim-flammery," citing that the negotiations for the purchase were arm's length and that the court's analysis follows that of the NLRB's.

As these two cases illustrate, the application of the alter-ego theory is dependent on the factors that are present, and we can expect funds to raise the alter-ego claim more frequently in the current multiemployer plan environment.

Private Equity Fund Deemed Trade or Business. The Employee Retirement Income Security Act of 1974 (ERISA), as amended by the Multiemployer Pension Plan Amendment Act of 1980 (MPPAA), imposes withdrawal liability against an employer for its proportionate share of a multiemployer pension fund's unfunded vested benefits when the employer withdraws from the fund. For this purpose, "employer" is defined to mean all trades or businesses that are under common control. Private equity funds have taken the position that they do not constitute trades or businesses, but are merely passive investors in their portfolio companies. As a corollary to this, private equity funds maintain that they may not be held liable for withdrawal liability resulting from a portfolio company's withdrawal from a multiemployer pension fund. The U.S. Court of Appeals for the First Circuit recently rejected this position, holding that a private equity fund constituted a trade or business.

Sun Capital Advisors, a private equity firm, formed two private equity funds, Sun Fund III and Sun Fund IV. Sun Funds III and IV were limited partnerships overseen by their respective general partners. Through a number of affiliated entities, Sun Fund III acquired 30 percent and Sun Fund IV acquired 70 percent of the outstanding stock in Scott Brass, Inc. (SBI). Sun Fund IV's general partner arranged for SBI to receive management services from employees of Sun Capital Advisors, who thereafter actively participated in the management and operations of SBI. Sun Fund IV was entitled to an offset against the 2 percent management fee it otherwise would have owed its general partner for any management fees received by the general partner from one of Sun Fund IV's portfolio companies.

At the time SBI was acquired by the Sun Funds, SBI was a contributing employer to a multiemployer pension fund. SBI subsequently was unable to make contributions to the multiemployer pension fund, triggering withdrawal liability. Involuntary bankruptcy proceedings were brought against SBI shortly thereafter. Following SBI's withdrawal from the multiemployer pension fund, the pension fund sent a notice and demand for withdrawal liability to SBI and to the Sun Funds. As discussed in our December 2012 newsletter article, the Sun Funds filed suit in federal district court, seeking a declaration that they were not a trade or business, with the district court deciding in favor of the Sun Funds.

In reversing the district court, the First Circuit adopted an "investment plus" test to determine the existence of a trade or business. That test asks 1) whether an entity has made an investment with the principal purpose of making a profit (the "investment prong"), and 2) whether the entity has undertaken sufficient activities with respect to the company it has invested in (the "plus prong"). With the investment prong found to be easily satisfied, the court also found the plus prong satisfied based on the following factors:

- The extensive management authority granted to Sun Fund IV's general partner by Sun Fund IV's partnership agreement and discussed in private placement memorandums.
- The general partner's own partnership agreement empowered it to make decisions about hiring, terminating, and compensating agents and employees of the Sun Fund and its portfolio companies.
- The general partner received a percentage of the total commitments to the Sun Fund and a percentage of the profits as compensation.

- The purpose of the Sun Fund was to seek out potential portfolio companies in need of extensive intervention with respect to their management and operations, to provide that intervention, and to then sell the companies.
- The Sun Funds' controlling stake in SBI placed them and their affiliate entities in the position of being intimately involved in the management and operation of SBI.
- Through the management agreements arranged by Sun Fund IV's general partner, Sun Capital Advisor employees became immersed in the management and operation of SBI.
- Sun Fund IV received a direct economic benefit from the ongoing management of SBI by Sun Fund IV's general partner through an offset to the two-percent fee it otherwise would owe to its general partner. Although the court disclaimed any one factor being dispositive, the fact that Sun Fund IV received this offset seemed to weigh heavily in favor of it being found to be a trade or business.

It is important to note that the court's holding was limited to Sun Fund IV. The issue of whether Sun Fund III also constituted a trade or business was remanded to the district court, along with the issue of whether the common control requirement needed to impose withdrawal liability was satisfied.

