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Time and Tide Wait for No Plaintiff

Supreme Court Reaffirms Primacy of Plan Document in Settling Disputed Claims

How long is three years? Well, in the over-regulated world of employee benefits, it took the US Supreme Court to rule that it is exactly...three years. At issue in *Heimeshoff v. Hartford Life & Accident Insurance Co.* was Wal-Mart's long-term disability (LTD) plan, which provided that a participant had three years from the time that "written proof of loss" must be filed under the plan to sue. Julie Heimeshoff missed that deadline but, backed by the Department of Labor and several other amici, asked the Court to ignore the clear terms of the plan document so she could sue to overturn the plan's denial of her LTD claim. Writing for the unanimous Court, Justice Thomas built on the Court's position that in ERISA litigation, the plan document reigns supreme.

Participants in an ERISA pension or welfare plan must follow a two-step dance to dispute a denied benefit claim. First, the plan's internal appeal procedures must be followed when the participant asks the plan committee or administrator to review the denial. If the claim is denied on internal appeal, the participant is considered to have exhausted his or her administrative remedies and may sue in federal court. Since, for whatever reason, ERISA does not specify a statute of limitations for suing over a denied benefit claim, courts have borrowed the most analogous state statute of limitation (SOL) period to determine when an ERISA dispute becomes stale, generally selecting the state's limit for bringing a breach of contract action. However, as ERISA is silent on the SOL, the courts have allowed plans to substitute their own time limit for participants to sue rather than rely on state law, provided the plan-set limit was reasonable.

Although it was well-settled that plans may specify an SOL, there was a dispute between the circuits whether employers could also specify when the clock begins to tick. That question brought the *Hartford* case to the Supreme Court.

Julie Heimeshoff, a senior PR manager for Wal-Mart, began to experience chronic pain, fatigue, and other maladies that were eventually diagnosed as lupus and fibromyalgia. On August 22, 2005, Heimeshoff filed a claim for LTD benefits with Hartford, Wal-Mart's LTD plan administrator. Hartford denied the claim in November because one of Heimeshoff's doctors had not provided the requested reports, but gave her extra time to complete the file. Heimeshoff got a new doctor who reported, in July 2006, that she was disabled. Hartford then hired its own MD, who concluded in November that Heimeshoff could do

sedentary work. At that time, Hartford denied Heimeshoff's claim. She then asked for, and received, extra time to file an appeal and provided additional medical evaluation in September 2007. Hartford had more doctors look at the reports and finally denied the claim on November 26, 2007. On November 18, 2010, Heimeshoff sued.

The LTD plan's a three-year statute of limitations stated: "Legal action cannot be taken against The Hartford [more than] three years after the time written proof of loss is required to be furnished" under the plan. Under the most generous reading, written proof of loss—meaning the documents, reports, applications, etc.—showing that Julie was disabled, was due on September 30, 2007. In that case, Heimeshoff had to sue by September 30, 2010, and her November 18, 2010, complaint was filed about a month and a half late. Wal-Mart and Hartford moved to have the suit dismissed as time-barred. The district court and the US Court of Appeals for the Second Circuit agreed.

Given that the courts allow employers to choose the limitations period, it is somewhat perplexing that some courts were unwilling to allow employers to select when the SOL clock begins to run. Otherwise, if the starting line could be moved by a sympathetic judge wishing to extend the limit for an otherwise late participant, the authority to set the SOL would be illusory. That's exactly what the unanimous Supreme Court ruled. Drawing on pre-ERISA principles of contract law, Justice Thomas noted that, in the absence of a controlling statute, parties to a contract are free to set their own limitations period as long as they are "reasonable." According to the Supreme Court, that a plan's SOL ordinarily should be enforced as written is especially appropriate when enforcing an ERISA plan. Then, quoting its recent decision in *US Airways, Inc. v. McCutchen*, the Court reiterated "[t]he plan, in short, is at the center of ERISA."

In advocating for the plaintiff, what got the Department of Labor's dander up was the fear that unscrupulous employers could keep a participant from his or her day in court by foot-dragging during an internal appeal or creating other obstacles during the claim process. The Court brushed these objections away with a feather, noting that the time limit must be reasonable, and a court can impose tolling or other equitable remedies if the participant was not given enough time to sue. The facts in *Hartford* hardly show a Machiavellian attempt to deny Heimeshoff a fair chance. Twice, it appears, Hartford gave her extra time during the claim process: once when she switched doctors and then again after she asked Hartford for extra time. Even then, Heimeshoff had almost a full year after the final denial to bring suit. She simply didn't act until it was too late.

Happily for employers wishing to offer their employees cost-effective benefits without spending their days in court litigating over those benefits, *Hartford* continues the Supreme Court's common-sense

approach that *thou shalt enforce the plan document as written*. Perhaps even the DOL will understand this point and stop wasting its valuable resources on a world view that lets courts and bureaucrats decide what's best for all. The DOL should recognize that certainty and ease of administration will encourage employers to offer benefits, while more rules and hurdles only serve to discourage them.

For employers, the “take away” is to review their plans and consider adding a reasonable SOL, including a clear statement of when the clock starts. Perhaps, to avoid disputes with retirees years after a benefit accrued (I worked full time in July 1997), with some retirement plans employers may wish to start the clock running with the distribution of an annual benefit statement. Employers also should consider a “blue pencil” clause providing that if a district court finds the plan’s SOL too restrictive, it should expand it only as necessary to make it enforceable. Bottom line: employers, you own your plan documents; write them as you wish them to be read.

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Recent Developments in “Marriage Equality” in the Wake of *Windsor*

Diane M. Soubly

On the final day of its 2013 term, in the landmark decision of *United States v. Windsor*,¹ the US Supreme Court held that Section 3 of the federal Defense of Marriage Act (DOMA)² (limiting the terms “marriage” and “spouse” to opposite-sex couples for purposes of federal laws and regulations) violated the Fifth Amendment of the US Constitution. The Court opined that “[t]he federal statute is invalid, for no legitimate purpose overcomes the purpose and effect to disparage and to injure those whom the State [of New York], by its marriage laws, sought to protect in personhood and dignity.”³ The Court did not reach the merits of *Windsor*’s companion case, *Hollingsworth v. Perry*,⁴ which challenged as unconstitutional the Proposition 8 ballot initiative that had halted the performance of same-sex marriages in California.

The Court appeared to defer to what might develop in the states and in the lower courts over time as it sidestepped a decision on the merits in *Perry* and limited *Windsor*’s holding to those states in which same-sex marriage had been “made lawful by the State.”⁵ In the aftermath of *Windsor*, federal and state courts and federal agencies have grappled with the contours of the 5–4 majority decision authored by Justice Kennedy.

As of March 2014, federal agencies have developed some, but hardly all, of the varied regulatory guidance inspired by *Windsor*, as they enforce different statutes that afford or relate to spousal benefits to partners in same-sex marriages recognized in the state of residence or in the state of celebration, whether domestic or foreign. Currently, 18 states and the District of Columbia have sanctioned same-sex marriage (sometimes described as “marriage equality”) or invalidated bans on such marriages, an accelerating trend since last June’s decision in *Windsor*.⁶ To complicate matters

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further, approximately 50 pending cases now await decision in states that do not provide marriage equality. Leading to speculation that it will take up another same-sex marriage case in the near future, the US Supreme Court has stayed the decision of a federal district court in Utah holding the state constitutional ban on same-sex marriage unconstitutional, pending appeal in the US Court of Appeals for the Tenth Circuit.

Against the backdrop of a developing legal landscape, this article offers a brief update on recent developments in marriage equality so that employee benefit plan designers and benefits litigation counsel can anticipate potential issues for plan sponsors, plan administrators, plan fiduciaries, and potential plan participants and beneficiaries.

STATUS OF SAME-SEX MARRIAGE RECOGNITION

States have adopted various approaches toward marriage equality. In some states, state or federal courts have found it unconstitutional for a state to withhold the designation of "marriage" from same-sex couples. Notably, it took nearly a decade for six such decisions to be issued prior to *Windsor*,⁷ but only a matter of months since *Windsor* for eight decisions to find bans on recognition of existing same-sex marriages and on the licensing of same-sex marriages within a state invalid.⁸ In the last five years, legislatures in some states and the District of Columbia have redefined marriage to include same-sex marriages.⁹ In other states (Maine, Maryland, and Washington), marriage equality won the popular vote.¹⁰

Regulatory Guidance following Windsor

After *Windsor* struck down DOMA Section 3 (which forbade recognition of same-sex marriages for federal law purposes), various federal agencies issued regulatory guidance according federal rights and benefits to same-sex married couples, but not to civil union or domestic partners. As of March 2014, the agencies have not yet issued comprehensive and much-anticipated regulatory guidance relating to the retroactive application of *Windsor*.

Several agencies have weighed in. The Office of Personnel Management (OPM) has issued a Benefits Administration Letter indicating that coverage for health benefits does not extend to civil union partners of federal employees.¹¹ The Department of Defense similarly makes "spousal and family benefits available... regardless of sexual orientation, as long as service member-sponsors provide a valid marriage certificate."¹² The Department of Labor has extended the protections of the federal Family and Medical Leave Act to legally married same- or opposite-sex couples whose marriages are recognized in their state of

residence, but not to civil union or domestic partners.¹³ In August 2013, the Internal Revenue Service (IRS) issued Notice 2013-17, in which it also excluded registered domestic partnerships, civil unions, and "other similar formal relationships" from the definition of "marriage" for federal tax purposes, but included same-sex or opposite-sex spouses legally married in any state, domestic or foreign (*i.e.*, the state of "celebration"). In doing so, the IRS returned to its pre-DOMA regulatory guidance, including Revenue Ruling 58-66. The Centers for Medicare & Medicaid Services issued a memorandum directing Medicare Advantage organizations to cover services in skilled nursing facilities for "validly married" same-sex spouses, to the same extent that services would be required for opposite-sex spouses, and indicating that the term "spouse" "includes individuals of the same sex who are *lawfully married* under the law of a state, territory, or foreign jurisdiction."¹⁴

On September 18, 2013, the Employee Benefits Security Administration (EBSA) of the Department of Labor issued Technical Release 2013-04 concerning the definitions of "spouse" and "marriage" for the purposes of the ERISA.¹⁵ The Technical Release adopts a "state of celebration" rule by permitting recognition of a legal marriage performed "in any state" and by rejecting a domicile rule as unworkable under the national administration of plans that ERISA promotes. The Technical Release expressly provides that "the term 'spouse' will be read to refer to any individuals who are lawfully married under any state law, including individuals married to a person of the same sex who were legally married in a state that recognizes such marriages, but who are domiciled in a state that does not recognize such marriages." The Technical Release also expressly states that "the term 'marriage' will be read to include a same-sex marriage that is legally recognized as a marriage under any state law. This is the most natural reading of those terms; it is consistent with *Windsor*, in which the plaintiff was seeking tax benefits under a statute that used the term 'spouse'; and a narrower interpretation would not further the purposes of the relevant statutes and regulations." However, the Technical Release specifically excludes from these terms "individuals in a formal relationship recognized by a state that is not denominated a marriage under state law, such as a domestic partnership or civil union,"¹⁶ whether such individuals receive benefits under state law or not.

On December 16, 2013, the IRS issued Notice 2014-01, relating to cafeteria plans, health and dependent care flexible spending plans (FSAs), and health reimbursement accounts (HSAs). The Notice provides that a cafeteria plan may treat a participant who was married to a same-sex spouse as of June 26, 2013 (the date of the decision in *Windsor*) as if the participant had experienced a change in legal marital status for purposes of the midyear election change rules. The participant may revoke an existing election and make a new election consistent with the change in legal marital status, and the cafeteria

plan may accept that election for any plan year that includes June 26, 2013, or December 16, 2013. In addition, an employer that receives appropriate notice of the change in legal marital status (through the employee's election form or revised Form W-4) must begin treating a participant's payment for the cost of a same-sex spouse's coverage on a pre-tax basis no later than the later of (a) the date that a change in legal marital status would be required to be reflected for income-tax withholding purposes, or (b) a reasonable period of time after December 16, 2013. A cafeteria plan may permit a participant's FSA to reimburse covered expenses incurred by the participant's same-sex spouse or that spouse's dependent that were incurred during a period beginning no earlier than (a) the beginning of the cafeteria plan year that includes June 26, 2013, or (b) the date of the marriage, if the marriage occurred after the *Windsor* decision. The Notice also clarifies that the same-sex married couple is subject to the joint deduction limit for contributions to an HSA and to the exclusion limit for contributions to a dependent care FSA.

CURRENT TALLY IN THE STATES

Civil Union Status

That post-*Windsor* stance by federal agencies has prompted varied responses in states with civil union statutes. As of March 2014, two states (Illinois and Hawaii) recognize same-sex marriage *and* maintain civil union statutes, while one state (New Jersey) has chosen not to appeal a state court decision holding its civil union statute unconstitutional.

New Jersey

In September 2013, in the *Garden State Equality v. Dow* case, a state court declared New Jersey's civil union statute unconstitutional under the New Jersey Constitution, because the statute's withholding of the designation of "marriage" from same-sex couples burdened such couples, who continued to be foreclosed from federal benefits and recognitions even after *Windsor*.¹⁸ Although the state initially appealed that ruling and unsuccessfully sought a stay, Governor Christie ultimately chose to withdraw the appeal.

In *Garden State Equality*, one of the two same-sex couples challenged both the definitional and the nonrecognition sections of New Jersey's "mini-DOMA," thereby challenging not only the state's prohibition on the licensing of same-sex marriages, but also its refusal to recognize same-sex marriages, performed in other states, as permitted by DOMA Section 2 (still in place because it was not challenged in

Windsor). The state court found plaintiffs’ claims ripe for adjudication, particularly since it could take federal agencies months or years to comply with President Obama’s directive on the day of the *Windsor* decision that federal agencies review affected statutes, rules, and regulations and issue regulatory guidance.¹⁹ The court also determined that a deprivation of constitutional rights, such as plaintiffs claimed, would constitute immediate and irreparable harm so as to warrant immediate review and confer standing upon plaintiffs, who raised justiciable claims.

