EMPLOYEE BENEFITS DEVELOPMENTS SEPTEMBER 2009

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Practices & Industries

Employee Benefits

RULINGS, OPINIONS, ETC.

DOL Provides Limited Relief for New Audit Standards for 403(b) Plans. Commencing for plan years beginning in 2009, sponsors of 403(b) plans that must file Form 5500 (governmental and church plans are generally exempted) are subject to new requirements on the information that must be contained in the filing. A significant new requirement is that the Form 5500 for larger plans (generally, 100 or more participants) must contain audited financial information. Receiving financial information on older annuity contracts and custodial accounts may prove difficult in some situations. The Department of Labor has provided limited relief where the necessary information cannot be obtained after good faith efforts have failed. To qualify for the relief from including these contracts and accounts in the financial statements, the following requirements must be met:

- The annuity contract or custodial account must have been issued to a current or former employee before January 1, 2009.
- The employer ceased to have obligations to make contributions (including employee deferrals) and in fact stopped making contributions to the contract or account before January 1, 2009.
- The employee can enforce all of his or her rights against the insurer or custodian without the involvement of the employer.
- The employee is fully vested in the contract or account at all times.

Additionally, employees whose contracts or accounts are excluded from the financial statements under this relief are excluded in determining whether or not the plan qualifies for the exception to preparing audited financial statements. (Department of Labor Field Assistance Bulletin 2009-02)

IRS Internal Guidance on Deduction Under 162(m) of Backdated Discounted Options. In an internal memorandum, the Office of Chief Counsel has provided advice to Internal Revenue Service Counsel offices regarding how to treat pending

cases where discounted stock options have been granted. Internal Revenue Code Section 162(m) generally provides that a publicly traded company may not deduct compensation with respect to "covered employees" to the extent that the compensation exceeds $1 million, unless the compensation meets certain exceptions, such as "performance-based compensation." Generally, a stock option granted at fair market value and meeting other requirements would qualify as performance-based compensation. A discounted stock option would not qualify. The memorandum states that discounted options could arise under two backdating situations: The first situation is where options are backdated with the benefit of hindsight to provide an increased benefit to the option holder. The second situation is where contemporaneous records are not available to establish when the grant date occurred. The memorandum takes the position that a discounted option that arises in either situation does not qualify as performance-based compensation. Additionally the memorandum concludes that attempts to reprice the option to eliminate the discount does not result in qualifying the option as performance-based compensation. The memorandum also contains a lengthy discussion of the position of the chief counsel on determining the date of grant for an option. This discussion should be reviewed not only in setting current option grant procedures but also to substantiate the current deductibility of exercises of options granted in prior periods. (IRS Advice Memorandum 2009-006)

Tax Levy Can Reach Stock Options and HSA Balance.
Two pronouncements issued by the IRS chief counsel's office explain the background and conclusion that IRS tax levies can reach qualified incentive stock options (ISOs), non-qualified stock options, and a participant's interest in a health savings account (HSA). ISOs are governed by statutory provisions, including a rule that the options cannot be transferred except by will or by the laws of descent and distribution. Non-qualified stock options are contractual in nature and their transferability may be restricted by contract. In both cases, however, the IRS has concluded that the statutory tax levy rules supersede these restrictions and do not prevent the IRS from exercising its authority in collecting unpaid taxes from a taxpayer's property or property rights held in the form of stock options. Similarly, in the case of an interest in an HSA, a taxpayer has a property right of withdrawal that may be seized by the IRS in a levy. In the case of a levy on an HSA, the taxpayer may be further obligated to pay a 10 percent tax penalty for a withdrawal that is not to pay for a qualified medical expense, unless the taxpayer meets one of the three exceptions: distributions after death, disability, or eligibility for Medicare. (IRS Chief Counsel Advice Memorandums 200926001, 200927019)

