EMPLOYEE BENEFITS DEVELOPMENTS AUGUST 2014

Hodgson Russ Newsletter
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RULINGS, OPINIONS, ETC.

Agencies Issue Final Rule on 90-Day Waiting Period and Orientation Period. The Departments of the Treasury, Labor, and Health and Human Services issued final regulations addressing the rule in the Affordable Care Act (ACA) that prohibits a group health plan from having a waiting period that exceeds 90 days. The final regulations generally incorporate the proposed regulations issued last February without any substantive changes and confirm that employers may require employees to complete an orientation period prior to the start of the waiting period. A waiting period is defined as the period that must pass before coverage for an employee or dependent who is otherwise eligible to enroll under the terms of the group health plan can become effective. For these purposes, being otherwise eligible to enroll in a plan means having met the plan's substantive eligibility conditions (e.g., being in an eligible job classification or satisfying a reasonable and bona fide employment-based orientation period). If a group health plan conditions eligibility on an employee's having completed a reasonable and bona fide employment-based orientation period, the orientation period may not exceed one month. The maximum one-month orientation period would be calculated by adding one calendar month and subtracting one calendar day, measured from an employee's start date in a position that is otherwise eligible for coverage. For example, if an employee's start date in an otherwise eligible position is October 16, the last permitted day of the orientation period is November 15, and coverage must begin no later than February 14 (the 91st day after the employee completes the orientation period). It is important to note that compliance with these regulations is not determinative of compliance with the shared responsibility payment provisions under Section 4980H of the Internal Revenue Code (Code), the so called "play-or-pay" provisions of the ACA. Under the play-or-pay rules, an applicable large employer must offer affordable minimum value coverage to certain newly hired employees by the first day of the fourth full calendar month of employment, or the employer could be assessed a penalty. Employers should take time to review their plan documents, summary plan descriptions, and enrollment materials to confirm that their group health plan waiting periods comply with all applicable regulations. (T.D. 9671)

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Employee Benefits

IRS Rulings Confirm Ability to Offer Lump Sum Cash-Out Window for Retirees. A popular approach to try to "de-risk" defined benefit plans has been to offer retirees receiving benefits a lump sum distribution option in lieu of continuing annuity payments. Based on current interest rates, the payment of the lump sum value may be lower than the liability amount reflected for other purposes. In 2012, the IRS issued two rulings that addressed the issues involved in allowing a retiree to elect a lump sum benefit. Recently, the IRS issued five additional private letter rulings that all follow the same principles as the 2012 rulings. Under the rulings, the offer of a lump sum benefit may be made to current retirees as part of a window benefit election if the proper steps are taken. As discussed in the rulings, the election must be part of a one-time window period, and any election to participate must comply with the qualified joint survivor annuity rules, including receipt of spousal consent, if applicable. The rulings also require that the payment of lump sum benefits not result in the plan becoming subject to benefit restrictions under Internal Revenue Code Section 436 and that the distribution does not result in a violation of Code Section 415 limitations applied at the time of the election. The lump sum benefit also must satisfy the Code Section 417(e) rules regarding minimum present values in calculating the lump sum. Depending on the retiree's situation, a portion of the lump sum benefit may not be an eligible rollover distribution. Plan sponsors who are interested in adopting a lump sum window program should review these rulings with their advisors to be certain that the window offering complies with IRS guidance and to be certain that all other legal requirements are met with such an offer. (PLR Numbers 201422028, 201422029, 201422030, 20142203, and 201424031)

Certain Stock Rights Exempt From Section 457A. Addressing a scenario in which a foreign corporation grants a stock option and a stock-settled stock appreciation right (SAR) to a service provider that is a limited liability company treated as a partnership for U.S. income tax purposes, the IRS ruled neither award will be treated as nonqualified deferred compensation subject to Section 457A of the Code. Code Section 457A generally provides that compensation deferred under a nonqualified deferred compensation plan of a "nonqualified entity" is includible in gross income when there is no substantial risk of forfeiture of the rights to the compensation. Nonqualified entities are "tax-indifferent" parties and include certain foreign corporations and partnerships as well as organizations that are exempt from income tax under the Code. To qualify for the exemption from taxation under Code Section 457A, the stock right (whether an option or a SAR) must be exempt from Code Section 409A. If the stock right is an SAR, it also must at all times by its terms be settled, and is in fact settled, in service recipient stock. If the SAR may be or is settled in cash or anything other than shares of stock of the service recipient, it will be subject to Code Section 457A. (Rev. Rul. 2014-18)

CASES

Inherited IRA Funds Not "Retirement Funds," and Not Excludable From Bankruptcy Estate. In 2000, an individual established a traditional individual retirement account (IRA). When she died, the IRA passed to her daughter and became an inherited IRA. The daughter and her husband subsequently filed a Chapter 7 bankruptcy petition and sought to exclude the roughly $300,000 held in the inherited IRA from the bankruptcy estate using the "retirement funds" exemption. The bankruptcy trustee and unsecured creditors objected to the claimed exemption. The bankruptcy court concluded an inherited IRA "does not contain *anyone's* 'retirement funds'" and disallowed the exemption. But the district court later reversed. The district court explained the "retirement funds" exemption "covers any account containing funds 'originally' 'accumulated for retirement purposes." The Court of Appeals for the Seventh Circuit disagreed and reversed the district court. Because of the distribution rules applicable to inherited IRAs, the Seventh Circuit held "inherited IRAs represent an

opportunity for current consumption, not a fund of retirement savings."