On the merits, the court rejected the state’s argument that the federal government, and not the state of New Jersey, did had created the injury by defining marriage to exclude civil union partners. Instead, the court found sufficient state action in the creation of distinct labels for similar unions based upon sexual orientation:

By creating two distinct labels, marriage for opposite-sex couples and civil union for same-sex couples, New Jersey civil union partners are excluded from certain federal benefits that legally married same-sex couples are able to enjoy. Consequently, it is not the federal government acting alone that deprives plaintiffs of federal marriage benefits—it is the federal government incorporating a state domestic relations structure, and it is the state structure that plaintiffs challenge in this motion.²⁰

Having found state action, the court concluded that, post-*Windsor* and in light of the court’s prior decision in *Lewis v. Harris*,²¹ directing that same-sex couples are entitled to the same benefits as opposite-sex couples under the state constitution, “same-sex couples must be allowed to marry in order to obtain equal protection of the law under the New Jersey Constitution.”²²

Illinois

In Illinois, the legislature passed a “marriage equality” act on November 20, 2013, representative of statutes that draw a balance between protecting same-sex marriages and religious freedom. Because the legislature did not muster a supermajority, the new law will not take effect until June 1, 2014. Until that time, only the Illinois civil union statute remains in effect.²³

Prior to passage of the “Religious Freedom and Marriage Fairness Act,” Illinois had accorded civil unions all the rights, benefits, and responsibilities of marriage but not the title of “marriage” and had banned same-sex marriages as contrary to public policy in Illinois. When it takes effect next June, the new act repeals that public policy²⁴ and recognizes marriages between “two persons” (rather than between “a man and a woman”) that are “licensed, solemnized and registered” as provided in the Illinois Marriage Act.²⁵ The new act

provides that all laws of Illinois applicable to marriage (whether the laws derive from statute, administrative rule, court rule, policy, common law, or any other source of civil or criminal law) "shall apply equally to marriages of same-sex and different-sex couples and their children."²⁶ It contains a "mini-Dictionary Act" including same-sex and different-sex marriage partners in all definitions or uses of terms for "spouse" or "family" or synonyms for such terms.²⁷ The act specifically commands that the parties to a marriage and their children "shall have all the same benefits, protections, and responsibilities under law."²⁸

Of interest to plan sponsors, plan designers, and employee benefits practitioners reviewing plan requirements for recognizing same-sex marriages in states or localities that had civil union statutes, the Illinois act adds a new procedure (and new Section 65 of the Illinois Marriage Act) under which both parties to a civil union may convert their civil union to a marriage.²⁹ Similarly, of interest to counsel fashioning venue provisions in benefit plans, the Illinois act adds a new section to the Illinois Marriage Act providing that, by operation of law, same-sex couples married in Illinois consent to the jurisdiction of Illinois courts "for the purpose of any action relating to the marriage, even if one or both parties cease to reside in this state."³⁰ Under this provision, same-sex marriages entered into in Illinois may be dissolved in Illinois, even if one or both members of the same-sex married couple reside elsewhere.

Although it recognizes marriage equality, the new Illinois act also delineates certain exemptions to permit the exercise of religious freedom. Section 5 of the Act notes that "[n]othing in this Act is intended to abrogate, limit, or expand the ability of a religious denomination to exercise First Amendment rights protected by the United States Constitution or the Illinois Constitution[,] nor is it intended to abrogate, limit, or expand the Illinois Human Rights Act or the Religious Freedom Restoration Act." Consistent with that statement of purpose, Section 15 of the Act cautions that "[n]othing in this Act shall interfere with or regulate the religious practice of any religious denomination or Indian Nation or Tribe or Native Group," and expressly leaves to such entities the "free[dom] to choose which marriages [each] will solemnize or celebrate."

Again consistent with that statement of purpose, the Act also amends Section 209 of the Illinois Marriage Act to exempt ministers, clergy, or officiants of such entities from solemnizing or celebrating same-sex marriages and grants them immunity from suit if they refuse to do so in order not to violate their religious beliefs. 750 ILCS 5/209(a-5). Similarly, the Act further amends Section 209 to provide that organizations "whose principal purpose is the study, practice, or advancement of religion" are not required to provide religious facilities for solemnizations or celebrations of same-sex marriages and grants them immunity from suit if they refuse to do so in order not to violate their religious beliefs. 750 ILCS 5/209(a-10). Amended Section 209(a-10) defines

“religious facilities” to include “sanctuaries, parish halls, fellowship halls, and similar facilities,” but to exclude “facilities such as businesses, health care facilities, educational facilities, or social services facilities.”

Finally, the Act amends the Illinois Marriage Act to extend legal recognition to same-sex or opposite-sex marriages (other than common-law marriages) entered into “in another jurisdiction.”

Hawaii

Shortly after Illinois passed its historic act, the Hawaii State Legislature extended the designation of “marriage” to same-sex couples; and the Hawaii Marriage Equality Act became effective on December 1, 2013. Passage of the act inspired the dismissal of an appeal to the US Court of Appeals for the Ninth Circuit, challenging Hawaii’s denial of marriage licenses and civil marriage benefits to same-sex couples as due process and equal protection violations. The Ninth Circuit had held the case in abeyance for *Windsor*, after which it was dismissed as moot. Subsequent to the passage of the Act, a single state legislator and three other individuals filed suit to enjoin the issuance of marriage licenses on the ground that the Hawaiian constitution prevented the legislature from passing such an act; however, a Hawaiian circuit court judge granted the state’s motion to dismiss the suit on January 29, 2014. In doing so, the court (which ruled from the bench) found that the state constitution did not compel the legislature to define marriage as a union between one man and one woman.³¹

In Hawaii (as in Illinois) same-sex couples may choose to remain civil union partners, even after the above-described regulatory guidance excluding them from federal benefits.

Indiana

The Indiana House has passed and sent to the Indiana Senate a proposed law that would place on the ballot a constitutional amendment banning same-sex marriage. The leading sponsor of the bill withdrew his support for the altered bill that eventually passed the House, one that no longer contained a provision prohibiting employers from providing employee benefits to same-sex partners, and that left open the question of future civil union status.³²

DOMESTIC PARTNERSHIP STATUS

In an interesting twist in Oregon after *Windsor* and the previously described OPM Benefits Administration Letter, the Executive Committee of the Ninth Circuit (acting under the Employment Dispute Resolution (EDR) Plan in place for actions brought by federal employees) vacated

a federal district court’s amended decision denying retroactive reimbursement of benefit costs to a former District of Oregon employee who had unsuccessfully attempted to enroll her same-sex domestic partner in the federal health insurance benefit program.³³

Recognizing that the Oregon state constitution limits marriage to one man and one woman and that OPM had relied upon *Windsor* in reaching its conclusion that domestic partners do not fall within the term “marriage,” the Committee held that OPM’s denial of benefits to a former employee’s same-sex domestic partner violated the EDR Plan’s prohibition against discrimination based upon sexual orientation. The Committee acknowledged that Oregon by statute purported to confer the same legal rights and benefits upon same-sex domestic partners as married couples under *state* law, but observed that statuses other than “married” in Oregon continued to be deprived of federal benefits, citing *Garden State Equality*. The Committee reasoned that, under Oregon law, the OPM denial resulted in disparate treatment of the employee and her same-sex domestic partner and similarly situated couples in two impermissible ways. First, the denial of *federal* health insurance benefits and retroactive reimbursement of those benefit costs turned upon a status that the state barred same-sex couples by law from obtaining. Second, the employee and her same-sex partner were treated differently than similarly situated federal employee same-sex couples in other states within the circuit who could marry, “violat[ing] the principle that federal employees must not be treated unequally in the entitlements and benefits of federal employment based upon the vagaries of state law.” Accordingly, the Committee believed that Oregon law suffered from the same deficiency that the Supreme Court described in *Windsor*.

With little more analysis than citing to *Windsor*, the Committee also found that “the distinction drawn by OPM based on the sex of the participants in the union amounts to discrimination on the basis of sex under the District of Oregon’s EDR Plan and, under *Windsor*, constitutes a deprivation of due process and equal protection.”

RECENT SIGNIFICANT COURT DECISIONS

Recent federal and state court decisions have broadly read *Windsor* in striking down state laws that burden same-sex couples by prohibiting them from marrying based on the gender of the partners or by otherwise discriminating against them.

Utah and Oklahoma—Tenth Circuit

On appeal before the Tenth Circuit, two federal courts recently found *Windsor* controlling in constitutional challenges, with only one court staying its decision on appeal.³⁴ In Utah, where the federal

district court denied the stay, some 1,300 same-sex couples were issued marriage licenses and married until the US Supreme Court stayed the decision pending Tenth Circuit review. In Oklahoma, the federal district court stayed the decision it issued on January 14, 2014. The Tenth Circuit has agreed to have one panel hear both cases and has set an expedited briefing schedule to be concluded in early April 2014.

An initial question for plan sponsors, administrators, and designers (and ultimately litigators) will be the recognition of marriages performed while same-sex marriage became legal in the absence of a stay striking down bans against such marriage. As in *Perry*, in which California's highest court had found withholding marriage licenses from same-sex couples unconstitutional, and thereafter same-sex marriages were performed until Proposition 8 passed, in Utah the same-sex marriages between Utah residents performed after the court decision but before the Supreme Court stay may fall within a plan's definition of marriage if the plan definition turns on the state law of the employee's residence or on federal law that incorporates such state law for purposes of defining "spouse."

Kitchen v. Herbert

At issue in the Utah case were two statutory bans: one prohibited all same-sex marriages and declaring all such marriages "void" (Utah Code Section 30-1-2 (1977)); and the second declared the policy of Utah to recognize marriage between one man and one woman as the only legal marriage and refusing to recognize, enforce, or give any effect to any law creating any legal status, rights, benefits, or duties substantially equivalent to those provided to legally married opposite-sex couples (Utah Code Section 30-1-4.1 (2004)). Also at issue was Article 1, Section 29 of the Utah Constitution, effective in 2005, known as "Amendment 3," a ballot initiative overwhelmingly passed on November 2, 2004. Amendment 3 provided that "[m]arriage consists only of the legal union between a man and a woman," and that "[n]o domestic union, however denominated, may be recognized as a marriage or given the same or substantially equivalent legal effect."

The district court's scholarly survey of cases discussing the right to marry as a fundamental right culminated in its reliance upon *Loving v. Virginia*³⁵ in order to determine whether plaintiffs sought an *existing* fundamental constitutional right to marry: "the Constitution protects their right to marry a person of the same sex to the same degree that the Constitution protects the right of heterosexual individuals to marry a person of the opposite sex."³⁶ Thus, the *Kitchen* decision most unequivocally recognized the existence of a fundamental right to marry a person of one's own choosing.

Having found such a fundamental right, the court then examined and rejected each rationale proffered by the State of Utah in support of the prohibition finding that the ban violated due process and equal protection guarantees.³⁷ Again the state's arguments echoed the arguments of Bipartisan Legal Advisory Group of the US House of Representatives (BLAG) in *Windsor* and met with as little success. The court first found that the state's "responsible procreation" argument defied reason and lacked competent proof, that the state's insistence on the traditional two-parent household raising biological children "humiliates" the children being successfully raised by same-sex parents (citing *Windsor*), and that the state's plea to preserve tradition amounted to no more (as Justice Scalia realized in his dissent in *Windsor*) than a "kinder way" of registering the state's moral disapproval of same-sex marriages.³⁸

Constrained by Tenth Circuit precedent so that it sidestepped entirely the issue of whether members of the LGBT community belong to a quasi-suspect class, the district court eschewed deciding the issue of whether the Utah scheme required heightened scrutiny. Rather, it held that the state of Utah had not even adequately demonstrated a rational basis for the statutory and constitutional bans on such a fundamental right. The court then analyzed the Supreme Court's rational basis methodology in *Windsor* as an atypical animus test invoked to analyze statutes discerned to be in a class of "discriminations of an unusual character [that] especially require careful consideration." Uncomfortable with that analysis because it could not peer into the hearts and minds of voters to determine animus, the court incorporated its rejection of the state's stated purposes for the statutory provisions and Amendment 3.

Bishop v. United States

The Oklahoma federal district court struck down Oklahoma's state constitutional provision limiting marriage to opposite-sex couples as a violation of the Equal Protection Clause of the Fourteenth Amendment of the US Constitution. The lawsuit also challenged DOMA Sections 2 and 3. However, as in the *Windsor* case, once the US Attorney General informed the court that the government would no longer defend DOMA, BLAG sought to intervene to defend DOMA Section 3. Following *Windsor*, the court concluded that plaintiffs' challenge to DOMA Section 3 was moot, particularly when the government had ceased to enforce DOMA Section 3 after the Supreme Court held it unconstitutional, and when the Barton couple requested only prospective declaratory relief.

On November 2, 2004, the voters in Oklahoma approved State Question No. 711 by a vote of 1,075,216 to 347,303, a voter initiative then implemented as Article 2, Section 35 of the Oklahoma

Constitution. Part A of that constitutional provision defined marriage as between one man and one woman, and Part B provided that a same-gender marriage performed in another state would not be recognized in Oklahoma as of the date of the marriage.

The Bishop couple, denied a marriage license in Oklahoma, challenged the definitional provision in Part A of Article 2, Section 35. The Barton couple, married in both Canada and California (before Proposition 8), challenged both DOMA Sections 2 and 3 and the Oklahoma constitutional provisions as violative of their federal substantive due process and equal protection rights under the Fifth and Fourteenth Amendments, respectively.

The court determined that the Bishop couple had standing to challenge Part A of the Oklahoma constitutional provision, and that the clerk was a proper defendant in a challenge to the definitional section.³⁹ Refusing to find that same-sex couples refused marriage licenses by Oklahoma court clerks were a suspect class, the court nonetheless concluded that, although *Windsor* did not control the outcome of the case, Part A intentionally discriminated against same-sex couples without a legally sufficient justification. Because *Windsor* tempered the states' traditional right to define marriage by proclaiming that right subject to constitutional guarantees, the court reasoned that *Windsor* stood for the "unremarkable proposition that a state has broad authority to regulate marriage, so long as it does not violate its citizens' federal constitutional rights."⁴⁰

To analyze the federal equal protection constitutional claim, the court looked to the two-part inquiry followed in the Tenth Circuit:

1. Did the law intentionally discriminate against a group of persons (*i.e.*, was it adopted because of, and not merely in spite of, its discriminatory effect upon a group of persons), and
2. If so, can the law be "justified by some reference to some upright government purpose?"⁴¹

The court easily found that the law intentionally discriminated against all members of one group and that the contemporaneous analyses of the amendment showed an intent to discriminate against homosexuals.⁴² However, the court concluded, as did the court in *Kitchen*, that the discrimination at issue was discrimination on the basis of sexual orientation (not gender), and that the Tenth Circuit had not accorded homosexuals suspect-class status. Therefore, the court applied rational basis scrutiny (and not heightened scrutiny).⁴³

Under the rational basis test, the court reasoned that, although moral disapproval of homosexuality (closely tied to religious views) might constitute a justification for the discrimination against

same-sex marriage, it did not constitute a permissible justification. The court also rejected each of four justifications actually proffered by the state. First, it found that, while the state might have a legitimate interest in "responsible procreation" and in steering "naturally procreative" relationships into marriage to avoid the economic burden to the state of unwarranted children, the means chosen (a same-sex marriage ban) was not rationally related to those ends. The court categorically rejected traditional exclusion as a rational basis for the justification, recounting the exchange between Justice Scalia and attorney Ted Olsen at oral argument in *Perry*, in which Mr. Olsen aptly argued that "the mere fact that an exclusion has occurred in the past (without constitutional problem) does not mean that such an exclusion is constitutional when challenged at a particular moment in history."⁴⁴

The court also noted that Oklahoma did not impose procreative ability as a prerequisite to marriage, and that the failure of Oklahoma to impose that prerequisite on other nonprocreative groups remained probative of an absence of rational basis.

