EMPLOYEE BENEFITS DEVELOPMENTS SEPTEMBER 2010

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Practices & Industries

Employee Benefits

RULINGS, OPINIONS, ETC.

Monitor 401(k) Fees!

A recent federal court case has emphasized the importance of regular monitoring of 401(k) and other defined contribution plan fees. Most 401(k) plans today utilize investment arrangements that produce asset-based fees that may be paid to record keepers, trustees, brokers, or other service providers. Recent Department of Labor (DOL) regulatory initiatives have been directed at providing both plan sponsors and plan participants with more information about asset-based fees. Asset-based fees are sometimes difficult to identify because they are netted out of plan investment performance. The use of multiple share classes with a single branded mutual fund further obscures the level of fees that might be assessed in the accounts of a plan. Because one of the stated responsibilities of plan fiduciaries is to act prudently to defray reasonable expenses of administering a plan, fiduciaries risk liability if unreasonable expenses are charged. In litigation that focused on whether it was prudent for plan fiduciaries to use “retail” share classes of several mutual funds rather than lower cost “institutional” share classes, the fiduciaries were found liable to the plan for the extra expenses charged to the retail shares. While the large size of the plan made it a potential target for this sort of fee litigation, the fiduciaries might have been surprised at their exposure because they had utilized professional investment consultants and advisors. The fiduciaries were also familiar with the different fee structures of retail and institutional share classes. While the court did not find that the use of retail class shares would necessarily be a fiduciary breach, the missing piece of protection for the fiduciaries was a good record of review of the plan’s overall administrative costs and the prudent management of asset-based fees used to cover those costs. Quarterly reviews of net investment performance without also reviewing asset-based fees and reasonable plan costs allowed the court to conclude that the plan fiduciaries breached their duty of prudence by using certain retail mutual fund shares instead of the institutional shares. This is an evolving area of law affecting 401(k) plans and will require enhanced administrative work by all plan fiduciaries. (*Tibble v. Edison International*, C.D. Cal. 2010)

DOL Issues Regulations on Fee Disclosures

The DOL has issued an interim final regulation on fee disclosures for 401(k), defined contribution, and defined benefit pension plan investments. These rules apply to the financial institutions and other service providers to employee pension plans that expect to receive at least $1,000 in compensation in connection with their services and require the disclosure of information to plan fiduciaries. Service providers include certain fiduciary or registered investment advisory services, recordkeeping or brokerage services to a participant-directed individual account plan in connection with the investment options made available under the plan, and certain other service providers who receive indirect compensation. These recently issued regulations are directed at providing fiduciaries with information to assist in assessing the reasonableness of investment contracts and administrative arrangements, including the reasonableness of compensation paid to service providers as well as potential conflicts of interest that may affect the performance of service providers. Information that must be disclosed in writing to the plan fiduciary includes a description of the services to be provided and all direct and indirect compensation to be received by the service provider, its affiliates, or subcontractors. The disclosure requirements are established as part of the prohibited transaction provisions under the Employee Retirement Income Security Act of 1974 (ERISA) because if a covered service provider fails to meet the disclosure requirements, the contract or arrangement will not be "reasonable" and fees paid to that service provider will be considered a prohibited transaction. It is expected that these regulations will result in comments and discussion, particularly from the financial community. The regulations have an effective date of July 16, 2011, and will likely result in changes in the scope and form of communications made by financial institutions and other service providers to plan sponsors and their fiduciaries. Another related initiative of the DOL involves finalizing a set of proposed regulations requiring disclosures from plan fiduciaries to plan participants about fees. (DOL Interim Final Rule on Reasonable Contract or Arrangement Under Section 408(b)(2)-Fee Disclosure; DOL Reg. § 2550.408b-2(c), 75 Fed. Reg. 41600)

HHS Issues Proposed Regulations on HIPAA's Privacy, Security, and Enforcement Provisions

The Department of Health and Human Services recently published proposed regulations for the implementation of statutory changes made to the Health Insurance Portability and Accountability Act of 1996 (HIPAA) as provided by the Health Information Technology for Economic and Clinical Health Act (HITECH). This proposed rule is the latest piece of guidance regarding the regulation of protected health information and how it is to be safeguarded by covered entities and business associates.

To understand the new guidance, it is necessary to have some background on HIPAA and the more recent changes made to HIPAA by the HITECH Act. The privacy and security provisions of HIPAA regulate individually identifiable health information that is created or received by or on behalf of covered entities. This sensitive information is referred to as protected health information (PHI). HIPAA defines a "covered entity" as a health plan, health care provider, or health care clearing house. A "business associate" is defined as an entity, other than an employee, that performs a function or activity involving the use or disclosure of PHI on behalf of a covered entity. These functions or activities include financial, legal, actuarial, accounting, and consulting services. To protect PHI, a covered entity and business associate are required to enter

into a contract, or a business associate agreement, that provides assurances that the business associate will safeguard the confidentiality of the covered entity's PHI.

