EMPLOYEE BENEFITS DEVELOPMENTS MARCH 2011

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Practices & Industries

Employee Benefits

RULINGS, OPINIONS, ETC.

Final Say-on-Pay Rules Adopted

The Securities and Exchange Commission (SEC) has adopted Final Rules under the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) regarding the shareholder approval of executive compensation and "golden parachute" arrangements, commonly referred to as "say-on-pay" rules. The Dodd-Frank Act requires shareholders to be provided with a non-binding vote on the overall compensation practices of a company: a say-on-pay vote. Frequency of say-on-pay votes may be every one, two, or three years as determined in a separate shareholder vote held at least once every six years: a say-when-on-pay vote. Additionally, the Dodd-Frank Act requires shareholders to be provided with a non-binding vote on compensation with named executive officers relating to mergers, acquisitions, or similar transactions (including total amounts payable): a vote on "golden parachute" payments. These final rules generally follow the proposed rules previously issued by the SEC and are effective for shareholder votes held on or after April 21, 2011. However, the statutory effective date for initial say-on-pay and say-when-on-pay votes remains on the first annual meeting of shareholders on or after January 21, 2011. One significant change in the final rules is that smaller reporting companies (generally those with a public equity float of less than $75 million) will not be required to conduct initial say-on-pay and say-when-on-pay votes until the first annual meeting on or after January 21, 2013. Publicly traded companies should review the final rules and additional guidance provided by the SEC in preparation for filing their proxy statements. (SEC Release No. 339178; January 25, 2011, http://www.sec.gov/rules/final/2011/33-9178fr.pdf; Regulation S-K, Compliance & Disclosure Interpretations, Question 128B.01, http://www.sec.gov/divisions/corpfin/guidance/regs-kinterp.htm; Compliance and Disclosure Interpretations 169.01, 169.02, 169.03, 169.04, 169.05, and 169.06 http://www.sec.gov/divisions/corpfin/guidance/exchangeactrules-interps.htm#169-01)

IRS Significantly Increases User Fees

The Internal Revenue Service (IRS) is significantly increasing the cost to plan sponsors for submitting their plans for IRS determination letters and other rulings. When a plan applies for a determination letter or other ruling, the IRS requires a user fee to be paid. In some cases, those user fees more than doubled. For example, the user fee for a base level determination letter application for a single employer plan is jumping from $1,000 to $2,500. In most instances, the user fee increases take effect February 1, 2011. (Rev. Proc. 2011-8)

IRS Publications Issued on 401(k) Plans for Small Business

In a continuing effort to provide information and guidance to smaller employers, the IRS and the Department of Labor's Employee Benefits Security Administration (EBSA) have jointly issued IRS Publication 4222, entitled *401(k) Plans for Small Business*. This publication, as well as other materials that provide information about retirement and other employee benefit plans, is available at the EBSA website, www.dol.gov/ebsa, in the section on "Compliance Assistance." The publication may also be found at the IRS website, www.irs.gov, in the "Retirement Plans Community" section under the heading "Forms/Pubs/Products." This 11-page booklet provides information about the basic elements of a 401(k) plan, including information about safe harbor plans, automatic enrollment provisions, Roth 401(k)s, and guidance on recordkeeping and plan investments. The booklet can be helpful in hiring service providers, understanding reporting and disclosure requirements, rules about prohibited transactions and other compliance issues. At the same time, the two agencies also issued IRS Publication 3998, entitled *Choosing a Retirement Solution for Your Small Business*, which summarizes the features of 401(k) plans, SEPs (Simplified Employee Plans), SIMPLE IRAs, and Payroll Deduction IRAs. This guidance may be found at the same websites referred to above.