Finding the state's argument "ironic" in light of the circumstances of the constitutional amendment's passage, the court rejected as equally irrational the state's purported "lack of interest" in same-sex marriages. Such marriages could not flow from the "unintended consequences" of unprotected sexual relations of opposite-sex couples (presumably unintended pregnancies) that would encourage the biological parents to marry.⁴⁵

Similarly, the court rejected the state's justification of enshrining the "gold standard of child-rearing" (a stable, two-parent household composed of the opposite-sex biological parents of the child or children), in light of affidavit testimony from the Bishop couple that the ban on same-sex marriages would not somehow cause them to "change course" and marry an opposite-sex partner in order to achieve that ideal. Instead, the court recognized the harm to the children of same-sex couples described in *Windsor* and other cases. The court concluded that the state simply failed to demonstrate that a same-sex marriage ban encouraged opposite-sex marriages.⁴⁶

Finally, the court rejected the state's "negative impact on marriage" argument as just another means of arguing impermissible moral disapproval of homosexuals.⁴⁷

In reaching its conclusion that Part A of the Oklahoma same-sex marriage ban violates the Equal Protection Clause of the Fourteenth Amendment, the court explained:

The Supreme Court has not expressly reached the issue of whether state laws prohibiting same-sex marriage violate the US Constitution. However, Supreme Court law now prohibits states

from passing laws that are born of animosity against homosexuals, extends constitutional protection to the moral and sexual choices of homosexuals, and prohibits the federal government from treating opposite-sex marriages and same-sex marriages differently. There is no precise legal label for what has occurred in Supreme Court jurisprudence beginning with *Romer* in 1996 and culminating in *Windsor* in 2013, but this Court knows a rhetorical shift when it sees one.⁴⁸

New Mexico—State Constitutional Challenge

In mid-December 2013, in *Griego v. Oliver*,⁴⁹ the New Mexico Supreme Court determined that the state’s statutory marriage scheme resulted in the denial of the benefits of civil marriage to “same-gender” couples in violation of the equal protection and due process guarantees of the New Mexico Constitution.

Recalling that the US Supreme Court had struck down the Virginia law that restricted the freedom to marry based on racial classifications in *Loving*, the New Mexico Supreme Court also recognized that it could not prefer one religion over another in deciding the “same-gender marriage” issue. Finding no explicit prohibition against same-gender marriage, the court nonetheless found (as has the Massachusetts Supreme Court in 2003) that mere silence (*i.e.*, the absence of an express ban) did not evince approval of same-sex marriage, and that New Mexico laws, read as a whole, acted to prohibit such civil marriages and to preclude same-sex couples from receiving the benefits that flow from such civil marriages.⁵⁰

In ruling on the equal protection challenge under Article II, Section 18 of the New Mexico Constitution, the court first determined that same-gender couples and opposite-sex couples were similarly situated, citing the pre-*Windsor* decisions of the Massachusetts, California, Connecticut, and Iowa highest courts. In so finding, the court rejected arguments from the proponents of the New Mexico legislation that were strikingly similar to the argument on “responsible procreation” advanced by BLAG in *Windsor* in opposition to same-sex marriage, observing that the ability or willingness to procreate had never been a condition precedent to opposite-sex marriage, that the refusal or the inability to have children had never served as grounds for divorce, and that New Mexico permitted same-gender couples to adopt.⁵¹

Most significantly, having satisfied the first prong of an equal protection analysis under New Mexico precedent by finding same-sex and opposite-sex couples similarly situated, the court then recognized that LGBT couples belonged to a relatively politically powerless, discrete group subject to a history of discrimination and violence, so that

the “intermediate scrutiny” constitutional test (and not rational basis constitutional scrutiny) was warranted.⁵²

Accordingly, New Mexico may neither constitutionally deny same-gender couples the right to marry nor deprive them of the rights, protections, and responsibilities of marriage laws, unless the proponents of the legislation—the opponents of same-gender marriage—prove that the discrimination caused by the legislation is “substantially related to an important government interest.” *Breen v. Carlsbad Mun. Sch.*, 2005-NMSC-028, ¶13, 138 N.M. 331, 120 P.3d 413 (internal quotation marks and citation omitted).⁵³

Before it applied this intermediate scrutiny standard, the New Mexico Supreme Court noted the US Supreme Court’s “equivocation” in *Windsor* over whether civil marriage is a fundamental right and chose not to reach the issue definitively. Instead, the court rejected the justifications offered by the proponents of the New Mexico statutory scheme (“responsible procreation,” “responsible child-rearing,” and “deinstitutionalization of marriage”—all discussed by BLAG in *Windsor*) in favor of finding that the children of same-sex couples and the couples themselves were deprived of equal protection and were impermissibly burdened:

Excluding same-gender couples from civil marriage prevents children of same gender couples from enjoying the security that flows from the rights, protections, and responsibilities that accompany civil marriage. There is no substantial relationship between New Mexico’s marriage laws and the purported governmental interest of responsible childrearing. There is nothing rational about a law that penalizes children by depriving them of state and federal benefits because the government disapproves of their parents’ sexual orientation.⁵⁴

To remedy the constitutional violation, the court did not strike down New Mexico’s statutory scheme, but required (1) “civil marriage” to be construed to mean marriage of two persons to the exclusion of all others; (2) New Mexico’s laws and regulations to be construed to include same-sex marriages; and (3) all clerks to use gender-neutral language on all applicable forms.⁵⁵

NONRECOGNITION OF SAME-SEX MARRIAGES PERFORMED ELSEWHERE—OHIO AND KENTUCKY

Two cases in the Sixth Circuit have held that a state’s refusal to recognize same-sex marriages performed in other states violates federal equal protection and due process guarantees.

Obergefell v. Wymyslo

In what the court termed a narrow "unconstitutional as applied" challenge in *Obergefell v. Wymyslo*,⁵⁶ two same-sex spouses and a funeral director sued to invalidate Ohio's constitutional and statutory bans on the recognition of same-sex marriages performed in other states. The first same-sex spouse had married his spouse in Maryland aboard a medically equipped plane, and they sought a preliminary injunction against enforcement of the bans, arguing that they would be irreparably harmed if the terminally ill spouse died before a ruling on the merits would require that the surviving spouse be listed on the certificate of death. The court granted the preliminary injunction, shortly after which the terminally ill partner passed away. The second same-sex spouse, added as a plaintiff, sought to return his spouse's ashes to a funeral home in Ohio and to be listed as the surviving spouse on his spouse's certificate of death.

On December 23, 2013, the court entered a permanent injunction against Ohio's nonrecognition bans. Observing that the electorate could not order a violation of the due process or equal protection clauses of the US Constitution by referendum or otherwise,⁵⁷ the federal district court found that Ohio's statutory and constitutional bans on recognizing same-sex marriages entered into in other states violated the substantive due process rights of legally married same-sex couples, and that Ohio had failed to demonstrate a sufficiently compelling state interest to counterbalance the harm to the surviving spouses in those married couples.⁵⁸ Reasoning that a "heightened scrutiny" should apply but finding that the Ohio non-recognition bans failed even rational basis constitutional scrutiny, the court also concluded that Ohio impermissibly treated same-sex married couples differently than opposite-sex married couples: it recognized the marriages of opposite-sex couples based on the state of celebration *including marriages that Ohio outlawed (e.g., marriages of first cousins and marriages of minors)*, but refused to apply the state of celebration standard to same-sex couples.⁵⁹ The court also rejected any rational connection between Ohio's asserted state interest that "children are best off when raised by a mother and father" and the constitutional and statutory prohibitions; the court observed that the asserted state interest did not prevent gay and lesbian couples from having children and, in fact, harmed the children of same-sex couples "denied the protection and stability of having parents who are legally married."⁶⁰ Instead, the court found that, in failing to recognize valid same-sex marriages, Ohio engaged in discrimination of an unusual character without a rational basis for doing so.⁶¹

A notice of appeal to the Sixth Circuit was filed on January 16, 2014.

Bourke v. Beshear

Four same-sex couples validly married outside of Kentucky pursued a successful constitutional challenge to Kentucky's refusal to recognize their out-of-state marriages. Applying "rational basis" review, the court noted that Kentucky had limited its assertion of state interest to the preservation of the state's institution of traditional marriage, but that an amicus brief had raised all of the other purported state interests (responsible procreation and childrearing, steering naturally procreative relationships into stable unions, promoting the optimal child-rearing atmosphere of two parents of opposite genders, and proceeding with caution when considering changes in how the state defines marriage) that "comprise[d] all those of which the Court might possibly conceive, and all of which had "failed rational basis review in every court to consider them post-*Windsor*, and most courts pre-*Windsor*."⁶² Moreover, the court recounted that "ancient lineage" and the "antiquity" of a practice does not insulate it from rational basis review.⁶³ Accordingly, the court struck down Kentucky's prohibitions against recognizing same-sex marriages from other states as unconstitutional, indicating that its permanent injunction against enforcement of the prohibitions constituted a final order ripe for review.

Interestingly, the court permitted new plaintiffs who sought to enter into same-sex marriages in Kentucky to challenge the state's ban on the licensing of such marriages, but denied the new plaintiffs' request for preliminary and permanent injunctions. Mindful that the US Supreme Court had reached down to stay the Utah federal court's decision pending review in the Tenth Circuit, the Kentucky court may have differentiated between the two types of plaintiffs (*i.e.*, those same-sex spouses seeking to have existing marriages from other states recognized in Kentucky, and those unmarried same-sex couples seeking to marry in Kentucky), in part to support its denial of Kentucky's request to stay its decision relating to validly married same-sex spouses.

SAME-SEX MARRIAGE BANS AND STRICT SCRUTINY

Two cases in February 2014 imposed strict scrutiny constitutional review, one within the Fourth Circuit and one within the Fifth.

Bostic v. Rainey

On February 13, 2014, a Virginia federal district court found that Virginia's marriage laws, which prohibited the issuance of marriage licenses to same-sex couples, impermissibly burdened the fundamental right to marry.⁶⁴ The court articulated that strict scrutiny constitutional review applied to a fundamental right so "implicit in the

concept of ordered liberty" as a substantive due process protection, a scrutiny requiring the state to justify its infringement on the fundamental right to marry by compelling state interests and laws "narrowly drawn to express only those interests."⁶⁵ The court rejected the litany of state interests advanced by Virginia. The court concluded that Virginia's first articulated state interest of "minimizing marriage fraud" by discouraging individuals from "abusing marriage rights by marrying for the sole purpose of qualifying for benefits for which they would otherwise not qualify" lacked any rational basis where the laws excluded a segment of Virginia's population based on sexual orientation.⁶⁶ The court also rejected Virginia's claim that "radical change" in marriage laws would have unintended consequences—for example, churches whose teachings do not accept homosexuality as moral might be compelled to teach that civil unions or homosexual marriage should be equivalent to "traditional marriage" or risk losing tax-exempt status.⁶⁷ The court then rejected Virginia's claim of federalism, that is, that defining marriage is the province of the states, by citing *Windsor* and *Loving* for the proposition that such state laws must respect the constitutional rights of persons.⁶⁸ As have all other courts that have considered the issue, the Virginia court rejected the justifications of procreation and "optimal" child-rearing and misconstruing the profound nonprocreative elements of marriage and as unfounded presumptions:

"The "for-the-children" rationale rests upon an unconstitutional, hurtful and unfounded presumption that same-sex couples cannot be good parents. Forty years ago a similarly unfortunate presumption was proffered to defend a law in Illinois that removed children from the custody of unwed fathers upon the death of the mother. *Stanley v. Illinois*, 405 U.S. 645, 653 [citations omitted] (1972). Proponents of the law asserted "that Stanley and all other unmarried fathers can *reasonably be presumed to be unqualified* to raise their children." *Id.* (emphasis added). The Supreme Court said that such a startling presumption "cannot stand." *Id.* at 657.⁶⁹

For the same reasons, the court also found that Virginia's purported justifications did not support its differing treatment of similarly situated unmarried couples under the Equal Protection Clause.

DeLeon v. Perry

Near the end of February, a federal district court in San Antonio, Texas, granted (but then stayed) a preliminary injunction finding that prohibitions in Texas' Family Code against recognizing marriages and civil unions lawfully performed in other states and prohibiting the issuance of marriage licenses to same-sex couples deprived same-sex

couples of equal protection and due process, in violation of the US Constitution.⁷⁰ Plaintiffs recited a litany of state law benefits denied to them because of the prohibitions, including statutory protections for surviving spouses under Texas' probate code, lack of standing to bring wrongful death actions, denial of the community property presumption afforded to marriage couples, lack of a right to seek spousal maintenance upon separation or divorce, lack of succession rights under intestacy laws, spousal evidentiary privileges, spousal rights to make burial or other decisions, and spousal protections against partition of a homestead following the death of a spouse.⁷¹ Plaintiffs also claimed that they suffered "state-sanctioned discrimination, stigma, and humiliation as a result of Texas' ban on same-sex marriage," and that "they are considered inferior and unworthy under Texas law."⁷²

Although it concluded that plaintiffs would likely meet the criteria for heightened constitutional scrutiny, the court posited that it was not necessary to apply heightened scrutiny to plaintiffs' equal protection claim because the bans on same-sex marriage failed even the most deferential rational basis review, under which the discrimination must bear at least some rational relationship to a legitimate government purpose.⁷³ As had other courts, the Texas court held that an absolute ban on homosexual marriage did not rationally relate to or advance the state's articulated interests of 1) increasing the likelihood that a mother and a father will be "in charge of childrearing"; 2) increasing family stability; and 3) encouraging responsible procreation.⁷⁴

The court did find the right to marry a fundamental right and applied strict scrutiny review under the Due Process Clause. Citing *Loving*, the court found that the state of Texas had "failed to identify any rational, much less a compelling, reason that is served by denying same-sex couples the fundamental right to marry."⁷⁵

As for same-sex spouses who had married outside of Texas, the court read *Windsor* as prohibiting a state from treating state-sanctioned same-sex marriages differently than state-sanctioned opposite-sex marriages.⁷⁶

Because plaintiffs had shown a likelihood of success on the merits, substantial irreparable injury if an injunction did not issue, and the absence of harm to the public interest if one did issue, the court issued a preliminary injunction.⁷⁷

UPCOMING DEVELOPMENTS TO WATCH

Bench Trial—Michigan Federal District Court

Having held *Baker v. Snyder*, No. 2:12cv10285 (ED. Mich), in abeyance for *Windsor*, the federal district court in Michigan declined to determine whether the Michigan Marriage Amendment to the state constitution banning same-sex marriages (which followed a voter

initiative) violated the US Constitution without a fully developed record. In an opinion setting the matter down for a bench trial, the court observed that the US Court of Appeals for the Sixth Circuit had not yet adopted an intermediate or "heightened" scrutiny analysis because it had not found members of the LGBT community a suspect class. As of March 2014, the bench trial has concluded and the trial court is expected to issue its decision shortly, resulting in a certain appeal by the losing side to the Sixth Circuit and setting the stage for a federal circuit conflict.