In 2009, the HITECH Act was signed into law as part of the American Recovery and Reinvestment Act. Among other changes to HIPAA's privacy and security provisions, HITECH expanded the scope of HIPAA by applying most of the privacy and security standards directly to business associates. Previously, these provisions of HIPAA only applied indirectly to business associates through a business associate agreement entered into with a covered entity.

One important aspect of the new proposed regulations is that they address the duties and responsibilities regarding a business associate's use of subcontractors. Under the new regulations, the definition of "business associate" has been expanded to include subcontractors who provide services to business associates. This in effect creates a new category of business associates that previously were unconcerned with complying with HIPAA requirements. In addition, the new regulations make it clear that it is the business associate's (not the covered entity's) responsibility to enter into a business associate agreement with each of its subcontractors to obtain assurances from the subcontractors that they will adequately protect the security of the covered entity's PHI. In the event that a subcontractor discovers a breach of unprotected PHI, the subcontractor will be required to notify the business associate, who in turn will be required to notify the covered entity.

Since February 2009, when HITECH was enacted, is has been unclear whether all business associate contracts would need to be revised as a result of the HITECH changes, or whether they would be deemed updated as an operation of law. By providing covered entities and business associates with an extended period of time in which to revise agreements, these new regulations implicitly answer this question: these contracts must ultimately be renegotiated and re-executed. While the new regulations will generally provide covered entities and business associates with 180 days (six months) beyond the effective date of the final rule to comply with the majority of the new provisions ("compliance date"), it is permitting covered entities and business associates to operate under their existing agreements for one year beyond this compliance date. In other words, after the effective date of the final rules, parties will have 18 months in which to revise existing business associate agreements, assuming the agreements existed prior to the publication date of the modified rules.

Sponsors of health plans should use this opportunity to inventory the outside relationships associated with their health plans to identify existing business associate relationships and confirm that an adequate business associate agreement is in place. Although amendments to existing business associate agreements (as well as notices of privacy practices and privacy and security policies) will likely be required, plan sponsors may wish to wait for the proposed regulations to be finalized before making any changes to existing agreements.

CASES

District Court Rules DOMA Unconstitutional

The U.S. District Court for the District of Massachusetts held that a section of the Defense of Marriage Act (DOMA) violates the equal protection rights of same-sex couples. Section three of DOMA, provides that "marriage" and "spouse," for purpose of federal law, include only the union of one man and one woman. In this case, a group federal employees sued the federal government's Office of Personnel Management, contending that they, as same-sex couples married in Massachusetts,

were denied certain federal marriage-based benefits that are available to similarly situated heterosexual couples. In granting summary judgment in favor of the plaintiffs, the court ruled that DOMA had no rational basis and violated the principles of equal protection embodied in the Due Process Clause of the Fifth Amendment. The ultimate impact of this case is not yet unknown. However, if the case is upheld on appeal and followed by other circuits, mandated benefits provided to heterosexual couples would also have to be made available to same-sex couples. (*Gill v. Office of Personnel Management*, D. Mass. 2010)

Recent Cases Involving Beneficiary Designations

Two recent cases are instructive when it comes to determining the validity of beneficiary designations. In the first case, two individuals claimed they were the designated beneficiary of a decedent in a life insurance plan and were thus entitled to the death benefits. Those individuals were the decedent's wife at the time of his death and his ex-wife. In February 2007, the decedent indicated he wanted to change his primary beneficiary to his new wife, and he sent the executed form to the employer's designated agent. The form, however, was never sent to the carrier that issued the life policy. On the decedent's death in April 2007, the carrier received competing claims from the ex-wife and the wife. When the carrier told the wife that the carrier's records named another person, the ex-wife, as the beneficiary, the wife sent the carrier a copy of the February 2007 beneficiary change form. The insurance carrier initiated the case seeking a determination as to who was entitled to the death benefits. The plan, in this case, specifically stated that a participant may change a named beneficiary by sending a written request to the carrier, that the change will not be effective until recorded by the carrier, and that, once recorded, the change will apply as of the date the request was signed. The ex-wife argued she was the beneficiary on the carrier's records at the time of the decedent's death, and the recorded beneficiary had never been changed on the carrier's records. The court ruled the ex-wife's contention that she is entitled to the insurance proceeds because she was the beneficiary on the carrier's records at the time of the decedent's death was without merit. The plan clearly stated that once the carrier records the change, it "will apply as of the date the request was signed." The fact that the ex-wife was the beneficiary of record at the time the decedent died was not determinative. (*Principal Life Insurance Company v. Smith*, 11th Cir., 2010)