The First Circuit's holding raises numerous benefits- and non-benefits-related issues. For example, one benefits-related issue arising from the decision is whether portfolio companies and fund management companies may be required to be viewed as a single employer for purposes of the qualified retirement plan rules relating to plan coverage and nondiscrimination requirements. (*Sun Capital Partners III, LP et al. v. New England Teamsters & Trucking Industry Pension Fund*)

Employer Breached Fiduciary Duty by Allowing Ineligible Employee to Enroll in Plan. The U.S. District Court for the Eastern District of Virginia held that an employer breached its fiduciary duty by misleading an employee regarding his eligibility to participate in the employer's life insurance plan. In this case, an employee who was on long-term disability inquired on several occasions as to whether he was eligible to participate in the employer's life insurance policy. The employer responded to these inquiries by allowing the employee to enroll in the plan and deducted amounts from his paycheck to pay for the premiums. Following the employee's death, his beneficiary's claim for benefits was denied because the employee was not working enough hours to be eligible for coverage under the terms of the plan. The court held that the employer had the exclusive role to determine eligibility and that the employer had a fiduciary duty to make these determinations "with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use…." The court notes that the employer failed in carrying out this duty by allowing the employee to enroll in the plan, encouraged him to believe that he was covered by the plan, and deducted premiums from his salary to pay for the plan. As this case illustrates, plan administrators have a responsibility to understand and clearly communicate the eligibility provisions of their plans. (*Lewis v. Kratos Defense & Security Solutions Inc.*, E.D. Va. 2013)

$1.8M Penalty Assessed for COBRA Notice Violations. The U.S. District Court for the Southern District of Indiana held that an employer was responsible for paying $1,852,000 in penalties for failing to issue timely COBRA election notices to a class of 741 former employees. In this case, the employer had hired a number of third-party administrators (TPAs) to perform payroll, benefits, and COBRA administrative services. However, over the course of several years, many employees failed to receive timely COBRA notices because of a breakdown in communication between the employer and the various

TPAs. Under COBRA, after a qualifying event, an employer must provide notice to an employee of his or her right to elect continuation coverage. A plan administrator generally must provide notice of COBRA rights to qualified beneficiaries within 44 days of the date of the qualifying event, such as the termination of employment. If a plan administrator fails to abide by the notice provisions of COBRA, a court may, at its discretion, award a penalty of up to $110 per day from the date of the failure to provide the timely COBRA notice. In this case, the district court justified the large penalty on the basis that the employer lacked an internal system for tracking the status of its employees, failed to provide oversight of its TPAs on an ongoing basis, and failed to accept responsibility for its COBRA notice system. Often employers hire TPAs so that they don't have to worry about administrative and compliance issues. However, this case serves as a reminder that hiring a TPA, while reducing the administrative burden, does not absolve an employer from these compliance obligations. (*Pierce v. Visteon Corp.*, S.D. Ind. 2013)

ERISA Governs Claim Under Phantom Carried Interest Plan. Several employees brought an action in state court in Colorado relating to their compensation benefit under a phantom carried interest plan sponsored by a subsidiary of Fidelity Investments. The defendant removed the case to federal court, and the employees asked the court to remand the case back to state court. The district court found that the plan, while an incentive compensation plan, was covered under ERISA because it constituted an employee pension benefit plan. Under the terms of the plan, certain payments would be made only at the time the participant separates from the company or if there is a change in control. The court found that because the plan by its terms postponed certain payments under the plan until termination of employment, and the timing of such payment was more than mere happenstance, the plan met the definition of a pension benefit plan because it systematically defers payment to the termination of covered employment or beyond. While the exact terms of the plan were not set out, it may well be the case that the payment terms occurring at termination of employment or upon a change in control may have been structured to comply with permissible payment requirements of Internal Revenue Code Section 409A. Payment tied to termination has become a more common payment trigger under 409A and, as a result, may bring more incentive compensation-type plans within the ERISA definition of an employee pension benefit plan.

State Breach of Contract Claim for Severance Preempted by ERISA. A district court recently dismissed a former employee's state breach of contract claim, relating to his employer's denial of severance benefits, on the grounds that the claim was preempted by the Employee Retirement Income Security Act (ERISA). In 2011, the plaintiff's employer implemented a voluntary executive separation program (VESP), offering certain employees a one-time lump sum payment based on their years of service with the company in exchange for voluntarily resignation within a specified time period. On applying for the VESP, the plaintiff was informed that his estimated severance benefit would be $245,353. The plaintiff resigned his employment and executed a standard release of claims. Shortly after resigning, the plaintiff submitted a reimbursement claim for travel expenses for $4,700. The large reimbursement claim triggered an investigation, resulting in an audit of the plaintiff's expense reimbursement history. The company subsequently determined that the plaintiff had collected more than $42,000 in expense reimbursements that he was not entitled to receive. Based on the improper expense reporting, the company informed the former employee that his termination had been reclassified as a termination for cause, resulting in his disqualification for the severance payment under the VESP. Following denial of his claims appeal by the company, the employee filed a state claim for breach of contract.