Actions by State Attorneys General

In *Windsor*, the Supreme Court determined that an injury continued to occur to plaintiff Edith Windsor, even though the federal government declined to defend DOMA Section 3, because the IRS had continued to follow that statute in denying her a refund of almost half a million dollars in estate tax that she would have paid had she married a man. The Court also recognized the common practice of the federal government in announcing by letter that it would enforce, but not defend, certain laws that the president and the attorney general believed were unconstitutional, absent a ruling by the highest federal court otherwise.

Similarly, state attorneys general and state clerks who issue marriage licenses are beginning to state that they have a constitutional obligation to all the citizens of their states, including same-sex couples, so that they will no longer defend what they believe are unconstitutional laws banning same-sex marriage, as has the defendant county clerk in the *DeBoer* case.

If a plan design relies upon definitions under "local law," and the local law enforcement officer declines to enforce the law as unconstitutional, is the plan administrator on notice that it might be making a potentially unreasonable decision in denying benefits?

Anticipated Regulatory Guidance

In the early months of 2014 the regulatory guidance relating to the retroactive application of *Windsor* should be forthcoming. Although the OPM Benefits Administration Letter provided for a special enrollment period and some retroactivity (including a deemed "first date of marriage" as the June 26, 2013, date of the *Windsor* decision itself, and not the date of its mandate in mid-July), and IRS Notice 2013-17 provided for an effective date in September 2013 and a subsequent guidance described an amendment process for past individual returns, the agencies have yet to issue regulatory guidance on key retroactivity questions arising from *Windsor* for plan sponsors, plan designers, plan administrators, and benefits litigators.

CONCLUSION

The decisions and regulatory guidance post-*Windsor* do not yet provide a legal landscape that employee benefits practitioners can navigate comfortably. Many questions still remain. May a plan designer rely upon *Windsor's* emphasis on domestic relations as the traditional province of states and define "spouse" as defined under "local law" or will doing so run the risk of a legal challenge? May a plan administrator recognize same-sex spouses or provide spousal equivalency benefits to same sex spouses or to civil or domestic partners, unless prohibited under local law? What retroactivity should a plan or plan administrator accord the *Windsor* decision? May a plan subject civil unions and domestic partnerships to different proofs than married couples for purposes of dependent coverage, if such coverage is extended to spouses? Will ERISA preempt state-law discrimination claims based upon sexual orientation or identification, sexual stereotyping, or "marital-status-plus"—that is, unmarried or married status plus sexual orientation or identification? Will local variations frustrate a core purpose of ERISA: to facilitate the national uniform administration of benefit plans?

Amid the growing trend of recognizing same-sex marriages as equally deserving of all the benefits and rights of civil marriages, including employee benefit rights, the recent developments in marriage equality after *Windsor* militate in favor of increased collaboration between plan designers and benefits litigators to anticipate the nuances of the interstices between employee benefits design and employment discrimination law as the cases and regulatory guidance proliferate.

NOTES

1. -- U.S. --, 133 S.Ct. 2675, 186 L.Ed.2d 808 (2013).
2. 1 U.S.C. § 7 (DOMA).
3. 133 S.Ct. at 2696.
4. 133 S.Ct. 2652 (2013).
5. 133 S.Ct. at 2695.
6. Perhaps bucking the new trend, on January 27, 2014, the Indiana House of Representatives passed a resolution to place a ban on same-sex marriage on the ballot, an issue that now goes to the Indiana Senate. If the Senate agrees, under Indiana law, the soonest such an initiative could be placed on the ballot in Indiana is November 2016. <http://www.foxnews.com/politics/2014/1/28/indiana-house-approves-constitutional-ban-on-gay-marriages>.
7. See, *Baehr v. Lewin*, 852 P.2d 44 (1993) (finding refusal to grant same-sex couples marriage licenses discriminatory); *Baker v. State*, 744 A.2d 874 (Vt. 1999) (exclusion from license to marry violates state constitution's common benefits (privileges & immunities) clause); *Goodridge v. Dep't of Public Health*, 798 N.E.2d 941 (Mass. 2003); *In re Marriage Cases*, 183 P.3d 394 (Cal. 2008) (later reversed

by public initiative upheld by the California Supreme Court); *Kerrigan v. Comm’r of Public Health*, 957 A.2d 407 (Conn. 2008); *Varnum v. Brien*, 763 N.W.2d 862 (Iowa 2009).

8. *Garden State Equality v. Dow*, No. L-1729-11, 2013 WL 5687193 (Superior Court of New Jersey Law Division, Mercer County, Sept. 27, 2013), state’s request for stay of lower court decision denied, 79 A.2d 1036 (N.J. Sup. Ct. Oct. 18, 2013); *Griego v. Oliver*, No. 34-306, 316 P.3d 865 (N.M. Sup. Ct. Dec. 19, 2013); *Kitchen v. Herbert*, No. 2:13-cv-217, 2013 WL 6697874 (C.D. Utah Dec. 20, 2013); *Obergefell v. Wymyslo*, No. 1:13-cv-501, 2013 WL 6726688 (S.D. Ohio Dec. 23, 2013); *Bishop v. United States ex rel. Holder*, No. 04-cv-848, 2014 WL 116013 (N.D. Okla. Jan. 14, 2014); *Bourke v. Beshear*, No. 3:13-cv-750-H, 2014 WL 556729 (W.D. Ky. Feb. 12, 2014); *Bostic v. Rainey*, No. 2:13-cv-00395, 2014 WL 561978 (E.D. Va. Feb. 14, 2014); *Lee v. Orr*, No. 13-cv-8719, 2014 WL 683680 (N.D. Ill. Feb. 20, 2014 (applicable to Cook County, Illinois only)); *DeLeon v. Perry*, No. SA-13-CA-00982, 2014 WL 715741 (W.D. Tex. Feb. 26, 2014).

9. See, e.g.: “An Act to Protect Religious Freedom and Promote Equality in Civil Marriage,” 2009 Vt. Acts & Resolves 3; “An Act Relative to Civil Marriage and Civil Unions,” 2009 N.H. Laws 60; Eligible to Marry,” 2013 R.I. Pub. Laws 4; “An Act to Amend Title 13 of the Delaware Code Relating to Domestic Relations to Provide for Same-Gender Civil Marriage and to Convert Civil Unions to Civil Marriages,” 79 Del. Laws 19 (2013); the “Illinois Religious Freedom and Marriage Fairness Act” (2013); “An Act Relating to Marriage, Providing for Civil Marriage Between Two Persons, Providing for Protections and Exemptions Based on Religious Association,” 2013 Minn. 74; Hawaii Marriage Equality Act, Hawaii Stat. 1 (2013).

10. See Richard Socarides, “Obama and Gay Marriage: One Year Later,” *The New Yorker* (May 6, 2013, available at <http://newyorker.com/online/blogs/news-desk/2013/05/obama-and-gaymarriage-one-year-later.html>).

11. Federal Employee Health Benefit Program Carrier Letter No. 2013-203 (July 3, 2013), available at <http://www.opm.gov/healthcareinsurance/healthcare/carriers/2013/2013-203.pdf>.

12. Press Release, American Forces Press Service, “DOD Announces Same-Sex Spouse Benefits,” (Aug. 14, 2013), available at <http://www.defense.gov/news/newsarticle.aspx?id=120621>.

13. DOL Fact Sheet #28F: Qualifying Reasons for Leave under the Family and Medical Leave Act (2013) (defining spouse for the purposes of the FMLA as “a husband or wife as defined or recognized under state law for purposes of marriage where the employee resides, including ‘common law’ marriage and same-sex marriage.”)

14. “Impact of United States v. Windsor on Skilled Nursing Facility Benefits for Medicare Advantage Enrollees,” August 29, 2013, available at http://www.cms.gov/Medicare/HealthPlans/HealthPlansGeninfo/Downloads/SNF_Benefits_Post_Windsor.pdf.

15. Guidance to Employee Benefit Plans on the Definitions of “Spouse” and “Marriage” under ERISA and the Supreme Court’s Decision in *United States v. Windsor*, available at <http://www.dol.gov/ebsa/newsroom/tr.13-14.html>.

16. *Id.*

17. IRS Notice 2014-01, December 16, 2013, available at www.irs.gov/pub/irs-drop/n-14-01.pdf.

18. *Garden State Equality v. Do*, Docket No. L-1729-11, 2013 WL 5687193 (Superior Court of New Jersey Law Division, Mercer County, Sept. 27, 2013).

19. The court noted the danger to a civil union partner denied FMLA leave because of the DOL's interpretation of *Windsor* as limited to spouses, and not civil unions or domestic partners.
20. *Id.* at 37.
21. 188 N.J. 415 (2006).
22. *Id.* at 53.
23. Three states (Colorado, Hawaii, and Illinois) continue to maintain legislation that grants same-sex couples an alternative to civil marriage and makes available to them many benefits granted to married couples. See Colo. Rev. Stat. §§ 14-15-102 to -119 (2013); 750 Ill. Comp. Stat. 75/1 to 75/90 (2011); Hawaii Stat. 1 (2011). As discussed in the text, *Garden State Equality* held the New Jersey civil union statute (N.J. Stat. Ann. 37:1-28 to 1-36 (2006)) unconstitutional.
24. The Religious Freedom and Marriage Fairness Act repeals Section 213.1 of the Illinois Marriage Act (750 ILCS 5/213).
25. The Religious Freedom and Marriage Fairness Act amends Section 212(a) and 201, respectively, (750 ILCS 5/212 and 209).
26. Religious Freedom and Marriage Fairness Act, Sec. 10(a).
27. *Id.*, Sec. 10(c).
28. *Id.*, Sec. 10(b).
29. 750 ILCS 75/65). Plan sponsors and administrators operating under this statute should note the following: (1) new Section 65(a) expressly waives the application fee for such a conversion; (2) new Section 65(b) also provides for conversion by signature for a period of one year after the effective date of the Act, during which the signatures of a civil union couple on a marriage license and its return for recording "shall be sufficient to convert the civil union into a marriage," which shall be "deemed effective on the date of solemnization of the civil union"; and (3) new Section 65(c) clarifies that, when parties to a civil union have married or converted their civil unions to marriage under Section 65, "the parties, as of the date stated on the marriage certificate, shall no longer be considered in a civil union, but rather shall be in a legal marriage." 750 ILCS 75/65(c).
30. See new Section 220 (750 ILCS 5/220).
31. <http://www.hawaiiireporter.com/?p.491908>.
32. See *supra*, n.6.
33. *In the Matter of Margaret Fonberg*, EDR No. 1302 (Nov. 25, 2013).
34. *Kitchen v. Herbert*, 2013 WL 6697874, *Bishop v. United States*, 2014 WL 116013.
35. 388 US 1, 12 (1967).
36. 2013 WL 669789 at *11-*13.
37. *Id.* at *13-*24.
38. *Id.* at *25-*28.
39. The court appeared to accept the view that DOMA Section 2, purportedly authorized by the "Effects Clause" of the Full Faith and Credit Clause, does not confer any additional power upon the states than that which they already possess: the power

to determine which marriages from other states they will recognize. Accordingly, the court disavowed any suggestion in its earlier opinion that the Barton couple would have standing to challenge DOMA Section 2 and dismissed the couple's challenge to that federal statute for lack of standing: their purported injuries (nonrecognition, unequal treatment, and stigma) did not flow from the federal statute, but from state action.

The court also dismissed the Barton couple's constitutional challenge to Part B of the Oklahoma constitutional provision because they did not dispute the state's evidence that there were no circumstances under which the clerk of the circuit court could recognize out-of-state marriage licenses.

40. 2014 WL 116013 at *18.

41. *Id.* at *21.

42. *Id.* at *22-*23.

43. *Id.* at *24-*26.

44. *Id.* at *26-*29.

45. *Id.* at *29-*30.

46. *Id.* at *30-*31.

47. *Id.* at *32.

48. *Id.* at *33.

49. 316 P.3d 865.

50. *Id.* at 876-877.

51. *Id.* at 877-879.

52. *Id.* at 879-884.

53. *Id.* at 871.

54. *Id.* at 887-889.

55. *Id.* at 889.

56. *Obergefell v. Wymyslo*, 2013 WL 6726688 at *4 (S.D. Ohio Dec. 23, 2013).

57. *Id.* at *9.

58. *Id.* at *5-*9.

59. *Id.* at *9-*18.

60. *Id.* at *20.

61. *Id.* at *19, citing *Windsor*.

62. 2014 WL 556729 at *7-*9.

63. *Id.* at *7.

64. 2014 WL 561978 at *11-*13.

65. *Id.* at *13-*14.

66. *Id.* at *14.

67. *Id.*

68. *Id.* at *15-*17.

69. *Id.* at *18-*20.

70. 2014 WL 715741.

71. *Id.* at *7.

72. *Id.* at *8.

73. *Id.* at *12-*14.

74. *Id.* at *14-*17.

75. *Id.* at *17-*21.

76. *Id.* at *21-*24.

77. *Id.* at *24-*27.