In the second case, a lawsuit was initiated by the decedent's wife (the plaintiff) to recover life insurance benefits after those benefits were paid to a woman the decedent designated by name as his beneficiary. The decedent and the plaintiff were never formally divorced, but the decedent still was "remarried." After he was "remarried," the decedent named his second "wife" as the beneficiary of his life insurance benefit. Because the first marriage was never formally dissolved, the second marriage was null and void. The plaintiff claimed she was entitled to the life insurance proceeds and, in so doing, argued that the beneficiary designation naming the second "wife" was defective because the second "wife" was identified as the decedent's spouse when in fact she was never legally married to the decedent. The court upheld the determination of the carrier that the second "wife" was the proper beneficiary. The court ruled that it must defer to the carrier's determination that the second "wife" was the proper beneficiary, unless that decision was arbitrary and capricious based on the information that the carrier had at the time it made the decision. In the end, the court concluded that the plaintiff failed to produce any evidence from which a reasonable fact finder could conclude the carrier was arbitrary and capricious in determining the decedent properly designated the second "wife" as the beneficiary. (*Bayer v. Fluor Corp., et. al.*, E.D. Pa., 2010)

Wife's Murder Leads to Ruling That State Courts Have Jurisdiction Over QDROs

The U.S. Court of Appeals for the Ninth Circuit recently ruled that state courts have jurisdictional authority to determine whether domestic relations orders (DROs) satisfy the requirements of qualified domestic relations orders (QDROs) under ERISA. Beginning as a routine divorce proceeding relating to the division of pension benefits, the case at hand took a deadly turn when, prior to the issuance of a DRO assigning a portion of a participant's 401(k) account to his wife, the husband murdered his wife and shot the state court judge who was presiding over the divorce. After the wife's death, her estate moved for the entry of a DRO memorializing the oral orders entered by the divorce judge before the murder. The state court responded with a posthumous order, entered as of a date when the wife was still alive. The husband appealed the order to the Nevada Supreme Court, arguing that there was no valid QDRO in place before his wife's death. The court disagreed and ruled that the order was a valid QDRO under ERISA.

A complicated series of actions and appeals ultimately sent the case to the 9th Circuit, where the husband argued that the ruling by the Nevada Supreme Court was not binding because state courts have no jurisdiction to determine whether DROs are QDROs. The 9th Circuit disagreed, ruling that a state court is "a court of competent jurisdiction" and is therefore empowered under ERISA to determine the qualification of an order. According to the appeals court, ERISA provides state courts with concurrent jurisdiction over cases "to recover benefits" or "to enforce…or to clarify" rights under the terms of the plan. Moreover, it is state family law, not ERISA, that creates, recognizes, or assigns the alternate payee's right to plan benefits. In the course of proceedings to enforce, clarify, or collect on rights to benefits under an ERISA plan, a state court may be required to determine the qualification of a DRO. Because a state court has concurrent jurisdiction over these proceedings, it also has jurisdiction "to decide the intermediate question of whether or not the DRO is a QDRO."

In a related issue, the court also held that "administrative exhaustion" was not required before the issue could be decided by the state court. This means that the plan administrator need not be given the opportunity to determine whether the DRO is a QDRO before a suit is filed. The court cautioned, however, that a court should consider whether and why the litigant failed to present the DRO to the plan administrator for a QDRO determination before filing suit. (*Mack v. Kuckenmeister*, 9th Circ, 2010)

IRS Rules That Transfer in Connection With Divorce Does Not Trigger Deferred Gain for Qualified Replacement Property

Under Internal Revenue Code (IRC) § 1042, an individual taxpayer can elect to defer gain on sale of employer securities to a company's employee stock ownership plan (ESOP) if qualified replacement property is timely acquired. If the requirements of IRC § 1042 are satisfied, the gain that would otherwise be recognized is deferred and the taxpayer's basis in the qualified replacement property is reduced by the gain not recognized. If the taxpayer then disposes of the qualified replacement property, any deferred gain is then recognized. There are some limited exceptions to this triggering of deferred gain on disposition including an exception for gifts. While the IRC § 1042 does not define a gift, the IRS in a Private Letter Ruling (PLR) examined whether a transfer pursuant to a divorce triggered recapture of the deferred gain. The IRS

determined that IRC § 1021 treats the transfer as a gift to the transferee but does not specifically characterize it as a gift by the transferor. However, the IRS concluded that the transfer to a spouse in connection with a divorce should be treated as a gift and does not trigger recognition of the deferred gain. (PLR 201021005)

Participants Lose Cash Balance Plan Lilly Ledbetter Age Discrimination Claim

A group of El Paso Corporation employees brought an action saying that the conversion of a traditional defined benefit plan into a cash balance plan violated certain laws. One of the claims was that the conversion violated the Age Discrimination Employment Act (ADEA). In January of 2009, the District Court of Colorado held that the ADEA claim was time barred. Shortly thereafter, the Lilly Ledbetter Fair Pay Act was enacted. The plaintiffs cited this new law as an intervening change in the controlling law and asked the court to reinstate the ADEA claim. The district court agreed that the Lilly Ledbetter law does apply in this area. However, following a series of cases on cash balance plans, the Court ultimately rejected the participant's ADEA claims. (*Tomlinson v. El Paso Corp.*, D. Colo., 2010)

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