CASES

Court Rules Plan Sponsor Did Not Breach Fiduciary Duties by Continuing to Offer Employer Stock as Investment Option. It seems like so-called "stock drop" cases are being decided every month. In yet another case, a federal trial court ruled that plan fiduciaries did not breach their fiduciary duties to prudently and loyally manage an eligible individual account plan (EIAP) by investing plan assets in employer stock and by continuing to offer employer stock as an investment option. The participant/plaintiff in the case asserted that fiduciary duties had been breached because the employer's stock value was impaired by its investment in an affiliate that was entangled in the subprime mortgage market crisis. In dismissing the claims of the participant/plaintiff, the court ruled that the defendants are entitled to the presumption articulated in *Moench v. Robertson* (3rd Cir., 1995) that they, as fiduciaries of an EIAP, acted consistently with ERISA (i.e., a presumption of prudence) by making or allowing investments in employer stock, and that the generalized allegations of wrongdoing in the participant/plaintiff's complaint were insufficient to rebut the presumption of prudence. The court also dismissed the

participant/plaintiff's claim that the plan fiduciaries breached their fiduciary duty of disclosure by failing to provide all material information regarding the value of the employer stock fund. The court held that the disclosures in the plan documents together with the disclosures in public filings provided plan participants the opportunity to make their own informed investment choices. (*Johnson v. Radian Group, Inc.*, E.D. Pa. 2009)

Collective Bargaining Agreement Grants Retirees Lifetime Health Care Benefits Upon Retirement, but Level of Benefit Might Change. A federal appeals court recently revisited the issue of whether an employer that entered into a collective bargaining agreement (CBA) with a group of employees promising lifetime health care benefits can later eliminate or modify those retiree health care benefits. In deciding whether the retirees have a "vested" right to lifetime health care benefits, the court said that "ordinary principles of contract interpretation" are applied to determine whether benefits stemming from a CBA have "vested." Because this case involved a CBA that was entered into in 1998, because it involved a health care benefits plan with identical language concerning entitlement to benefits upon retirement, because the CBA tied eligibility for health benefits to eligibility for a pension, and because the CBA clause did not contain a specific durational clause while other benefits provisions in the CBA contain such clauses, the court found that the CBA granted retirees a right to lifetime health benefits. The court made this ruling despite the fact that the retirees accepted summary plan descriptions (SPDs) in 1999 and 2000 that described the benefits as terminable at the employer's will - with respect to the SPDs, the court ruled that no divesting occurred because the SPDs also had language indicating that the CBA, not the SPD, governs if there is a conflict between the documents. However, because the CBA and related documents do not say anything about subsequent modifications to these benefits and because the relevant CBA provisions suggested that the parties contemplated reasonable modifications, the court remanded the case to the federal trial court to determine what types of changes are permitted. So, while the retirees are entitled to health care benefits for their lives and those benefits cannot be terminated, that does not necessarily mean, in this case, that the promised benefits must be maintained at the exact same levels described in the 1998 CBA. (*Reese v. CNH America LLC*, 6th Cir., 2009)

Cashed-Out Participant Maintains Fiduciary Lawsuit.
A participant in a 401(k) plan terminated his employment with the company maintaining the plan and received a full distribution of his accounts from the plan. The distribution was made in the normal course of plan operations. Seven months after leaving the company, and at a time when the participant no longer had an account balance in the plan, the participant commenced a lawsuit alleging that fiduciaries of the plan had breached their duty, and as a result of the breach the plan assets were negatively affected. The district court never got to the substance of the lawsuit because it ruled that the cashed-out participant was no longer a party who could maintain a fiduciary lawsuit. On appeal, the Ninth Circuit Court of Appeals reversed this decision. In following precedents in two other Federal Circuits, the court held that a former employee who has voluntarily withdrawn his assets from a defined contribution plan continues to have standing as a "participant" and may assert a claim for breach of fiduciary duty under ERISA. The decision does not award any relief to the participant, but it allows him a day in court to prove the fiduciary breach. (*Harris v. Amgen, Inc.*, 9th Cir., 2009).

Trustee Not Liable for Unpaid Medical Claims. The U.S. Court of Appeals for the Tenth Circuit affirmed a district court's ruling that a CEO serving as a trustee for his company's self-insured medical plan was not personally liable for the plan's unpaid medical claims. In this case, a group of participants sued, alleging that the trustee breached his fiduciary duty by failing to assure adequate funding for the self-insured medical plan. Facing financial difficulties, the company sponsoring the plan ultimately terminated the plan and declared bankruptcy. A trustee owes a number of fiduciary duties to plan