ERISA's Better Mousetrap Backfires: Fifth Circuit Holds That Accounting Firm's Succession Plan Is Not an ERISA Plan

Carol A. Cantrell

This article examines the position that accounting firm Briggs & Veselka (B&V) took when two former shareholders brought suit against them in state court to recover payments under the CPA firm's succession plan. Briggs removed the case to federal court on the basis that the succession plan was an "ERISA plan." Why? Because if the plan was covered by ERISA, B&V had the unilateral right to terminate their retirement payments if it determined that the shareholders competed with the CPA firm anytime in the next 10 years or for any other "cause." On the other hand, if the succession plan was not an ERISA plan, as it turned out, disputes over benefit payments must be resolved in state court, where state laws generally protect employees from unreasonable competition and forfeiture clauses. It is not often easy to tell whether a plan is subject to ERISA, but the stakes are high. The author of this article is also one of the plaintiffs in the case.

Most accounting firms would not even consider their succession plans to be ERISA plans. Nonetheless, that is the position that Briggs & Veselka (B&V) took when two former shareholders brought suit in state court to recover payments that the company refused to pay them under their employment contracts.¹ B&V sought to have ERISA apply because if the plan was governed by ERISA, the dispute would have to be resolved under federal law, which generally affords considerable deference to the company's decision to pay, or not, under the plan.² But if the plan was not an ERISA plan, as it turned out in *Cantrell v. Briggs & Veselka*, disputes over the former employee's entitlement to payments would need to be resolved in state court, where state laws generally protect employees from unreasonable termination and forfeiture clauses.

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In a fact-specific determination, the US Court of Appeals for the Fifth Circuit found that the Cantrells' employment contracts did not require "enough ongoing, particularized, administrative discretionary analysis" to constitute an "ongoing administrative scheme" as required by ERISA. This ongoing administrative scheme requirement of ERISA was first articulated by the US Supreme Court in *Fort Halifax Packing Company, Inc. v. Coyne*, in which the Court described such a scheme as a commitment to "undertake[] a host of obligations, such as determining the eligibility of claimants, calculating benefit levels, making disbursements, monitoring the availability of funds for benefit payments, and keeping appropriate records in order to comply with applicable reporting requirements."³ In other words, ERISA covers not merely employee benefits, but employee benefit *plans*.

The Fifth Circuit's finding that the deferred payments under the Briggs & Veselka plan did not constitute an ERISA plan can have enormous implications for CPA firms that pay deferred compensation to their retired owners. This is especially true when there are significant clawback or penalty provisions that reduce the originally agreed-upon payments to a former owner if he or she fails to transition their book of business, fails to give adequate notice before leaving, competes with the firm after retirement, or commits other enumerated transgressions. If a dispute arises over whether the retired owner violated one of these requirements, the outcome can depend on whether the plan is covered by ERISA or not.

Partnership plans are expressly excluded from ERISA coverage if they are partnership buy-out agreements described in Internal Revenue Code (IRC) Section 736.⁴ However, accounting firms that are taxed as a corporation, such as Briggs & Veselka, face the critical issue of whether their deferred compensation or succession plan is an ERISA plan or not.

FACTS OF THE CASE

Cantrell v. Briggs & Veselka involved a dispute over whether two shareholders were entitled to the deferred compensation payments under their employment contracts when they retired and went into the practice of law together. By way of background, the Cantrells were married and operated a successful CPA firm for years before they merged their accounting firm with Briggs & Veselka Co. in 2000. Pursuant to the merger, the Cantrells and the B&V shareholders exchanged their shares in their former companies for restricted stock in the merged entity, a deferred compensation plan equal to four times salary, and a mandatory stock-redemption plan at cash-basis book value. B&V reported the merger as a "tax-free

exchange” on its tax returns, although the IRS never examined the transaction.

The B&V plan was a typical succession or “retirement pay” plan for a CPA firm as described in the AICPA 2012 Succession Survey.⁵ The deferred payments were intended to compensate the owner for the value of his or her equity, goodwill, or “book of business” in the firm, and the stock redemption payments represented the owner’s interest in the firm’s tangible assets. B&V represented that it had no ERISA plans at the time of the merger except a cafeteria plan under IRC Section 125. Nonetheless, three months after the merger, B&V notified the Department of Labor (DOL) that it had nine separate ERISA “top hat” plans, which were exempt from the annual ERISA reporting requirements.

Fast forward 11 years after the B&V merger. Carol Cantrell announced her intention to retire and practice law with her husband, Patrick Cantrell, who was also a lawyer and a former B&V shareholder who had retired four years earlier. Both Cantrells were board certified in Tax Law by the Texas Board of Legal Specialization (TBLS), which includes tax planning, IRS examinations and appeals, and litigation. B&V was disgruntled with Carol Cantrell’s decision and claimed that she and her husband would be competing in the “same business” as B&V because their law practice would necessarily involve the preparation of tax returns. Accordingly, B&V refused to accept her resignation, terminated her “for cause,” and refused to pay either of the Cantrell’s deferred compensation under their employment contracts.

The Cantrells disagreed that their tax law practice would be in the same business as B&V because they would not be providing public accounting and other financial services, which was B&V’s business as defined in the merger agreement. Nor would the Cantrells have a practice unit license to do so. Likewise, B&V did not have a license to practice law. The mere fact that both businesses would prepare tax returns did not mean that they were in the same business, anymore than a heart surgeon and a dentist are competing in the same business because they both write prescriptions for the same pain medication. Accordingly, the Cantrells sued to recover their benefits in state court. Briggs & Veselka immediately removed the case to federal district court claiming that the deferred compensation payments were an “ERISA top hat” plan, entitling them to federal preemption over the Cantrell’s state law protections.

WHAT IS A TOP HAT PLAN?

A top hat plan is a special breed of nonqualified plan under ERISA “maintained by an employer primarily for the purpose of providing deferred compensation for a select group of management or highly

compensated employees.”⁶ It is exempt from most of ERISA’s oversight, reporting, and fiduciary duties.⁷ All claims for benefits under a top hat plan must be submitted to the plan administrator, who has the sole authority to make decisions under the plan. If there is a dispute over benefits, the employee’s state law claims and defenses are null and void because all state causes are trumped by federal law.⁸

It is common for a top hat plan to provide that an employee’s benefits are entirely forfeited if the employee competes with the employer or is terminated “for cause.” In that case, the plan administrator acts as the sole judge, jury, and arbiter of whether the employee competed or was terminated “with cause.” This can be a serious conflict of interest in a closely held corporation if the employer is also the plan administrator. But it is entirely legal in an ERISA top hat plan. This is why top hat plans have become “an employer’s best friend” according to an article by James P. Baker in the *Benefits Law Journal* titled “ERISA’s Better Mousetrap” in the Spring 2011.⁹

The rationale for the lack of fiduciary duties in a top hat plan is that its participants are supposedly sophisticated enough to negotiate for themselves and do not need ERISA’s protection.¹⁰ But because a top hat plan is still an ERISA plan, a dispute over its benefits is governed solely by federal law. Employees are precluded from bringing any state law claims or defenses, such as the enforceability of an unreasonable noncompete provision in the plan. This is why the parties in *Cantrell v. Briggs & Veselka* fought so hard over whether they should be in state or federal court. And as it turns out, ERISA’s better mousetrap backfired on the Briggs & Veselka accounting firm.

HOLDING

Applying Fifth Circuit and other precedent, the court held that deferred compensation provisions in B&V’s employment contracts are not ERISA plans because they do not require “enough ongoing, particularized, administrative discretionary analysis” to be considered an ERISA plan. The payments were based on a one-time calculation using a fixed formula and paid over a 10-year period. They required only writing a check each quarter, which is “hardly an administrative scheme.” Eligibility was based on a specific triggering event such as death, disability, or termination, which did not require any more than a “modicum of discretion.” Even though the accounting firm could terminate the payments if the employee was fired with cause or competed with the employer during the 10-year period, this “minimal quantum of discretion” was not sufficient to turn it into an ERISA plan. Moreover, the plan did not expressly grant the employer the sole discretion to make the decision. The accounting firm had no system in place to monitor for competition, suggesting that one was not needed.

Nor could it explain how such a system would work or that it would require an ongoing administrative scheme to implement. Accordingly, the Fifth Circuit remanded case to state court where the dispute will be governed by Texas law, unless the case settles.

In a separate dissenting opinion, Judge Priscilla R. Owen perceived the provisions to be complex enough to constitute an ERISA plan. In particular, she focused on a benefit cap in the agreements. Such a cap is common in many CPA firm succession plans. It acts as a cash flow cushion by placing an annual ceiling on the total payouts to all retired partners in a single year. However, it does not change the total amount due under the contract. Any deficit is caught up and paid in later years when the ceiling does not apply. Thirty-six percent of CPA firms surveyed have such caps in their partner buy-out plans, according to a recent AICPA survey. Owen also said that the employer's ability to terminate an employee for cause was sufficient discretion to constitute an ongoing administrative scheme, despite a contrary holding in *Velarde v. PACE Membership Warehouse, Inc.*¹¹

PLANNING IMPLICATIONS FOR CPA FIRM SUCCESSION PLANS

Accounting firms with succession plans that have forfeiture provisions should carefully review their plans to determine whether they are ERISA plans. Whether a plan has *enough* ongoing, particularized, administrative discretionary analysis to make it an ERISA plan is a fact-specific determination generally made by balancing the weight of all the facts. If the employer wants ERISA to apply, it should generally avoid plans that contain a one-time calculation using a fixed formula. CPA firms typically compensate a retired owner for his or her equity in the firm by paying the owner a fixed sum over time, based on the retiree's share of the firm's value. This can be calculated in a number of ways. The most common ways are listed in a survey conducted by the AICPA in 2012 and include payments based on the number of shares owned, a multiple of the shareholder's average salary, or the value of his or her book of business.

Eligibility for benefits should not be based solely on fixed and determinable events, such as death, disability, or retirement, but rather on factors that require more than a modicum of discretionary analysis. The right to terminate an employee "for cause" does not require enough discretionary analysis to meet ERISA's standard, according to the Fifth Circuit. An example of sufficient discretionary analysis would be the employer's right to determine whether the employee suffered a substantial reduction in job responsibilities before and after a merger, according to another recent Fifth Circuit case.¹² In addition, if the plan contains a noncompete provision, the plan should expressly reserve

the sole authority to the employer to decide whether the employee, in fact, competed and describe how the employer will make that decision and monitor for such activity.

Based on all of these factors, if the "succession plan" is found to be an ERISA plan, the retired owner can lose all or part of his or her hard-earned equity if the plan administrator decides that he or she has violated one of the provisions. Therefore, both the firm and the employee should seek competent legal advice on whether the plan is subject to ERISA before entering into such an agreement.

INCOME TAX CONSIDERATIONS

ERISA's application to a firm's succession plan can also have significant income tax consequences. If ERISA applies, the payments will be deductible by the firm as compensation and reported to the employee as ordinary income on Form W-2.¹³ But if ERISA does not apply, the payments will not likely be deductible by the employer but, rather, constitute redemption payments, which the former owner should report as long-term capital gain upon the sale of his or her interest in the firm.

As noted previously, partnership succession plans are expressly excluded from ERISA coverage under the DOL regulations if they are partnership buy-out agreements described in IRC Section 736.¹⁴ Thus, retirement payments made by an entity taxed as a partnership in liquidation of a retired partner's interest are generally treated as a distributive share of partnership income or as a guaranteed payment. This includes a partner's share of unrealized receivables and unstated goodwill of a general partnership. However, payments for a partner's interest in property, including goodwill expressly provided for in the partnership agreement, are IRC Section 736(b) payments, which are treated as distributions by the partnership and taxable as capital gain to the partner to the extent they exceed the basis of his partnership interest.

CONCLUSION

Accounting firms taxed as corporations should carefully review their succession plans to determine whether ERISA applies. If ERISA applies, disputes over coverage and benefits must be resolved in federal court where employees have no state law protections. If ERISA does not apply, employees can invoke favorable state law protections to protect against losing valuable deferred compensation benefits. Not all "broken" plans can be amended. If the plan is part of an enforceable contract with the employee, both the employee and the employer must agree to any changes.

NOTES

1. *Cantrell v. Briggs & Veselka Co.*, No. 12-20294 (5th Cir. 2013), *cert. denied* (U.S. Mar. 10, 2014) (No. 13-824).
2. ERISA § 514(a); 29 U.S.C. § 1144(a).
3. *Fort Halifax Packing Company, Inc. v. Coyne*, 482 U.S. 1 (1987).
4. 29 C.F.R. 2510.3-3(b).
5. AICPA 2012 PCPS Succession Survey, available at <http://www.aicpa.org/InterestAreas/PrivateCompaniesPracticeSection/StrategyPlanning/center/DownloadableDocuments/SuccessionSurveyMultiComm.pdf>.
6. 29 U.S.C. § 1051(2).
7. 29 U.S.C. § 1101(a).
8. ERISA § 514(a); 29 U.S.C. 1144(a).
9. James P. Baker, "ERISA's Better Mousetrap," *Benefits Law Journal*, Vol. 24. No. 1, Spring 2011.
10. DOL Opinion No. 90-14A, 1990 WL 123933, at *1 (E.R.I.S.A.).
11. *Velarde v. PACE Membership Warehouse, Inc.*, 105 F3d 1313 (9th Cir. 1997).
12. *Clayton v. ConocoPhillips*, No. 12-20102, 2013 WL 3357574 (5th Cir. 2013).
13. IRC § 3401(a)(22) (flush language).
14. 29 C.F.R. 2510.3-3(b).

Working While Receiving a Pension: Do State and Local Government Pension Plans Violate Tax Law?

Laura Brauer

State and local government pension plans apply a variety of rules to determine when retirees may return to work while continuing to receive pension benefits. State and local governments favor liberal “retire-rehire” rules for a variety of reasons, including a desire not to lose good employees to competitors,¹ the inability to find qualified replacements,² and saving money by not providing benefits to rehired retirees.³ Because these retire-rehire rules have the potential to impact the job market and the cost and fairness of public employee pension plans, they have come under public scrutiny in recent years.⁴ The public debate has largely overlooked an important concern: the requirements of tax law. This article analyzes inconsistencies between tax law and “retire-rehire” rules in use by state and local government pension plans.