Focusing on whether the VESP qualified as an employee benefit plan within the meaning of ERISA, the court determined that the program required an ongoing administrative scheme and required the company to exercise a non-trivial degree of discretion in deciding which employees were permitted to participate. The discretion retained by the company to deny eligible employees participation in the program based upon the needs of the business, along with the existence of a comprehensive appeals process to challenge any denials, was determined by the court to sufficiently implicate the necessary "ongoing administrative scheme." The fact that some employees were denied enrollment indicated that the company did, in fact, exercise "ongoing particularized discretion" with respect to the administration of the VESP. Even though only a handful of employees were denied enrollment, the court concluded that the exercise of this type of discretion is sufficient to "transform a simple severance agreement into an ERISA employee benefits plan." Finally, the court pointed to the circumstances triggering the severance offer, noting that the company's strategic decision to "de-layer" its upper management level workforce required the company to exercise discretion in determining which employees would be allowed to participate. Concluding that the VESP is precisely the type of employee benefit plan that "by nature requires an ongoing administrative program to meet the employer's obligation," the court granted the company's motion for summary judgment on ERISA preemption grounds. (*Edwards v. Lockheed Martin Corp.* E.D. Wash., 2013)

New Stock Drop Case Decision. In many stock drop cases that are reported in this newsletter, courts apply a presumption of prudence that protects fiduciaries from liability for fiduciary breaches when the plan permits but neither requires nor encourages the fiduciaries to offer employer stock as an investment option. The U.S. Court of Appeals for the Ninth Circuit, however, takes a more restrictive position that the presumption of prudence is applied when the plan terms require or encourage the fiduciary to invest in employer stock. The Ninth Circuit's position is evidenced in its recent decision in *Harris v. Amgen, Inc.* (9th Cir. 2013), in which participants in two company retirement plans that each included an employer stock fund sued the plan fiduciaries for breaches of fiduciary duties, including the duties of prudence and care, by continuing to offer the stock fund as an investment option after a drop in employer stock value. A federal district court dismissed the claims. On appeal, the Ninth Circuit reversed the district court's decision and remanded the case for further proceedings. In reaching its decision, the Ninth Circuit ruled that because the plan terms did not require or encourage the defendant fiduciaries to invest in employer stock, a presumption of prudence did not apply – plan language merely permitting investments in employer stock is not sufficient to protect the presumption. It is worth noting that the U.S. Court of Appeals for the Second Circuit takes a similarly restrictive view of the presumption of prudence (see discussion of Taveras v. UBS in Employee Benefits Developments April 2013). In the absence of the presumption, the Ninth Circuit held that the plaintiffs sufficiently alleged violation of defendants' fiduciary duties regarding two employer-sponsored retirement plans. Finally the court held that the plaintiffs sufficiently alleged that the defendants violated their duties of loyalty and care by failing to provide material information to plan participants. The posture of the courts in the Second and Ninth Circuits strongly suggests that including specific plan language mandating the availability of, or otherwise favoring, investments in an employer stock fund as a participant investment fund option may be important for preserving the presumption of prudence.

Employer Liability for Benefit Plan Mistakes. Two recent cases involving benefit plan mistakes illustrate the increased litigation and liability risks faced by employers in the wake of the Supreme Court's decision in *Cigna Corp. v. Amara*. In one case, a participant was erroneously told that a surgical procedure she planned to have would be covered by her employer's health insurance plan. It wasn't, and she sued her health plan for money damages equal to the medical expenses she incurred in connection with the surgery. The plaintiff in this case claimed that the plan's fiduciaries had breached their

obligations by failing to adequately explain the process that employees needed to follow to obtain clarification of the benefits to which they are entitled and to inform employees that verbal statements about benefits were not binding on the plan (*Kenseth v. Dean Health Plan, Inc.*, 7th Cir., June 2013). In the other case, discussed in more detail on page three of this newsletter, a part-time employee was erroneously enrolled in a life insurance plan and died a little over a year later. When the life insurance carrier refused to pay up, the employee's widow sued the employer for money damages equal to the life insurance the employee thought he had. The court held that the employer breached its fiduciary duties "as it erroneously allowed [the employee] to enroll in the plan, encouraged him to believe he was covered by the plan, and deducted premiums from his salary to pay for the plan" (*Lewis v. Kratos Defense and Security Solutions, Inc.*, E.D. Va. 2013). Before *Amara*, cases of this kind were routinely dismissed on the grounds that ERISA only permits a plaintiff to recover "appropriate equitable relief" and that an award of "make-whole" money damages was not equitable relief. The Supreme Court in *Amara* reversed this trend by "clarifying" that equitable relief may come in the form of money damages when the defendant is a fiduciary who is alleged to have breached a fiduciary duty. These cases are examples of a growing body of post-*Amara* case law that exposes employers who breach their fiduciary duties to suits seeking to hold them liable for money damages equal to the benefits an employee or beneficiary claims he or she would have been paid but for the employer's breach of duty.

To reduce the risk of *Amara*-type liability, employers should engage in a risk management review process that focuses on plan governance, plan documents, and employee communications.