CASES

Tax Court Upholds IRS Decision to Disqualify an ESOP

These days, there are enough options for correcting the improper operation of a qualified retirement plan that one does not read very often about the IRS disqualifying a plan altogether. But every once in a while, a plan sponsor comes along that pushes the IRS to its limits. Such was the case for the sponsor (in this case, a dentist) of an employee stock ownership plan (ESOP) with respect to which the Tax Court concluded the IRS did not abuse its discretion when the IRS disqualified the ESOP and the underlying trust. The fatal errors that caused the IRS to disqualify the ESOP included: (1) a failure to timely amend the plan document to reflect changes in the laws governing qualified retirement plans; (2) a failure to vest participants in their account balances in accordance with the plan's vesting schedule; (3) a failure to use an independent appraiser to value the employer securities held by the ESOP, as is legally required of an ESOP that holds employer securities not readily tradeable on an established securities market; and (4) a failure to limit allocations made to the dentist's plan account in accordance with the limitation on annual additions under IRC § 415(c). With respect to at least some of the errors, the Tax Court noted that the plan sponsor was offered the opportunity to correct the failures through the Closing Agreement Program and chose not to do so. Accordingly, the Tax Court sustained the IRS's determination that the ESOP was disqualified all the way back to the 1987 plan year and for all plan years thereafter. (*Michael C. Hollen, D.D.S. P.C. v. Commissioner*, Tax Ct. 2011)

Purchaser of Assets Not Liable for Benefits Under Seller's Top Hat Plan

The U.S. Court of Appeals for the Seventh Circuit recently ruled that RM Acquisition, LLC (RM), which purchased all of the assets of Rand McNally in 2007, was not liable for benefits under Rand McNally's top hat plan for senior executives. Under the sale contract, RM assumed some, but not all, of Rand McNally's liabilities. Importantly, RM did not assume liabilities attributable to Rand McNally's unfunded top hat plan. After the sale, neither Rand McNally nor the plan had assets to pay benefits to the participating senior executives. As a result, the affected participants decided to pursue a nonpayment of benefits claim against RM under Section 502 of the Employee Retirement Income Security Act of 1974 (ERISA). In its decision affirming a district court ruling, the Seventh Circuit noted that the proper defendant in the case should have been the plan itself, but acknowledged that since the asset-less plan and plan sponsor (Rand McNally) were "empty eggshells," RM was the only viable defendant for the participants. The Seventh Circuit then applied general common law and federal successor liability rules to the facts and determined that RM was not liable for benefits under the top hat plan. The common law standard, which looks for "identity of ownership between seller and buyer" through some sort of fraud or a failure of the seller and buyer to be "meaningfully separate," was not met in this case. The Seventh Circuit explained that RM did not assume the plan's liabilities under the sale contract, and the evidence did not demonstrate any attempt on RM's part to "connive" with Rand McNally to deprive participants of benefits, nor did it demonstrate that RM was merely continuing Rand McNally's business under another name. The federal standard, which expands the analysis for claims involving a violation of federal rights, looks for "identity of operations between a seller and a buyer that may have been dealing at arm's length" through evidence of notice of the claim prior to the purchase and "substantial continuity in the operation of the business before and after the sale." Here, the federal standard could not be met because the participants did not provide any evidence to meet the second element of the standard.

After addressing the successor liability issue, the Seventh Circuit then addressed the participants' additional claim that RM could be found liable under ERISA Section 510 for interference with their rights under the plan. ERISA Section 510 provides that it is "unlawful for any person to discharge, fine, suspend, expel, discipline, or discriminate against a participant or beneficiary for exercising any right to which he is entitled under the provisions of an [ERISA plan] . . . or for the purpose of interfering with the attainment of any right to which such participant may become entitled under the plan." RM argued that Section 510 only applies to actions taken to intentionally impair an employee-participant's rights under an ERISA plan by firing the participant or otherwise altering the participant's employment relationship. The Seventh Circuit disagreed, explaining that although Section 510 does apply to such situations, "[t]here is more to the statute," and liability under Section 510 can arise from actions taken against participants or beneficiaries who are not employees. As the court noted, "the words 'suspend,' 'expel,' and 'discriminate' denote actions that can be taken against a participant or beneficiary who is not an employee." Even though the Seventh Circuit rejected RM's argument, it nevertheless concluded that RM had not attempted to interfere with the participants' rights in this case. Indeed, "RM had nothing to do with the plan." In light of all of these considerations, the Seventh Circuit concluded that RM was not liable for benefits under the plan.