The U.S. Supreme Court agreed to hear the case and recently affirmed the decision of the Seventh Circuit. The court concluded inherited IRAs are not "retirement funds" for purposes of the bankruptcy exemption and identified three legal characteristics of inherited IRAs to support that conclusion. First, holders of inherited IRAs, unlike traditional IRA holders, "may never invest additional money in the account." Second, the Code requires holders of inherited IRAs "to withdraw money from such accounts, no matter how many years they may be from retirement." Finally, an inherited IRA holder "may withdraw the entire balance of the account at any time – and for any purpose – without penalty," which allows the inherited IRA to be freely used for current consumption.

The court noted the Bankruptcy Code's exemption provisions attempt to establish a careful balance between the interests of creditors and the essential needs of debtors. Allowing debtors to protect funds held in traditional and Roth IRAs is consistent with protecting debtor's essential needs because it helps "to ensure that debtors will be able to meet their basic needs during their retirement years." Because of the currently consumable nature of inherited IRAs, however, the court concluded that extending the "retirement funds" exemption to inherited IRAs goes too far and "would convert the Bankruptcy Code's purposes of preserving debtors' ability to meet their basic needs and ensuring that they have a 'fresh star'…into a 'free pass.'"

Because inherited IRAs may no longer be entitled to creditor protection in bankruptcy, holders of traditional IRAs will want to take a more critical look at who they designate as their IRA beneficiary or consider alternative techniques for protecting wealth accumulated in IRAs from creditors. (*Clark v. Rameker*, U.S. Sup. Ct., 2014)

Court Establishes Test for Determining Whether Transaction Was Undertaken to Evade or Avoid Withdrawal Liability. ERISA directs that, if a principal purpose of any transaction is to evade or avoid withdrawal liability, then withdrawal liability will be determined and collected without regard to the transaction.

Mark Lindquist was the owner of M.A. Lindquist Co., Inc., which was a contributing employer to the Carpenters Pension Trust Fund for Northern California prior to its withdrawal from the pension fund. Following M.A. Lindquist's withdrawal from the pension fund, the pension fund filed separate suits against M.A. Lindquist and Mark Lindquist individually to recover withdrawal liability. Summary judgment was granted against M.A. Lindquist on February 8, 2011, and against Mark Lindquist on July 19, 2011. On November 7, 2011, the court entered judgment against Mark Lindquist in the amount of $1,580,337.91, representing the withdrawal liability owing to the pension fund.

Mark Lindquist also owned a 20-percent membership interest in the Lindquist Family LLC. The other four members of the Lindquist Family LLC were Mr. Lindquist's mother and siblings, each of whom owned a 20-percent interest. In December 2010, Mr. Lindquist executed two unsecured promissory notes, one in favor of the Lindquist Family LLC and another in favor of his mother. On June 1, 2011, after summary judgment had been entered against M.A. Lindquist, but before summary judgment had been entered against Mark Lindquist individually, the two promissory notes were amended so as to be secured by Mr. Lindquist's 20-percent membership interest in the Lindquist Family LLC. The pension fund challenged the amendment of the promissory notes as a transaction undertaken with a principal purpose to evade or avoid withdrawal liability.

The district court applied a three-part test to determine whether the amendment of the promissory notes constituted an abusive transaction under ERISA: (1) was the transaction a bona fide, arm's-length transaction, (2) did the employer have knowledge of its withdrawal liability, and (3) did one or more of the parties to the transaction intend to frustrate the purposes of ERISA.

The court first found that the transaction did not constitute a bona fide, arm's-length transaction, noting that a transaction between family members, in which no negotiations take place, could not be viewed as a bona fide, arm's-length transaction.

With respect to the second prong, the court concluded that there could be no doubt the parties were aware of the potential withdrawal liability. In particular, the promissory notes were amended after summary judgment had been granted against M.A. Lindquist and just one day before Mark Lindquist's attorney filed an opposition to summary judgment in the suit filed against Mr. Lindquist individually. Further, e-mails between the siblings following the grant of summary judgment against M.A. Lindquist demonstrated that the siblings were concerned that Mr. Lindquist's membership interest in the Lindquist Family LLC might be reached by the pension fund.

