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Outside Counsel

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The Increasing Responsibility to Make Meaningful Disclosure to Participants

By Russell E. Greenblatt, Mark S. Weisberg, Linda Lemel Hoseman, and Niki Kanellopoulos

Recently, courts have begun using ERISA's fiduciary responsibility principles to expand disclosure obligations in an effort to correct perceived abuses by employers and others who fail to share important plan information with participants and beneficiaries.

Duty to Disclose: ERISA Framework

The Employee Retirement Income Security Act ("ERISA") and the Department of Labor ("DOL") regulations impose basic disclosure obligations with respect to ERISA plans. Plan sponsors must give plan participants and beneficiaries initial and periodic reports of the plan's design and financial condition. ERISA generally requires that plan participants and beneficiaries receive summary plan descriptions, summaries of material modifications, summary annual reports, and individualized statements regarding the value of benefits accrued by the participant or beneficiary. Congress has not significantly expanded upon these basic disclosure obligations. In addition, little regulatory energy has been expended to consider the disclosure obligation that might arise as the result of behind-the-scenes administrative decisions and developments that could have an effect on the right to receive benefits under an ERISA plan.

Duty to Affirmatively Volunteer Pertinent Information: "Serious Consideration" Cases

Through a number of cases, known as the serious consideration cases, fiduciaries have been held to a duty to avoid making material misrepresentations to plan beneficiaries either explicitly or through their silence. These cases involve situations in which an employer is considering altering its benefit package, but misinforms or fails to inform affected participants about this potential change. Litigation typically ensues when a participant acts in a manner that appears to be different from the action he or she would have taken if the undisclosed information had been provided to the participant.

These cases generally have acknowledged that an employer's decision to amend a plan involves a settlor function that is not governed by ERISA's fiduciary provisions. Nevertheless, many courts have held that a breach of fiduciary duty may occur when an employer affirmatively misrepresents or remains silent about significant plan changes that are under serious consideration.

In *Varity Corp. v. Howe*,[1] the U.S. Supreme Court held that a plan sponsor was acting in a fiduciary capacity when it made misrepresentations about the viability of a subsidiary to which it convinced a large number of employees to voluntarily transfer. The Court held that the plan

sponsor had violated its fiduciary duties by "the kind of conduct that often creates liability even among strangers."

The Ninth Circuit, in *Bins v. Exxon Co.,*[2] held that an employer had an affirmative duty to disclose information about a special retirement incentive when this type of plan amendment was under serious consideration. In this case, an employee, months before retirement, had tried to confirm rumors about this special incentive, but was repeatedly informed that no such plan was under consideration, when, in fact, the employer was giving serious consideration to implementing such an incentive. The employee retired in reliance on these assurances, and after his retirement, the employer instituted the program. The court also held, however, that there is no affirmative duty to volunteer information to employees who do not inquire about potential plan changes before their adoption.

When is a plan amendment under serious consideration? The Third Circuit has provided some guidance. In *Fischer v. Philadelphia Electric Co.,*[3] the court stated that serious consideration of changing plan benefits exists when: (1) a specific proposal (2) is being discussed for purposes of implementation (3) by senior management with the authority to implement the change.

Duty to Volunteer Other Important Information

Courts have also held that on occasion employers and plan fiduciaries must disclose certain information that will help employees make prudent benefit decisions. One example of this trend is *Farr v. U.S. West Communications,*[4] in which the Ninth Circuit found that an employer had breached its fiduciary duty under ERISA by failing to inform participants about the potential tax consequences of a lump sum distribution of an early retirement benefit, even though this same employer had encouraged employees to consult a tax advisor about such consequences. The court stated that, although the committee did not have a duty to give plaintiffs individualized notices of the tax consequences of the distributions, the employer had failed to give employees sufficiently detailed information that would alert them to the precise nature and likelihood of such a possibility. The court stated that the employer had an obligation to explain the nature of the potential problem and, in general terms, who might be negatively affected and that participants could make an informed decision about whether they needed to consult a tax advisor only if this information was provided.

Similarly, in *Jordan v. Federal Express Corp.,*[5] the Third Circuit held that a participant's specific request for information is not necessarily a prerequisite for finding a fiduciary breach for failure to inform. The court found that an issue of material fact existed as to whether a failure to inform a participant that a benefit election was irrevocable constituted a material omission and a breach of fiduciary duty to disclose. This duty arose even though the plaintiff had never asked whether the election was irrevocable.