THE LAW

Tax Requirement for Paying Pensions

Section 401(a) of the Internal Revenue Code (IRC) provides the basis for the creation of tax-qualified retirement plans.⁵ Retirement plans receive special tax treatment when they follow all qualification requirements set forth in tax law.⁶ On the other hand, retirement plans that violate applicable tax law are not tax-qualified to the detriment of the employer, plan participants, and the trust holding plan assets.⁷

In the case of a tax-qualified retirement plan that tax law classifies as a “pension” plan (a defined benefit pension plan or a money purchase pension plan⁸), benefits may be paid to active employees only in limited circumstances.⁹ A tax-qualified pension plan must “provide systematically for the payment of definitely determinable benefits over a period of years, usually for life after retirement or attainment of normal retirement age.”¹⁰ To satisfy this rule, the IRC specifies that a tax-qualified pension plan may not pay benefits to an employee before he has (1) reached the age of 62 or an earlier normal retirement age for certain industries or (2) separated from employment.¹¹

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The policy behind this rule is that pensions receive special tax treatment so that employees do not need to rely on the government for support in retirement.¹² The purpose of the special tax qualification would be thwarted if employees could receive money intended for retirement before reaching retirement age or separating from employment. It is important for pension plan sponsors and participants to understand the scope of these legal requirements.

Minimum Age Requirement

A tax-qualified pension plan may pay benefits to an employee who satisfies minimum age requirements, even if the employee does not stop working.¹³ The IRC allows pension payments to an employee who has reached the earlier age of 62 or “the earliest age that is reasonably representative of the typical retirement age for the industry in which the covered workforce is employed.”¹⁴ Thus, the default normal retirement age is 62 with lower ages permitted for certain industries.¹⁵ Once an employee has reached the normal retirement age for the industry, pension plan distribution is allowed regardless of employment status.¹⁶ An employee who has satisfied this minimum age requirement may continue to work for the employer in the same capacity as previously while also receiving distributions from the pension plan.¹⁷

Separation from Employment¹⁸

A tax-qualified pension plan may also permit payment to an employee under the normal retirement age if the employee has achieved a “separation from employment.”¹⁹ The determination of whether an employee has separated from employment is more difficult to determine than whether an employee has reached normal retirement age. There is no succinct definition of what constitutes a separation from employment for this purpose in IRC Section 401(a) or its accompanying regulations. Case law, rulings, proposed regulations, and information letters provide insight into the meaning of the term “separation from employment.”

Legal Interpretation of What Constitutes a Separation from Employment

A core concept recurring in the pertinent cases, rulings, regulations, and information letters is that a separation from employment must be bona fide. In the seminal case of *Barrus v. United States*, the Tax Court warned against “employees [who] retire in ‘bad faith’ and as

a sham to attain preferred tax treatment of the subsequent distribution from a qualified employees trust; and having received such favorable tax treatment, resume the employment relationship.”²⁰ Instead, the court determined that an employee experiences a bona fide separation from employment when the employee “sincerely and honestly terminate[s] in every respect his employment relationship.”²¹ The separation must be made in good faith and be a complete separation between the employee and employer.²² The determinative factor in this good faith analysis is the intent of the employee at the time of the separation.²³

Separation from employment does not occur with every change in employment status.²⁴ To find that a separation from employment has occurred, the Tax Court has required “a change in the employment relationship in more than a formal or technical sense.”²⁵ Similarly, the IRS has stated that a “retirement” for the sole purpose of receiving plan distributions is not a bona fide separation from employment.²⁶ Thus, the “retiree” remains an employee and does not qualify for plan distribution.²⁷

Specific Applications

The following summary of tax decisions, rulings, and regulations illustrates applications of the definition of separation from employment to specific fact situations.

A valid separation from employment was found when:

- An employee retired due to illness with no intent to return to employment at a later date but recovered unexpectedly and then returned to employment;²⁸
- An employee retired but later returned to work due to the employer’s unforeseen need of the employee’s services due, for example, to termination of the retiree’s replacement;²⁹
- An employee retired and then became a valid part-time independent contractor³⁰ of the employer;³¹
- An employee transferred employment between unrelated employers;³² or
- Employment was terminated due to a disability rather than layoff, sickness, or accident.³³

A valid separation from employment was not found when:

- An employee’s termination or retirement was prearranged with the intent to immediately rehire or rehire at a later date;³⁴

- An employee's status was changed to independent contractor although the nature of the employee's work remained substantially the same;³⁵
- An employee changed from full-time to part-time employment or had another reduction in work hours without any other alteration in employment;³⁶
- An employee was promoted;³⁷
- An employee transferred to a position not covered by the plan;³⁸ or
- An employee returned to the same position "with only a formal or technical change in employment relationship" after a change in employer resulting from liquidation, merger, or consolidation of the former employer occurs.³⁹

ACTUAL PRACTICES IN STATE AND LOCAL GOVERNMENT PENSION PLANS

A review of state and local government pension plans reveals many practices that do not appear to comply with tax law described previously.⁴⁰ Most state and local government pension plans allow retired public employees to return to work after retirement while continuing to receive pension plan distributions.⁴¹ Retire-rehire policies and stipulations vary greatly between states but may be divided into the following categories.⁴²

Waiting Periods

Many states allow retirees⁴³ to return to work after a specified waiting period while still qualifying as retirees and receiving pension distributions.⁴⁴ This waiting period typically ranges from a one-month to a one-year break in employment between retirement and rehire.⁴⁵ Colorado does not allow retirees to return to work during the month in which retirement occurred.⁴⁶ South Carolina allows retirees to return to work after a 30-day break in employment.⁴⁷ Utah⁴⁸ and Georgia⁴⁹ allow retirees to return to work after 60-day and two-month waiting periods, respectively. South Dakota requires retirees to have a three-month break in employment before allowing them to return to work while continuing to receive pension distributions,⁵⁰ whereas, Texas,⁵¹ Hawaii,⁵² and New Mexico⁵³ allow certain retirees to return to work while continuing to receive pension distributions only after a one-year break in employment. None of these state policies require that retired and subsequently rehired employees have reached the

normal retirement age. Neither do these state policies specifically consider whether the waiting period qualifies as a bona fide separation from employment for employees, who have not yet reached normal retirement age. Because tax law precedents do not recognize a specified waiting period as a valid separation from employment, these policies potentially do not have a clear basis for approval by the IRS and violate tax law to the extent that they permit receipt of a pension due to a prearranged termination and rehire before normal retirement age.

Income Limits

Many states allow rehired retirees to collect pension distributions only when their rehire salaries fall within a certain range. In Massachusetts, for example, rehired retirees can only earn \$15,000 more than they did at retirement.⁵⁴ Utah allows rehired retirees to earn \$15,000 annually or “one-half of the retiree’s final average salary upon which the retiree’s retirement allowance is based.”⁵⁵ South Carolina allows rehired retirees to earn only up to \$10,000 per year while receiving pension distributions.⁵⁶ Because such salary range limits are not included in and are irrelevant to the separation from employment analysis, these retire-rehire policies appear to jeopardize the tax-qualified status of pension plans that use salary limits to permit pension payment to employees who are younger than normal retirement age.

Pension Reductions

Other states take a different approach to limiting the income of rehired retirees, allowing them to collect pension distributions at a reduced rate. For example, when retirees are validly rehired in South Dakota, their pension distributions are reduced by 15 percent and cannot be increased during the time of reemployment.⁵⁷ These rehires also cannot receive any additional benefits associated with the period of reemployment.⁵⁸ When participants of the Colorado Public Employees’ Retirement Association exceed certain limitations on the scope of their rehire, their pension benefits are reduced during the time of reemployment.⁵⁹ Such pension reductions upon rehire are irrelevant to the determination of whether a retire-rehire policy is in compliance with tax law because they do not address whether the retirements of employees who are younger than normal retirement age were bona fide separations from employment.

Limit on Hours Worked

Another way states limit rehired retiree income is by setting a limit on the number of hours that can be worked while gaining pension distributions. In Alaska, rehired teachers can receive pension

distributions only while working when they work less than a year of service total.⁶⁰ Georgia allows retirees to collect distributions only when they return to work for no more than a total of 1,040 hours.⁶¹ Colorado Public Employees' Retirement Association participants can only return to work for 110 or 140 days per year when working more than 4 hours per day or for 270 or 916 hours per year when working more than 4 hours per day depending on the type of employment.⁶²

According to Treasury Regulation 1.401-1(b)(3), such limits on the work of rehired retirees are irrelevant to the determination of whether a retire-rehire policy is in compliance with tax law. Because placing limits on the amount of time rehired retirees work does not address whether the retirements of employees who are younger than normal retirement age were valid separations from employment, they appear to jeopardize the tax-qualified status of the pension plans.

Employee Shortages or Lack of Qualifications

Some states only allow retirees to return to work when certain events occur, such as when there is an employee shortage or lack of qualified applicants. For example, Hawaii only allows retirees to return to work when there is a "labor shortage or difficult-to-fill position."⁶³ Colorado provides that public education facilities "may hire up to ten service retirees in areas where the employer determines that there is a critical shortage of qualified candidates and that the service retiree has unique experience, skill, or qualifications that would benefit the employer."⁶⁴ According to IRS Information Letter 201147038 issued on April 20, 2010, rehire due to unforeseen need for the employee's service, for example, due to the termination of the retiree's replacement, does not violate tax law because the original separation from employment was valid. Retire-rehire policies may violate tax law if they do not limit whether the retirement and rehire of employees who are younger than normal retirement age were due to unforeseen employee shortages.

No Retire-Rehire

A few states provide that pension distributions are suspended when the retiree returns to work.⁶⁵ Both Delaware⁶⁶ and Michigan⁶⁷ do not allow retirees to continue collecting pension distributions during any time they return to work with limited exceptions. State and local government pension plans that prohibit rehired retirees from continuing to receive pension distributions after rehire do not present the issue of whether the rehire made the initial separation from employment invalid. Therefore, assuming the initial separation from

employment was not invalid for other reasons, these plan rules comply with tax law.

WHAT THE FUTURE MAY HOLD

Given the recent scrutiny and debate regarding this issue throughout the United States, state and local government employers may want to reconsider some of their retire-rehire policies. The IRS has made its interpretation of basic tax law on this topic clear. Pension plans may not allow payment to employees who (1) have not reached age 62 or an earlier valid normal retirement age or (2) have not experienced a bona fide separation from employment. Violation of this rule may lead to disqualification of the pension plans that engage in retire-rehire practices. Because many state and local government pension plans have policies that appear to violate this rule, it seems that the IRS has not been vigilant in enforcing this rule up to this point. How the IRS chooses to deal with this inconsistency in the future remains to be seen.

Recently, state and local government pension plans have come under great public scrutiny. It has become public knowledge that members of the legislature in Texas⁶⁸ and Colorado⁶⁹ are receiving pension disbursements from their previous state employment while also earning a salary for their current work in the legislature. There is also a steady stream of articles about retire-rehire policies published throughout the United States.⁷⁰ Additionally, several cities throughout the country have recently declared bankruptcy.⁷¹ The inability of these cities to handle their large pension liabilities was a major factor in the decision to declare bankruptcy for each of these cities.⁷² These events highlight problems with state and local government pension plans and may lead to greater scrutiny of these plans by the IRS.

State and local governments should be wary of any inconsistency between their pension plan practices and tax law. If the IRS chooses to enforce this area of tax law more stringently, the tax-qualified status of many state and local government pension plans may be in jeopardy. To prevent the potential for such an occurrence, state and local governments should seriously consider reviewing their pension plan retire-rehire rules to assess compliance with tax law.

NOTES

1. See Max Reinhart, "Lakeland OKs Retire-Rehire Program," *The News-Herald*, Nov. 1, 2012, available at www.news-herald.com/articles/2012/11/01/news/doc50931d-b1b472c784088743.txt?viewmode=default.

2. See Shelley Grieshop, "Ongoing Debate of Retire-Rehire: Educators' Rights Double Taxpayers' Burden," *The Daily Standard*, Jun. 2, 2012, available at www.dailystandard.com/archive/story_single.php?rec_id=18205; see also Anya Sostek, "Double-Dip

Dilemma: Should Public Employees Who Have Retired and Collect a Pension Be Able To Return To Work and Draw a Salary?," *Governing: The States and Localities*, Jul. 2003, available at www.governing.com/topics/public-workforce/Double-Dip-Dilemma.html; see also Andrew W. Knight, "The Retire and Rehire Controversy: What It Means for the Public Sector," 3 *GAP News: Published by the Institute of Internal Auditors* 1 (2008), www.theiia.org/gap/index.cfm?act=GAPprinta&aid=2690.

3. See Grieshop, "Ongoing Debate of Retire-Rehire," *supra*, n.2; see also Chip Johnson, "Retire-Rehire Practice is Double-Dipping," *San Francisco Chronicle*, Oct. 1, 2010, available at www.sfgate.com/bayarea/johnson/article/Retire-rehire-practice-is-double-dipping-3171985.php.

4. See Grieshop, "Ongoing Debate of Retire-Rehire," *supra*, n.2; see also Tim Troglen, "School Board to Decide on Retire/Rehire List June 10," *Hudson Hub Times*, Jun. 2, 2013, available at www.hudsonhubtimes.com/news%20local/2013/06/02/school-board-to-decide-on-retire-rehire-list-june-10; see also Sostek, "Double-Dip Dilemma," *supra*, n.2; see also Steven Verburg, "Republicans Go Further Than Scott Walker with Tougher 'Double-Dipping' Bill," *Wisconsin State Journal*, May 13, 2013, available at http://host.madison.com/news/local/govt-and-politics/republicans-go-further-than-scott-walker-with-tougher-double-dipping/article_40a99042-60c6-52d9-afd5-56025f4b9c5a.html; see also David Giuliani, "Pension Perks: Is It Case of Double Dipping?" *Sauk Valley*, Aug. 6, 2013, www.saukvalley.com/2013/06/01/pension-perks-is-it-case-of-double-dipping/aouow4i/; see also Brittany Anas, "CU Hires Retirees, Again," *The Denver Post*, Feb. 27, 2012.

5. See 26 U.S.C. § 401(a)(1).

6. See 26 U.S.C. § 402(a); see 26 U.S.C. § 501(a); see also Treas. Reg. § 1.401(a)-1; see also I.R.S., A Guide to Common Qualified Plan Requirements, www.irs.gov/Retirement-Plans/A-Guide-to-Common-Qualified-Plan-Requirements (last reviewed or updated Oct. 20, 2012).

7. See I.R.S., Tax Consequences of Plan Disqualification, www.irs.gov/Retirement-Plans/Tax-Consequences-of-Plan-Disqualification (last reviewed or updated Jun. 18, 2013).