participants, including a duty to make prudent decisions with regard to the plan and to act in the best interests of plan participants. The plaintiffs allege that the trustee failed to satisfy his fiduciary obligations by failing to take such actions as notifying participants of the underfunding, threatening to sue the company for its failure to make adequate contributions to the plan, or hiring independent counsel to represent the plan to prevent any potential conflict of interest. In affirming the lower court's decision, the Court of Appeals reasoned that the trustee was not liable for the unpaid medical claims because the plaintiffs failed to show that the plan's underfunding was caused by any alleged fiduciary breach. The failure to adequately fund the plan "more likely than not" resulted from the broader financial difficulties facing the company rather than the trustee's failure to take any additional aggressive action taken on behalf of the plan and its participants. Although the court did not rule against the trustee in this case, trustees can be held personally liable for a breach of their fiduciary duties. In cases where a company is struggling financially, an individual who serves in the dual capacity of a company officer and a plan trustee should document his or her compliance with the decision-making requirements of a fiduciary. (*Holdeman v. Devine*, 10th Cir., 2009)

Debtor Loses Protection From Creditors by Misusing Retirement Plan. The U.S. Court of Appeals for the Ninth Circuit held that, in reviewing the totality of circumstances, a debtor's retirement plans were not designed and used primarily for retirement and therefore California's bankruptcy exemption for assets held by private retirement plans should not apply. The circuit court's holding reverses a district court decision that held the assets exempt. Under California Civil Procedure Code section 704.115, all amounts held, controlled, or in process of distribution by a private retirement plan are exempt and therefore beyond the reach of creditors. In this case, a debtor facing a substantial civil judgment filed for personal bankruptcy and attempted to exempt his assets by making contributions to a number of private retirement plans. The debtor established these plans through several wholly owned corporations and he was the only participant in these plans. Between 2001 and 2005, the debtor aggressively funded the plans both personally and through his controlled corporations. These contributions were not accurately disclosed to the IRS and in many cases significantly exceeded the annual contribution limits. In all, the overfunding represented approximately 20 percent of the total value of the plans. The circuit court characterized the debtor's actions as egregious and deceptive. The court ruled that, when considering the totality of the circumstances, the debtor's behavior was more consistent with a primary goal of hiding assets than a primary purpose of saving for retirement. As such, the plans' assets are not protected from creditors under the California law. (*Cunning v. Rucker* (9th Cir., 2009)

Severance Denial Upheld for Former Employee Offered Comparable Employment. Determining that a former employee received an offer of comparable employment after the company he worked for was sold, the U.S. District Court for the Southern District of New York denied his claim for benefits under the company's severance plan. Under the terms of the plan, employees who met certain requirements were entitled to severance benefits if they suffered a "Job Elimination." Employees would not be deemed to have suffered a Job Elimination if, in connection with a sale of the business, they were offered "comparable employment," as determined by the plan administrator. Comparability factors under the plan included similarity of duties, salary range, and commuting distance. In this case, the former employee argued that the new position he was offered following the sale of the company was not comparable to his former position because the total amount and structure of his compensation was not the same and because he might eventually be required to relocate. In finding for the company, the court determined that a guaranteed salary of at least $1 million, with an opportunity to earn a bonus, was within the same salary range as the plaintiff's former salary of $1.4 million, despite the change in the structure of the compensation. The court also dismissed the plaintiff's relocation argument, because he was not required to relocate

immediately and because his final employment offer provided that he would be eligible for severance if his position was later relocated and he chose to terminate employment for any reason. *Pelosi v. Schwab Capital Markets L.P.* (SDNY, 2009).

Third Circuit Joins Eighth Circuit in Holding Payments Made By ESOP Sponsor to Redeem Stock Not Deductible as a Dividend Paid. Affirming a lower court decision, the Third Circuit has denied a tax deduction for shares Conopco, Inc. redeemed from its employee stock ownership plan (ESOP) in order to pay terminating employees cash distributions from the ESOP. Thus, the Third Circuit joins the Eighth Circuit in it refusal to follow the Ninth Circuit's decision in Boise Cascade. Following reasoning similar to that adopted by the Eighth Circuit, the Third Circuit found that the dividend payment by the corporation was "in connection" with a redemption of its stock and that a deduction was barred by the provisions of
IRC § 162(k)(1). (*Conopco Inc. v. United States*, 3d Cir., 2009)