Another illustration of how far the disclosure obligation runs is the case of *McNeese v. Health Plan Marketing, Inc.,*[6] in which the district court held that, when the plan sponsor became insolvent and its single-employer self-insured medical plan was underfunded, both the consultant/third party administrator ("TPA") and the president of that TPA were liable for the plan's unpaid medical claims despite the absence of any suggestion that the TPA had financial responsibility to fund the claims in question. Rather, the liability arose from their failure to inform plan participants that the sponsoring employer was falling behind on its financing of the plan and that, as a result, the plan was experiencing financial problems.

The clear trend is to require plan sponsors and fiduciaries to disclose all facts material to a participant's decision relative to the participant's benefits under a plan. If an ERISA party possesses such material information, whether as employer, administrator, insurer, or other service provider, and irrespective of whether it is acting in its fiduciary capacity, failure to disclose such information may create liability under ERISA.

Cash Balance Conversions

One area in which the fairly minimal disclosure requirements of ERISA have been heavily criticized lately pertains to the conversion of traditional defined benefit pension plans to cash balance plans. A major criticism of cash balance conversions, and a situation in which a potential breach of fiduciary duty claim may arise, is that sponsors are not adequately com-

municating to participants the effects of the conversion on the workers' benefits. Specifically, the criticisms focus on communicating whether the participants will be subject to wear away periods and how the benefits under the new plan compare to those under the old plan.

The current statutory scheme, under ERISA § 204(h), requires 15 days' advance notice to participants of any significant reduction in the rate of future benefit accruals at normal retirement age. The notice may consist of a summary of the changes as long as it is written in a manner calculated to be understood by the average plan participant. The summary need not, however, include an explanation of how the benefits of each individual will be affected.

Several bills introduced in the 106th Congress attempted to address the perceived lack of sufficient information. Some of the bills contained a requirement that employers provide individualized benefit calculations to employees affected by a cash balance conversion.

More recently, the General Accounting Office ("GAO") issued two reports on cash balance plans. The GAO recommended that ERISA's disclosure provisions be amended to require a 90-day notice period for cash balance conversions. The GAO also recommended that the Internal Revenue Service ("IRS") continue its moratorium on determination letters approving conversions until regulations are promulgated addressing conversion problems. The reports also contained recommendations that the DOL amend the disclosure requirements for summary plan descriptions and summaries of material modifications to include a clear statement regarding the hypothetical nature of cash balance accounts and to clearly identify the potential of a conversion to reduce future pension accruals and early retirement benefits.

Conclusion

Employers, insurers, fiduciaries, administrators, and health care providers are understandably uneasy with some of the positions adopted by the federal courts in an effort to hold them to a high standard, perhaps a higher one than that set forth in ERISA.

In response to these court cases and the cash balance developments, the DOL has taken initial steps in attempting to address the perceived shortcomings in ERISA's disclosure requirements. On September 14, 2000, the DOL solicited public comments regarding the effect on employee benefit plans and employers of recent court rulings regarding the extent of an ERISA fiduciary's duty to disclose information to participants and beneficiaries and with respect to the specific disclosure requirements imposed under ERISA.

It remains to be seen whether the new administration or Congress chooses to address these developments before the DOL reacts with new regulations.

Notes

1. 516 U.S. 489 (1996).
2. 220 F.3d 1042 (9th Cir. 2000)
3. 96 F.3d 1533 (3d Cir. 1996).
4. 151 F.3d 908 (9th Cir. 1998).
5. 116 F.3d 1005 (3d Cir. 1997).
6. 647 F.Supp. 981 (N.D. Ala. 1986).

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Receipt of Distributions from Insurance Company Demutualization

By Russell E. Greenblatt

The receipt of proceeds from an insurance company demutualization raises several significant issues for employers. Demutualization occurs when a mutual life insurance company changes its structure and becomes a stock insurance company via an initial public offering ("IPO"). The policyholders, who own the mutual company, receive stock in the new company in exchange for their membership interests. The tax and ERISA guidance available to employers is limited and needs to be considered. If the issues can be addressed before the demutualization occurs, the employer will be better off.

Excise Taxes

The initial concern for employers is whether the demutualization distribution would constitute a prohibited reversion to the employer

from a welfare benefit fund if the employer receives the distribution. Under § 4976 of the Internal Revenue Code, such a reversion subjects an employer to a 100 percent excise tax.