8. See I.R.S. Notice 2007-8.

9. Note: Different rules apply to tax-qualified retirement plans that are classified as profit-sharing or stock-bonus plans. See 26 U.S.C. § 401(a)(1); see also 26 U.S.C. § 404(a)(3)(B).

10. Treas. Reg. § 1.401(a)-1(b)(1)(i); see also 26 U.S.C. § 401(a)(36).

11. See Treas. Reg. § 1.401(a)-1(b)(1)(i); see also 26 U.S.C. § 401(a)(36).

12. See John A. Turner, "Pension, Tax Treatment," in *The Encyclopedia of Taxation and Tax Policy* (Joseph J. Cordes, Robert D. Ebel & Jane G. Gravelle eds. Urban Institute Press) (1999), available at www.urban.org/publications/1000541.html.

13. See 26 U.S.C. § 401(a)(36).

14. Treas. Reg. § 1.401(a)-1(b)(2)(i).

15. See Treas. Reg. § 1.401(a)-1(b)(2)(ii)-(iii).

16. See 26 U.S.C. § 401(a)(36); see Treas. Reg. § 1.401(a)-1(b)(2)(i)-(ii).

17. See 26 U.S.C. § 401(a)(36).

18. The terminology of this event varies among statutes and case law. It has been termed "separation from service," "separation from employment," "severance from

employment,” and “termination of service” among other things on different occasions. It appears that all of these terms refer to the same event. The term “separation from employment” will be used here to encompass all of these different terms. *See* 26 U.S.C. § 402(e)(1); *see* 26 U.S.C. § 401(a)(36); *see* Rev. Rul. 56-693, 1956-2 C.B. 282; *see* Rev. Rul. 74-254, 1974-1 C.B. 91.

19. *See* Treas. Reg. § 1.401(a)-1(b)(1)(i); *see also* 26 U.S.C. § 401(a)(36); *accord Barrus v. United States*, 69-1 T.C. 9281 (1969).

20. *Barrus*, 69-1 T.C. 9281.

21. *Id.*; *accord* IRS Information Letter 2000-0245 (9/26/00).

22. *See Barrus*, 69-1 T.C. 9281; *see also Edwards v. Comm’r*, 89 T.C. 1990 (1989); *see also* IRS Information Letter 2000-0245 (9/26/00).

23. *See Barrus*, 69-1 T.C. 9281.

24. *See Edwards*, 89 T.C. 1990.

25. *Burton v. Comm’r*, 99 T.C. 622 (1992) (citing *Reinhardt v. Comm’r*, 85 T.C. 511 (1985)).

26. *See* IRS Information Letter 201147038 (4/20/10).

27. *See id.*

28. *See Barrus*, 69-1 T.C. 9281.

29. *See* IRS Information Letter 201147038 (4/20/10).

30. It is important to note that in order to become an independent contractor the nature of the employee’s work must substantially change to the extent that the employer no longer supervises the former employee. *See* Rev. Rul. 69-647, 1969-2 C.B. 100.

31. *See* Rev. Rul. 69-647, 1969-2 C.B. 100.

32. *See Devinaspri v. Comm’r*, 50 T.C.M. (CCH) 846 (1985) (the court found that the employers were unrelated because there was no transfer of assets, stock, or other consideration between employers, no assumption of liabilities by either employer, no gaining of interests in either employer before or after the transfer, no merger or consolidation of employers, no liquidation of any part of either business related to the employee transfer, no person owning an interest in one employer who also owned an interest in the other employer, and both employers continued their businesses as prior to the employee transfer).

33. *See* Rev. Rul. 74-254, 1974-1 C.B. 91.

34. *See* IRS Information Letter 201147038 (4/20/10); *see also* Russ Hall and Bill Kalten, “IRS Says Rehired Employees Are Not Retirees,” 22-3 Insider 1, 1 (Mar. 2012), available at www.towerswatson.com/research/insider; *see also* Preamble to Prop. Treas. Reg. § 1.401(a)-1(b)(1) (2011) (regulation “specifically does not endorse a prearranged termination and rehire as constituting a full retirement”).

35. *See Reinhardt*, 85 T.C. 511; *see also Burton*, 99 T.C. 622; *see also* Rev. Rul. 69-647, 1969-2 C.B. 100.

36. *See* Treas. Reg. § 1.401(a)-1(b)(3); *see also* IRS Information Letter 2000-0245 (9/26/00).

37. *See Ridenour v. United States*, 3 Cl. Ct. 128 (1983).

38. *See* Rev. Rul. 74-254, 1974-1 C.B. 91.

39. See *Burton*, 99 T.C. 622 (citing *United States v. Johnson*, 331 F.2d 943, 949 (5th Cir. 1964); *Reinbart*, 85 T.C. 511; *Gittens v. Comm’r*, 49 T.C. 419 (1968)); see also Rev. Rul. 80-129, 1980-1 C.B. 86 (citing Rev. Rul. 79-336, 1979-2 C.B. 187); see also Rev. Rul. 79-336, 1979-2 C.B. 187 (citing *United States v. Haggart*, 410 F.2d 449 (8th Cir. 1969)); see also *Devinaspre*, 50 T.C.M. 846.
40. See Retired Educators Association of Massachusetts, Retirement Planning: A Look at Pensions, Taxes and Re-Employment, available at www.ream1951.org/retirement-planning/ (last visited Aug. 29, 2013).
41. See Retired Educators Association of Massachusetts; see also National Association of State Retirement Administrators, *Return-to-Work/Employment After Retirement* (2012), available at www.nasra.org/resources/NCSL/postemploymentretirement.pdf.
42. See Retired Educators Association of Massachusetts; see also National Association of State Retirement Administrators.
43. Throughout the Actual Practices in State and Local Government Pension Plans section, the term “retiree” includes all public employees classified by their state or local government as retired regardless of the IRS’s interpretation of their employment status.
44. See Retired Educators Association of Massachusetts; see also National Association of State Retirement Administrators.
45. See Retired Educators Association of Massachusetts; see also National Association of State Retirement Administrators.
46. See Colo. Rev. Stat. § 24-51-1101(1).
47. See South Carolina Public Employee Benefit Authority, Retired Members: Returning to Covered Employment, www.retirement.sc.gov/retired/returning.htm.
48. See Utah Code § 49-11-505(3)(b)(i).
49. See Ga. Code Ann. § 47-2-110(3).
50. See S.D. Codified Laws § 3-12-199 (if a retiree returns to work within three months of retirement, the retirement is deemed to be invalid).
51. See Tex. Gov’t Code § 824.602; accord Texas Education Agency, Provisions Related to Employment of Retired Educators: Attachment I, http://ritter.tea.state.tx.us/eddev/retire/Attachment_I_RR.pdf (last visited Jul. 15, 2013).
52. See Haw. Rev. Stat. §§ 88-9(d)(4)(A), (d)(5)(A).
53. See N.M. Stat. § 22-11-25.1(a).
54. See Mass. Gen. Laws ch. 32, § 91(b).
55. Utah Code § 49-11-505(3)(b)(iii).
56. See Retired Members: Returning to Covered Employment.
57. See S.D. Codified Laws § 3-12-200.
58. See *id.*
59. See Colo. Rev. Stat. §§ 24-51-1102(1)(a), (1)(b).
60. See Alaska Stat. § 14.25.043(a).
61. See Ga. Code Ann. § 47-2-110(3).

62. See Colo. Rev. Stat. §§ 24-51-1101(1)(a), (1.8)(a).
63. Haw. Rev. Stat. §§ 88-9(d)(4), (d)(5).
64. Colo. Rev. Stat. § 24-51-1101(1.8)(b).
65. See Del. Code Ann. tit. 29, § 5502(a); see Mich. Comp. Laws § 38.68c; see Retired Educators Association of Massachusetts.
66. See Del. Code Ann. tit. 29, § 5502(a).
67. See Mich. Comp. Laws § 38.68c.
68. See Sarah Ferris, “Double Dipping? Texas Lawmakers Receive State Retirement Payments While Serving in Congress,” *The Houston Chronicle*, Jul. 1, 2013, available at <http://blog.chron.com/txpotomac/2013/07/double-dipping-texas-lawmakers-receive-state-retirement-payments-while-serving-in-congress/>.
69. See Allison Sherry, “Pension Critic Rep. Mike Coffman Already Gets PERA Money,” *The Denver Post*, Jul. 9, 2013, available at www.denverpost.com/ci_23622907/pension-critic-rep-mike-coffman-already-gets-pera.
70. See Grieshop, *supra*, n.2; see Troglen, *supra*, n.4; see Giuliani, *supra*, n.4; see Todd Shepherd, “CO: Investigation Reveals Dozens of Police and Fire Pension ‘Double-Dippers,’” *Colorado Watchdog*, Oct. 29, 2012, <http://watchdog.org/60509/data-reveals-dozens-of-police-and-fire-pension-double-dippers/>.
71. See Bankrupt Cities, Municipalities List and Map, Governing: The States and Localities, www.governing.com/gov-data/municipal-cities-counties-bankruptcies-and-defaults.html (last updated Jul. 18, 2013).
72. See *id.*; see Tim Reid, Cezary Podkul and Ryan McNeill, “Special Report: How a Vicious Circle of Self-Interest Sank a California City,” *Reuters*, Nov. 13, 2012, available at www.reuters.com/article/2012/11/13/us-bernardino-bankrupt-idUSBRE8AC0HP20121113; see Jacob Adlerstein, “Detroit Bankruptcy Filing Puts Spotlight on Distressed Municipal Pensions,” *The Huffington Post*, Jul. 24, 2013, www.huffingtonpost.com/jacob-adlerstein/detroit-bankruptcy-pensions_b_3643995.html.

Guidance Eliminates Use of Stand-Alone HRA or Cafeteria Plan to Purchase Individual Health Policies

Christine L. Keller and Katie Bjornstad Amin

On September 13, 2013, Treasury published Notice 2013-54, which eliminates an employer's ability to use a standalone health reimbursement arrangement (HRA) or other tax-favored arrangement, such as a cafeteria plan, to help employees pay for individual health insurance policies on a tax-free basis.¹ This article summarizes the new guidance.

Treasury Notice 2013-54 points out that standalone HRAs fail to satisfy the Affordable Care Act's (ACA's) annual dollar limit and preventive health services "market reform" provisions. The Notice also discusses a long-standing exemption from certain group health plan requirements for health flexible spending arrangements (FSAs) that meet the definition of an excepted benefit, and provides a new exemption for employee assistance programs (EAPs) that do not provide significant benefits in the nature of medical care or treatment. The Notice applies for plan years beginning on or after January 1, 2014, but taxpayers may apply the guidance for prior periods.

The chart 1 provides a summary of the types of arrangements that will and will not be legally permissible after the Notice takes effect; the discussion that follows provides a more detailed explanation.

BACKGROUND

Recently, some employers have begun to explore the possibility of providing certain employee groups with contributions toward the

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Guidance Eliminates Use of Stand-Alone HRA

Chart 1	
Type of Arrangement	Legally Permissible?
HRA used to purchase health policy in the individual market	No; violation of annual limit prohibition and preventive health services requirements under the ACA.
HRA used to purchase individual health policy through a public or private exchange	No; violation of annual limit prohibition and preventive health services requirements under the ACA.
HRA used to purchase coverage under a group health plan	Yes, if integrated
HRA used to purchase coverage under a group health plan in a private exchange	Yes, if integrated
HRA used to reimburse only dental or vision expenses (with no requirement that participant enroll in group health plan)	No; although Notice does not address, an HRA that reimburses dental or vision expenses would generally not satisfy the definition of a HIPAA excepted benefit.
Stand-alone retiree-only HRA	Yes; not subject to ACA's insurance market reform rules, including annual limit prohibition and preventive health services requirements.
Premium-only plans for individual coverage (employees pay a portion of premiums pre-tax through a cafeteria plan)	No; violation of annual limit prohibition and preventive health services requirements under the ACA.
After-tax premium reimbursement arrangement	Yes
Premium-only plans for group health plan coverage (employees pay a portion of premiums pre-tax through a cafeteria plan)	Yes
Payroll practice of forwarding post-tax wages to a health insurer for an individual health policy	Yes, if DOL voluntary benefit safe harbor is met
Excepted benefit health FSA	Yes
Nonexcepted benefit health FSA offered through a cafeteria plan	No; violation of preventive health services requirements under the ACA (annual limit prohibition does not apply to health FSAs offered through cafeteria plans). Note that if enrollment in a group health plan is required in order to participate in the health FSA, it may be possible to argue that an FSA is an "integrated" arrangement for purposes of satisfying the preventive health services requirements.

<p>Nonexcepted benefit health FSA offered outside a cafeteria plan</p>	<p>No; violation of annual limit prohibition and preventive health services requirements under the ACA. Note that if enrollment in a group health plan is required in order to participate in the health FSA, it may be possible to argue that an FSA is an “integrated” arrangement for purposes of satisfying the annual limit prohibition and preventive health services requirements.</p>
<p>Excepted benefit EAP (<i>i.e.</i>, an EAP that does not provide significant benefits in the nature of medical care or treatment)</p>	<p>Yes</p>
<p>Nonexcepted benefit EAP (<i>i.e.</i>, an EAP that provides significant benefits in the nature of medical care or treatment)</p>	<p>No; violation of annual limit prohibition and preventive health services requirements under the ACA. Note that if enrollment in a group health plan is required in order to participate in the EAP, it may be possible to argue that an EAP is an “integrated” arrangement for purposes of satisfying the annual limit prohibition and preventive health services requirements.</p>

purchase of health coverage in the individual market (*e.g.*, on a tax-free basis through an HRA or cafeteria plan) in lieu of a traditional, employer-sponsored group health plan. The Notice is designed to discourage employers from following this approach by requiring that a participant in an HRA or other employer-sponsored arrangement that is designed to pay for health coverage on a tax-free basis also be enrolled in a group health plan. Absent group health plan enrollment and satisfaction of certain other requirements, the Notice takes the position that such arrangement would fail to satisfy two of the market reform provisions under the ACA: the prohibition against annual dollar limits on essential health benefits (EHBs) and the requirement to provide certain preventive health services without cost-share.

Significantly, the Notice’s application is not limited to HRAs. It creates a new term—an “employer payment plan”—that will also not comply with the annual limit and preventive health services requirements unless it meets the rules in the Notice pertaining to participation in a group health plan.² An employer payment plan appears to include any tax-advantaged arrangement to pay premiums. Thus, a “premium only plan,” under which employees pay for a portion of health insurance premiums through a cafeteria plan on a pre-tax basis, would generally not be permitted to the extent employees

are paying for individual health insurance premiums. Conversely, an “employer payment plan” does not include an employer-sponsored arrangement under which an employee may choose either cash or an after-tax amount to be applied toward health coverage. Thus, premium reimbursement arrangements made on an after-tax basis are still permitted.