The Seventh Circuit's decision, which provides a useful analysis of successor liability in the context of a deferred compensation plan and clarifies the application of ERISA Section 510 to actions taken against non-employee participants and beneficiaries, is best summed up with the final statement in the court's decision: "A buyer of assets has, with exceptions inapplicable to this case, no obligation to assume the seller's liabilities." (*Feinberg v. RM Acquisition, LLC*, 7th Cir. 2011)

Department of Labor Position Followed in "Stock Drop" Case and Plan Fiduciaries Exonerated

The U.S. Court of Appeals for the Seventh Circuit upheld a district court decision in a case reported in our August 2009 *Employee Benefits Developments*. In the lower court, the participants in a 401(k) plan alleged that plan fiduciaries had breached their responsibilities by selecting and continuing to offer a company stock fund as an investment choice in the 401 (k) plan. The case arose after some unsuccessful business decisions had resulted in significant drops in the value of the company stock. The participants also alleged that plan fiduciaries and company executives had been negligent or intentional in misrepresenting or failing to disclose the scope and effect of corporate decisions and that competent fiduciaries had not been placed on the company's administrative committee. The district court issued a summary judgment in favor of the defendants, ruling that not only had no duty been breached, but also that the defendants were entitled to rely on the "shield" of the ERISA Section 404(c) safe harbor. Section 404(c) is used, or is attempted to be used, by virtually all individual account plans that permit participant investment direction. If the Section 404(c) protection applies, a plan fiduciary is not liable for any loss that results from a participant's exercise of investment direction over his or her account in the plan. In order to have the protection of Section 404(c), the plan must offer sufficient investment choices to allow participants to diversify their account investments and the plan must provide adequate disclosures and information about the investment choices as described in regulations. The appellate court carefully went through the requirements of Section 404(c) and the general fiduciary obligations of the plan and its fiduciaries, and it fully upheld the district court decision in favor of the defendants. At the same time, however, the court emphasized that Section 404(c) provides no protection to plan fiduciaries in connection with the choice of investment vehicles that are made available in an individual account plan. Accordingly, 401(k) plan fiduciaries must be prudent and mindful of the investment selections provided and the disclosures given to participants about those selections in order to fulfill their duties and to avail themselves of the Section 404(c) protection. (*Howell v. Motorola, Inc*., 7th Cir. 2011)

TPA Breached Its Fiduciary Duties by Using Plan Assets for Its Own Purposes

A case from the U.S. District Court of the Northern District of Ohio held that a third-party administrator (TPA) breached its fiduciary duty when it used plan assets to defray its own operating expenses. In this case, a company hired a TPA to administer the claims for its self-insured medical plan. Under the administrative services agreement, the TPA was responsible for paying medical claims from funds in a segregated bank account funded by the company. Periodically, the TPA would request a check from the company to cover medical claims. In response to the request, the company would send a check to the TPA to be deposited into the account used exclusively for the payment of benefits to plan participants. However, the TPA did not always deposit the funds in the account to pay for expenses incurred by the plan. Instead, the TPA deposited the funds in an account it used to pay for its own expenses. In all, the company transferred over $500,000 to the TPA for the payment of claims that were instead used by the TPA for its own purposes.

As a threshold issue, the court had to determine if the TPA was a fiduciary. ERISA Section 3(21) defines a person as a fiduciary if:

(i) he exercises any discretionary authority or discretionary control respecting management of such plan or exercises any authority or control respecting management or disposition of its assets, (ii) he renders investment advice for a fee or other compensation ... with respect to any money or other property of such plan, or has any authority or responsibility to do so, or (iii) he has any discretionary authority or discretionary responsibility in the administration of such plan.