Insurance policies do not generally constitute welfare benefit funds. Consequently, demutualization distributions resulting from employer-owned policies may not trigger a serious excise tax analysis. In a private letter ruling issued in 2000,[1] however, the Internal Revenue Service ("IRS") concluded that the long-term disability policy at issue constituted a welfare benefit fund, presumably because (although this reason is not clear from the ruling) the policy included a claims fluctuation reserve. In cases in which an excise tax analysis is undertaken, it is generally very fact specific and should be done in light of IRS Announcement 86-45 regarding which policies constitute "funds." Another scenario in which the excise tax provisions could come into play is one in which the policy is either owned by a voluntary employees' beneficiary association ("VEBA") or other employee benefit trust or is owned by the employer but the premiums have been paid by the VEBA.

In the ruling referred to above, the IRS concluded that the demutualization distribution would not be treated as a reversion, but only because the proceeds were to be transferred directly from the insurance company to a VEBA rather than being retained by the employer. The ruling, however, should alert employers to the risk of incurring a § 4976 excise tax associated with retaining distributions received under similar circumstances.

Income Taxes

In the same ruling, the IRS took the opportunity to comment on the issue of income tax to the employer resulting from the demutualization distribution. The transfer in that case was taxable to the employer because the employer, rather than the VEBA, owned the policy and was entitled to the distribution (even though it had directed the distribution to be paid to the VEBA). Revenue Ruling 73-599 holds that a policyholder must include in gross income amounts payable from the policy in cases in which the contract does not expressly prohibit the return of funds to the policyholder, even though in the facts of 73-599 the employer had directed the distribution to be transferred directly to its VEBA.

The issue for an employer is whether the employer should be the policyholder. It is common for a VEBA or benefit plan fiduciary (rather than the employer) to be the policyholder, especially if the premiums are paid from the VEBA. In cases in which the VEBA is the policyholder and receives a demutualization distribution, the issue of income tax to the employer does not arise. The VEBA (rather than the employer) would typically recognize the income but likely could shelter it by virtue of its tax-exempt status. In such a case, the VEBA should plan as far in advance as possible for the receipt of the funds so as to minimize the risk of unrelated business taxable income ("UBTI") to the VEBA.

Employer Deductions

If an employer receives a demutualization distribution, recognizes the distribution as taxable income, and transfers the proceeds to a VEBA, the employer would likely be entitled to a deduction for some or all of the amount transferred. There is a limitation, however, imposed by Code §§ 419(b) and 419A(b), on the size of the deduction. The transfer will generally be deductible only to the extent that the VEBA does not have year-end assets in excess of the "account limit" determined under § 419.

Employees' Portion of Demutualization Distributions

Although the employer may be taxable on the entire demutualization distribution, such may not be the case in situations in which the employees contributed to the premiums paid on the policy.

The employer tax implications should depend in part upon how much of the demutualization distribution belongs to the employer and how much of it was given to the employer in a fiduciary capacity to be turned over to the employee benefit plan or the participating employees. For example, in the case of *Ruocco v. Bateman, Eichler, Hill, Richards, Inc.*,[2] the court held in a class action suit brought by employee participants that, when the employer received a demutualization distribution from an insurance company resulting from the employer's ownership of a group long-term policy, the distribution belonged to the employee-participants because they (not the employer) had paid the premiums. It follows that distributions that belong to employees would be recognized as income by them and not the employer.

Insurers generally refuse to help resolve the problem of allocating distributions between the employer and its employees, and in fact, they may add to the problem. For example, the insurer may issue a Form 1099 identifying the employer as the recipient of income triggered by the demutualization, even in the case in which the premiums are paid entirely by employee-participants and the employer returns the money to those participants.

Alternatively, the employer may determine that the distribution belongs to the benefit plan or may be directed to the carrier in the form of prepaid premiums in lieu of sending checks to employees. These determinations are to be made under the provisions of the benefit plan and ERISA.

ERISA Coverage Exclusions

Some employers take advantage of Department of Labor ("DOL") regulations[3] that exclude from ERISA coverage those insured benefit plans which are fully employee-paid and which the employer does not sponsor or administer. On occasion, benefit plans, such as supplemental life insurance or dependent life insurance, may qualify for such treatment. This exclusion, however, applies only if the employer does nothing more than forward employee-contributions to the carrier and does not get involved with funding or administration of the plan.

This exclusion likely will be in jeopardy if the employer receives the demutualization distribution and either retains it or transfers it to its VEBA and then pays the premiums out of its VEBA. By taking these steps, the employer would likely be considered involved in the funding of the plan. To avoid the plan becoming subject to ERISA, it appears that the safest route for an employer would be either to pay the money to the employees or to return it to the carrier as prepaid premiums.