The court also concluded that the intent of the transaction was to frustrate ERISA's purpose of requiring a withdrawing employer to fund its share of a pension fund's unfunded vested benefits through withdrawal liability payments. While the stated reason for amending the promissory notes was to ensure repayment of those notes, e-mails between Mark Lindquist's siblings indicated the primary concern was to prevent the pension fund from reaching Mr. Lindquist's interest in the Lindquist Family LLC. In addition, Mark Lindquist's mother testified she was unconcerned whether Mr. Lindquist would repay the loans and did not care whether he did so during her lifetime.

In concluding that a principal purpose of amending the promissory notes was to evade or avoid withdrawal liability, the court noted the fact that the amount of the withdrawal liability was three times the value of Mr. Lindquist's interest in the Lindquist Family LLC, the amendment was unsupported by any consideration, and the timing of the amendment in relation to the pension fund's attempts to secure a judgment for withdrawal liability also supported a finding that the transaction was undertaken with a principal purpose to evade or avoid withdrawal liability. Accordingly, the amendment of the promissory notes was to be ignored for purposes of determining and collecting Mark Lindquist's withdrawal liability to the pension fund. (*Carpenters Pension Trust Fund for Northern California v. Lindquist Family LLC*, N.D. Cal., June 10, 2014)

The Surcharge Remedy Is Alive and Well After *Amara*. A recent case highlights the increased litigation and liability risks to which employers are exposed following the U.S. Supreme Court decision in *Cigna v. Amara*, which expanded the remedies available to participants who claim to have lost benefits because of a fiduciary's failure to comply with ERISA's fiduciary standards.

Consider the following scenario:

> Smith is enrolled in her employer's group life insurance plan. Her employer is the plan administrator and, as such, is a fiduciary of the plan. As plan administrator, Smith's employer has an obligation to maintain and furnish a Summary Plan Description (SPD) that is written in a manner calculated to be understood by the average plan participant; that is sufficiently accurate and comprehensive to reasonably apprise the participants and beneficiaries of their rights and obligations under the plan; and that summarizes the circumstances that may result in disqualification, ineligibility, or denial or loss of benefits under the plan. Furthermore, when a fiduciary provides plan information through other

written communications (e.g., open enrollment materials) or in response to participant inquires, ERISA requires the information provided to be accurately and completely stated.

While enrolled in the plan, Smith is diagnosed with a terminal illness and goes out on a disability leave of absence. At the time Smith's leave begins, the company's human resources manager tells Smith that her life insurance benefit would continue during her leave. She is not informed of the policy provision that states coverage would continue for only one year following a leave and was not furnished an SPD that clearly and accurately explained this provision. She also is not informed, through the SPD or otherwise, that she could continue her life insurance coverage following the expiration of the one-year period by electing to convert her group coverage to an individual policy of insurance.

Smith passes away one year and three months after her leave begins, and the employer's life insurance carrier refuses to pay the benefit because Smith's coverage had terminated three months earlier, and she had not elected to convert her coverage to an individual policy. Smith's beneficiaries sue the employer for the life insurance benefits they claim they would have received had her employer complied with its obligations under ERISA. The court rules in favor of the beneficiaries and awards them a sum equal to the life insurance benefits they would likely have received in the absence of the fiduciary breach plus interest.

The above scenario is similar to the facts in the recent case of *Weaver Brothers Insurance Associates, Inc. v. Braunstein* (E.D. Pa., June 2014), which held a plan fiduciary can be individually liable for benefits that likely would have been paid absent the fiduciary's breach of ERISA's fiduciary standards. Interestingly, the court in *Weaver* ruled that the certificate of insurance was not part of the SPD because it was merely "included" with the SPD and not incorporated into the SPD by reference. Furthermore, the court went on to hold that even if the certificate of insurance was a part of the SPD, it also violated ERISA. In this respect the court held that the certificate of insurance, which was "37 pages, and having a table of contents with 12 sections and 68 subsections," did not explain the conversion right "in a manner calculated to be understood by the average plan participant."

While this represents the view of only one court, and a lower federal court at that, the case is instructive in the following respects:

• Employers and their benefits staff need to be familiar with the terms of their benefit plans and of ERISA's requirements with respect to those plans. In *Weaver*, the court found the fiduciary in that case had received no training on the obligations of an ERISA fiduciary and was lacking in knowledge of critical aspects of her responsibilities as a fiduciary under ERISA.

• In creating so-called "wrap" SPDs, it is important to ensure that the related certificates of insurance are expressly incorporated into the SPD by reference and not simply "included" with the SPD.

• It is best practice for the wrap SPD to highlight important provisions of the certificate of insurance, even if they are otherwise described in the certificate of insurance, such as, for example, actively-at-work, evidence of insurability, and conversion provisions. As evidenced by the ruling of the court in *Weaver*, insurance company certificates are often not models of clarity.