Although the administrative service agreement explicitly stated that "the claims administrator was not a fiduciary," the agreement also gave the TPA authority over plan funds provided by the company. Because ERISA defines fiduciary in functional terms of control and authority, and because the TPA controlled plan assets and exercised its authority and control over the funds by determining the account into which the funds would be deposited, the court determined that the TPA was a fiduciary. The court granted the company's motion for summary judgment on the breach of fiduciary claim because, as a fiduciary, the TPA breached its duties by diverting the funds for its own uses rather than for the benefit of the plan's participants. This case can be instructive because it highlights that even if an administrative service agreement states that a party is not a fiduciary, ultimately the party's actions may cause it to be deemed a fiduciary. (*Guyan International Inc. v. Professional Benefits Administrators, Inc.*, N.D. Ohio 2011)

Former Company President Jointly Liable With Plan Administrator for Losses to Retirement Plan

The Department of Labor (DOL) successfully sued former owners of a company for violations of ERISA relating to their failure to remit approximately $12,000 to $14,000 in employee contributions to the company's retirement plan over a period of four years. The contributions were deposited in the general account of the company and used to pay creditors. One of the owners involved in the suit was the plan administrator, and the other owner was the company's president. Although the owners acknowledged that the contributions were handled improperly, the owner-president argued that he was not a fiduciary and that the owner-administrator should be solely liable for the plan losses. He asserted that he was only a minority shareholder and relied on the owner-administrator to make required payments to the plan. The U.S. District Court for the District of Minnesota disagreed with the owner-president, ruling on the DOL's motion for summary judgment that both owners were fiduciaries. The owner-administrator was clearly a fiduciary because plan administrators have discretionary authority/responsibility in administering a plan. With regard to the owner-president, the court found that he was a "functional fiduciary." First, the court explained that individuals who appoint plan administrators are fiduciaries. Second, the owner-president had admitted to having responsibility to make administrative decisions and authority to direct payment to the plan. Finally, the owner-president paid the company's creditors from an account in which plan assets were commingled with company funds, which constituted an exercise of control over plan assets. Therefore, because both owners were fiduciaries and the mishandling of employee contributions resulted in violation of at least five provisions of ERISA, the court ruled that the owners were "jointly and equally responsible" for paying the amount of unremitted employee contributions plus interest to the plan. This case serves as a reminder that an individual who is not formally serving in a fiduciary role but takes actions that affect a retirement plan and plan assets, may be considered a plan fiduciary and be subject to fiduciary liability under ERISA. (*Solis v. Blackford*, D. Minn. 2011).

Former Trustee's Argument Regarding Mental State Solidifies His Liability for Losses to Profit-Sharing Plan

The current trustees of a medical practice's profit-sharing plan sued the plan's former sole trustee for breach of fiduciary duty under ERISA related to losses he caused to the plan. Ruling in favor of the current trustees on their motion for summary judgment, the U.S. District Court for the District of New Jersey found that the former trustee engaged in self-dealing and failed to satisfy his fiduciary duties of loyalty and care to the plan by making material misrepresentations, falsifying records, and improperly distributing plan assets. The former trustee unsuccessfully attempted to defend himself by arguing that he did not intend to commit fraud and that his actions were a result of being "careless, confused, and lack[ing] interest," not bad faith. The court explained that the former trustee's argument about his lack of intent or bad faith was not helpful because a breach of fiduciary duty can be established on the basis of negligence and strict liability. As the court noted, the proper analysis focuses on whether the trustee acted with appropriate care, not fault. Furthermore, the court found that the former trustee's admissions about his carelessness, confusion, and lack of interest only bolstered the current trustees' claims that he did not behave prudently as required by ERISA. Accordingly, the court ruled that the former trustee had to pay compensatory damages with interest to the plan. This case serves as a reminder of the high standards that plan fiduciaries are held to under ERISA. (*Chaaban v. Criscito*, D.N.J. 2011).

Employee Benefits Practice Group

Peter K. Bradley
pbradley@hodgsonruss.com

Anita Costello Greer
anita_greer@hodgsonruss.com

Michael J. Flanagan
mflanagan@hodgsonruss.com

Richard W. Kaiser
rkaiser@hodgsonruss.com

Arthur A. Marrapese, III
Art_Marrapese@hodgsonruss.com