Conclusion

Although the private letter ruling issued last year provides some insight into the tax implications to the employer of demutualization distributions, consideration should also be given to what to do with the employee-participant portion of such distributions, the deductibility of amounts transferred to a VEBA or returned to the carrier, and what the tax implications are to covered employees. The sooner the employer begins to prepare for any anticipated demutualization distribution, the better.

Notes

1. PLR 200011063 (Mar. 17, 2000).
2. 903 F.2d 1232 (9th Cir. 1990), *cert. denied,* 498 U.S. 899 (1990).
3. DOL Regulation § 2510.3-1(j).

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Start While You're Ahead: Be Current with Your ERISA Fiduciary Compliance

By Marla J. Kreindler and Mark S. Weisberg

If you are like many employers that sponsor ERISA-covered retirement plans, you have established a 401(k) plan or maybe even a profit-sharing or defined benefit plan to help your employees meet their retirement planning goals. You are not required to provide these programs, yet you offer them to be competitive in the market and to help retain key employees. Your company probably also allocates a lot of time and expense toward its retirement programs.

In other words, when you start taking 401(k) payroll deductions on behalf of your employees, you think you are establishing a nice employee benefit. What if you were also creating significant liabilities for the company? No one starts a retirement program to do the wrong thing, but how do you know whether you are creating liabilities instead of employee goodwill?

A poorly administered retirement plan can create legal liability in the form of fines and penalties, liabilities from governmental audits or investigations, and even class action litigation—not to mention the damage a poorly managed retirement program can wreak on employee morale.

As the sponsor of, or as a fiduciary for, a tax qualified retirement plan, you should know the risk management measures you can use to keep your retirement programs from turning into a company liability. This article proposes five easy steps to start you on your way.

Make Sure Your Plan Documents Are in Order

Your retirement plan's governing documents should include a written plan document and also a summary plan description that is distributed to plan participants. You likely also have a trust agreement and probably have employee communications that describe key features of your retirement plans, such as in company newsletters or periodic mailings.

ERISA fiduciaries are required to follow their written plan documents unless it is clearly prudent not to do so. Suffice it so say that, at least in this case, the exception should never become the rule. With that thought in mind, have someone at the company actually read through your plan documents, cover to cover, to see whether they accurately reflect your current administrative practices and whether they are consistent with one another. If plan procedures have changed, at the very least you will probably need to amend both your plan documents and the summary plan description. Sending out a one-page change notice and taking no further action will probably not be sufficient. Furthermore, some changes can be made only if very specific procedures are followed. Failing to follow such procedures can invalidate the amendment and give employees the right to have the plan's former provisions reinstated retroactively.

If you have a question regarding the operation of your plan, check to see whether the issue is addressed in your plan documents. If you call your third party administrator ("TPA") with a question, make sure that the TPA is consulting your plan documents, as well. Although retirement plans offer great flexibility in terms of design, you will always be limited by the terms of your written plan documents. Many court cases have been won (or lost) because the plan administrator dutifully followed (or failed to follow) the written plan documents. In other cases, liability has been found in situations in which plan documents, summary plan descriptions, or other employee communications were inconsistent or were not kept current.

Keep the Cart in Front of the Horse

Be careful about announcing a new retirement program or making changes to an existing program until such changes can be appropriately implemented. In order to be able to claim applicable deductions for retirement plan contributions, IRS rules require that a written plan document be in place. Changes that may sound simple can require coordination at multiple levels both internally and externally. Plus, some changes require governmental filings. For example, if you want to add a company stock fund investment option, you will need to prepare a Securities and Exchange Commission ("SEC") filing.

Keep in mind too that, for the past several years, the DOL's number one enforcement issue has been ensuring that employee payroll deductions are deposited on a timely basis into the retirement plan's trust account. Under DOL regulations, employee payroll contributions must be deposited as soon as administratively practicable after such contributions have been made, but no later than the 15th day of the month after the month in which such amounts were deducted. In our experience, this deadline is most often missed because of poor advance planning: payroll deductions are commenced before systems are fully in place; payroll functions of a newly acquired unit or division are not integrated at the time an acquisition is made effective; payroll systems are changed or are decentralized; contributions are missed, and so on.

Consider Your ERISA Fiduciary Liability

Start by considering your ERISA fiduciary obligations imposed by law and under your written plan documents. ERISA plan fiduciaries are held to the highest standard of care: plan fiduciaries are required to act in the same manner as a prudent expert would act under similar circumstances. As a result, in the face of ERISA's prudent expert standard of care, acting reasonably or in good faith is not enough.

This standard means that, if a plan fiduciary is not expert in such matters as modern portfolio theory or standard investment practices, obtaining independent counsel or advice will often be advisable. At the same time, recent case law decisions require that plan fiduciaries question assumptions and fully consider decisions that are made. Blindly accepting an advisor's recommendations will not withstand a claim for breach of fiduciary duty. Courts have developed the doctrine of procedural prudence, which can help insulate fiduciaries from liability to the extent that plan fiduciaries have documented

proper exercise of their ERISA fiduciary obligations. In this arena, inadequate documentation is tantamount to a showing of breach of fiduciary duty.

Implementing an investment policy for your plan can be an effective form of procedural prudence. Take into account the plan's funding requirements and liquidity needs. Specify appropriate investment funds or investment styles, establish appropriate benchmarks, provide for investment diversification across individual investments and assets classes, and provide appropriate restrictions on your plan's investment program, such as regarding the use of leverage and investments in derivatives or alternative investments.

Have you thought about changing your plan's investment providers? If so, standard practices include conducting a request for proposal ("RFP") and seriously considering alternative providers. Class action litigation has been instituted in cases in which changes had been made without deliberation or in cases in which the status quo had not been reevaluated.

If your plan offers participant-directed investments, consider whether you have designed the plan's investments to limit your liability for poor investment decisions made by your plan participants. Understanding the dynamics of § 404(c) of ERISA, including its core investment fund and disclosure requirements, is the foundation for this analysis. For example, does your plan's summary plan description expressly state that you are intending to comply with § 404(c) of ERISA and that, as a result, fiduciary liability may be limited? If this language doesn't sound familiar, it should.

Periodically review your plan's investment performance, and update your plan's investment policy from time to time. If you can't remember the last time your plan's investment policy was updated, now is the time.

Review Your ERISA Fiduciary Insurance

ERISA generally requires that you maintain an ERISA fidelity bond specifically naming each ERISA-covered employee benefit plan that you maintain and providing coverage in an amount equal to the lesser of 10 percent of the plan's assets or $500,000. An ERISA fidelity bond is separate from your standard corporate fidelity bond. If the word "ERISA" does not appear in the documentation, it is probably not an ERISA fidelity bond.

You will need to update your ERISA fidelity bond each time you adopt a new plan. You may also need to increase the amount of your ERISA fidelity bond if the market value of your plan's assets has increased over time. If you hire outside investment managers or trustees, you should also confirm that they have your plan covered under their ERISA fidelity bond, as well.

As a supplement to an ERISA fidelity bond, you may also consider obtaining ERISA fiduciary liability insurance, or you may want to require that your investment managers or corporate trustees obtain a minimum level of ERISA fiduciary liability insurance. Further, you should consider whether your plan documents or your company's corporate governance documents contain appropriate indemnities for company employees who also serve as plan fiduciaries.

At the same time, you may also want to consider whether your plan trust, administrative, or service agreements require that the company indemnify the plan's service providers for responsibilities that you intended to outsource to them. For example, a typical outsourcing agreement might provide that the recordkeeper or administrative services provider will not be responsible to act with due care and that the recordkeeper or administrative services provider will not be liable for its mistakes unless it is found by a court to be grossly negligent in its exercise of its duties. Think about it this way: would you trust someone with your employees' retirement funds if they refused to accept responsibility for their mistakes?

Establish Compliance Procedures and Implement Periodic Internal Audit Procedures

Effective risk management controls include procedures designed to facilitate compliance with ERISA and other related retirement plan laws. Increasingly, government regulators are more inclined toward leniency in cases in which errors are discovered by an internal audit and promptly corrected. Further, there are often more favorable corrective options available when problems are discovered soon after they occur. Because of the complexity of today's pension regulatory climate, many requirements are not easily understood or implemented, and a routine audit will

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often uncover simple mistakes. For experienced practitioners, assisting you with a self-audit of your retirement plan programs should be straight forward and cost effective.

If you think all this advice seems to be elementary, keep in mind that simple mistakes are not uncommon at even large employers that have adequate staffing. With proper diligence, however, ERISA plan fiduciaries can guard against unexpected fines, penalties, and other liabilities. Where ERISA fiduciary liabilities are concerned, an ounce of prevention is certainly worth a pound of cure.

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