With respect to health FSAs, the Notice restates rules that must be satisfied in order for a health FSA to be considered an “excepted benefit” that is exempt from the requirements that generally apply to group health plans under HIPAA, including the market reform requirements under the ACA.

With respect to EAPs, the Notice indicates that an EAP will be considered an excepted benefit as long as it does not provide significant benefits in the nature of medical care or treatment.

HRAs AND OTHER EMPLOYER PAYMENT PLANS

Prior to the Notice, the only formal guidance on the application of the annual dollar limit prohibition to HRAs was in the preamble to the annual and lifetime limits interim final regulations, which stated that an “integrated” HRA does not violate the prohibition against annual limits on essential health benefits, as long as the other coverage offered with the integrated HRA complies with the prohibition³. The interim final rule also clarified that “retiree-only” HRAs are exempt from the insurance market reforms. However, in FAQs issued on January 24, 2013, Treasury, the Department of Labor (DOL), and HHS indicated that in no circumstances will an HRA be considered to be integrated with an individual policy.⁴ Further, the HRA FAQs indicated that if an HRA participant is not also enrolled in the employer’s major medical group health plan, such participant will not be considered to be enrolled in an “integrated” HRA.⁵ Neither the preamble nor the HRA FAQs defined the requirements necessary for an HRA to be considered “integrated.” In addition, no prior guidance addressed the application of the preventive health services requirements to HRAs. The Notice provides as follows:

- **Individual market coverage.** An HRA or other employer payment plan used to purchase coverage on the individual market is not integrated with that individual market coverage for purposes of the annual dollar limit prohibition or the preventive health services requirements. In an example in the Notice, a group health plan that reimburses employees for an employee’s substantiated individual insurance policy premiums would not comply with the annual dollar prohibition.

- **Retiree-only HRAs.** The market reform provisions generally do not apply to standalone (nonintegrated) retiree-only HRAs. An HRA should be considered a retiree only arrangement as long as no participant is able to receive reimbursements from the account while an active employee. It is fairly common for employers to “credit” amounts to an HRA during a participant’s years of active service but not allow reimbursements until after retirement. These arrangements should be considered retiree-only HRAs. The Notice clarifies that standalone retiree-only HRAs that reimburse medical expenses, including premiums for individual health insurance policies, are minimum essential coverage under an eligible employer-sponsored plan for a month that funds are retained in the HRA (even after the employer has stopped making contributions). Thus, a retiree covered by a standalone HRA will not be eligible for an Internal Revenue Code (IRC) Section 36B premium tax credit for any month covered by the HRA.
- **Integration.** An HRA that is “integrated” with a group health plan (including a group health plan provided by another employer) complies with the annual dollar limit prohibition and the preventive health services requirements if the group health plan complies with the annual dollar limit prohibition and the preventive services requirements. An HRA will be “integrated” with a group health plan if it meets the requirements of either of two integration methods described in the Notice. The first method applies if the group health plan accompanying the HRA does not provide “minimum value” as defined under the ACA. The second method applies if the group health plan accompanying the HRA does provide “minimum value” as defined under the ACA. These methods are summarized in Chart 2.
- **Affordability and minimum value.** If an employer offers an employee a group health plan and an HRA that would be integrated with the group health plan if the employee enrolled in the plan, amounts newly made available for the current plan year under the HRA may be considered in determining whether the arrangement satisfies IRC Section 36B affordability or minimum value, but not both. However, an HRA that is integrated with a group health plan offered by another employer does not count toward the affordability or minimum value requirement of the plan offered by the other employer. Also, if an employer offers an HRA

Chart 2

Method	Group Health Plan	Group Health Plan Enrollment	Group Health Plan Sponsor	HRA Participants	HRA Reimbursements	Opt Out and Termination
Group Health Plan Does Not Provide Minimum Value	Cannot consist solely of excepted benefits	Employee must actually be enrolled	Not limited to the employer Example: can be sponsored by the spouse's employer	Only employees enrolled in traditional group major medical coverage	Limited to: <ul style="list-style-type: none"> • copays • coinsurance • deductible • premiums for non-HRA group health plan • non-EHB medical care HRA cannot cover a category of EHB not covered by the traditional major medical group coverage	Must allow permanent opt out and waiver of future reimbursements at least annually Upon termination of employment, must require remaining amounts to be forfeited or permanently opt out of and waiver of future reimbursements
Group Health Plan Does Provide Minimum Value	Must provide minimum value	Same	Same	Same	No restrictions	Same

on the condition that the employee enroll in group health plan coverage from another source instead of group health plan coverage offered by the employer, the HRA does not count in determining whether the employer's group health plan coverage satisfies the affordability or minimum value requirement.

- **Loss of integrated group health plan coverage.** Unused amounts that were credited to an HRA while the HRA was integrated with other group health plan coverage may be used to reimburse medical expenses in accordance with the terms of the HRA even after the employee ceases to be covered by other integrated group health plan coverage without causing the HRA to fail to comply with the market reforms. However, the HRA coverage will be considered minimum essential coverage, which will prevent an employee from obtaining a premium assistance tax credit for coverage purchased through the Exchange.
- **HRAs that provide only dental or vision benefits.** Under the current regulatory structure, limited-scope dental or vision benefits will be excepted from the ACA's market reform provisions "if they are provided under a separate policy, certificate, or contract of insurance, or are otherwise not an integral part of a group health plan..."⁶ The regulation further provides that benefits are not an integral part of a group health plan unless (1) participants have the right to elect not to receive coverage for the benefits and (2) if a participant elects to receive coverage for the benefit, the participant must pay an additional premium or contribution for that coverage.⁷ Consequently, because an HRA is not an insured arrangement, in order for dental or vision benefits provided through an HRA to be excepted from the ACA, employees that elect to have dental or vision coverage provided by the HRA must be charged a premium or contribution. This is problematic since an HRA must be "paid for solely by the employer and not provided pursuant to salary reduction election or otherwise under a [Code section] 125 cafeteria plan."⁸ Notice 2013-54 did not address this issue at all, but this seems like an area in which Treasury could provide relief by issuing guidance that an employee's payment of a premium for dental or vision benefits on an after-tax basis under a stand-alone HRA would not result in the plan losing its status as an HRA.

HEALTH FSAs

The Notice makes clear that the ACA's market reform requirements do not apply to health FSAs that meet the "excepted benefit" definition. A health FSA is defined in IRC Section 106(c)(2) as a benefit program that provides employees with coverage under which (1) specified incurred expenses may be reimbursed (subject to reimbursement maximums and other reasonable conditions), and (2) the maximum amount of reimbursement that is reasonably available to a participant for such coverage is less than 500 percent of the value of such coverage. Generally, this means that, as long as the maximum amount that a participant could be reimbursed from a health FSA is less than five times the amount that the participant could contribute to the health FSA through salary reduction, the arrangement is a health FSA. The HIPAA Portability regulations, which are quoted in the Notice, contain specific rules pertaining to health FSAs, set forth the requirements that must be satisfied in order for a health FSA to be considered an excepted benefit. Under these regulations, a health FSA is an excepted benefit for a "class of participants" if it meets the definition under IRC Section 106(c)(2) and satisfies the following "availability" and "maximum benefit" requirements:

- **Availability.** Under the availability requirement, other group health plan coverage, not limited to excepted benefits, must be made available for the year to the class of participants by reason of their employment. Although the class of participants must be eligible for other group health plan coverage, such participants need not actually elect such coverage. Therefore, as long as the employer offers other major medical coverage in addition to the health FSA to all members of the class of participants, it satisfies this condition.
- **Maximum benefit.** Under the maximum benefit requirement, the maximum benefit payable to any participant in the class for a year cannot exceed two times the participant's salary reduction election under the arrangement for the year (or, if greater, cannot exceed \$500 plus the amount of the participant's salary reduction election). The "salary reduction election" is the maximum amount that the employee can apply toward his or her FSA that would have been taxable income but for the employee's election. The "maximum benefit" is the entire FSA benefit amount, which includes the sum of the employee's salary reduction and any employer contributions.⁹

The Notice appears to assume that a nonexcepted benefit health FSA will not be integrated with a group health plan, but there is

still an open question regarding whether a health FSA that is not an excepted benefit (*e.g.*, because it exceeds the maximum benefit requirement) could satisfy the insurance market reforms if it is integrated with other group health plan coverage. With respect to the annual dollar limit prohibition, the Notice provides an annual dollar limit prohibition. The annual limit regulations contained an exception for health FSAs defined in IRC Section 106(c)(2). The Notice states that this exception was meant to be limited to only health FSAs offered through cafeteria plans because they are subject to a separate \$2,500 limit on salary reduction contributions. Thus, only health FSAs offered through cafeteria plans are exempt from the annual dollar limit prohibition. The Departments are considering whether an HRA may be treated as a health FSA for purposes of the exclusion from the annual dollar limit prohibition.

EMPLOYEE ASSISTANCE PLANS

EAP coverage is often provided by employers on an automatic basis to all employees without cost, whether or not the employees are enrolled in the group health plan. Absent relief, this coverage would constitute minimum essential coverage for purposes of the ACA, precluding an employee from receiving an IRC Section 36B tax credit, even if the employee did not have any other medical coverage. In addition, such EAP would presumably have to comply with all of the ACA's market reform requirements, including the prohibition against annual limits and the preventive health services coverage requirements. Fortunately, the Notice provides that benefits under an EAP will be considered excepted benefits as long as such benefits do not provide significant benefits in the nature of medical care or treatment. Such EAPs are not minimum essential coverage and will not prevent an employee from receiving an IRC Section 36B tax credit for coverage purchased through an exchange.

Unfortunately, the Notice does not discuss wellness programs, disease management programs, or onsite clinics. Guidance is needed to address whether those programs could also be considered excepted benefits if they do not provide significant benefits in the nature of medical care or treatment.

TRANSITION RELIEF

Cafeteria Plans

IRC Section 125(f)(3), effective for taxable years beginning in 2014, prohibits employees from purchasing coverage through a

public exchange on a pre-tax basis using the employer's cafeteria plan (but, employees may still purchase coverage on a Small Business Health Options Program (SHOP) exchange on a pretax basis using the employer's cafeteria plan if the employer offers SHOP coverage to its employees). However, some employers in states that have already established exchanges have cafeteria plan provisions that allow employees to use pretax cafeteria plan dollars to purchase individual exchange coverage. The Notice provides that for plans that as of September 13, 2013, operate on a noncalendar-year plan year, the IRC Section 125(f)(3) restriction will not apply until the first cafeteria plan year that begins in 2014. Individuals covered under these cafeteria plans may not claim an IRC Section 36B premium tax credit for any month they were covered through the exchange.

Amounts Credited or Made Available Before 1/1/14

The HRA FAQs stated that the Departments anticipated that future guidance will provide that, whether or not an HRA is integrated with other group health plan coverage, unused amounts credited before January 1, 2014, may be used after December 31, 2013, to reimburse medical expenses in accordance with the HRA terms in effect on January 1, 2013, without causing the HRA to fail to comply with the annual dollar limit prohibition. The Notice, however, does not address this transition relief, and thus it is unclear whether employers can rely on the relief provided in the FAQ. Guidance is needed to address this issue.

NOTES

1. The Department of Labor (DOL) issued substantially identical guidance on the same date (Technical Release 2013-03), and the Department of Health and Human Services issued a memorandum concurring with the IRS and DOL guidance as applied to the laws in its jurisdiction on September 16, 2013. See <http://www.cms.gov/ccio/resources/regulations-and-Guidance/downloads/cms-branotice-9-16-2013.pdf>.
2. Some have argued that it should be possible to interpret the term "employer payment plan" more narrowly to exclude employee pretax salary reduction contributions paid through a cafeteria plan. However, because employee pre-tax salary reduction contributions are treated as employer contributions under the Internal Revenue Code, and because it appears that Treasury is generally trying to eliminate tax incentives for the purchase of individual health insurance policies by employees, it does not seem likely that the IRS intended this interpretation.
3. 75 Fed. Reg. 37188 (June 28, 2010).
4. FAQs About Affordable Care Act Implementation, Part XI, FAQ-2.

5. FAQs About Affordable Care Act Implementation, Part XI, FAQ-3.
6. Treas. Reg. § 54.9831-1(b)(3).
7. Treas. Reg. § 54.9831-1(b)(3)(ii).
8. IRS Notice 2002-45.
9. Treas. Reg. § 54.9831-1(c)(3)(v); DOL Reg. 2590.732(c)(3)(v); HHS Reg. § 146.145(c)(3)(v).

Designing and Maintaining a Retirement Plan

Leslie E. DesMarteau

A number of different factors drive an employer's decision to offer a tax-qualified retirement plan. Once the decision to offer a plan has been made, the employer then has some important choices to make about plan design. Many options are available with respect to plan eligibility, benefits, vesting and payment timing, and methodology, among other things. In addition, federal law imposes significant obligations on the people charged with operating a retirement plan. The employer, and the individuals acting as plan fiduciaries, must be prepared to invest the necessary time, money and expertise to operate the plan properly, must understand their legal responsibilities, and must hire vendors to provide technology, expertise, and other support as needed.

The average US defined contribution plan account balance was roughly \$85,000 as of the end of 2012, an all-time high—and painfully inadequate as a source of retirement income.¹ Encouragingly, however, although employees rank health care ahead of retirement plans when prioritizing employee benefits, retirement plans have seen a jump in their perceived importance, with 63 percent of workers identifying the retirement plan as an important factor in accepting a job, and nearly half indicating that the retirement plan was a compelling reason not to terminate employment.² Whether motivated by paternalism, recruitment and retention needs, or retirement savings goals of owners and executives, there are good reasons for employers to invest the time and money necessary to build a robust retirement program.

That said, employers should look before they leap, and should keep a cautious eye on the terrain even once their plans are well-established. Significant legal obligations accompany the establishment and operation of a retirement plan, and the wide variety of design options available means that an employer must take the time to consider its alternatives when it sets up the plan, and periodically thereafter, if it wants to use the plan to best advantage.

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GETTING STARTED

Should You Maintain a Retirement Plan at All?

Retirement readiness is of increasing concern, and offering retirement benefits can be a valuable recruitment and retention tool, but attempting to maintain a retirement plan without paying proper attention can be much worse than not offering one at all. After all, no one wants to depend for retirement savings on a plan with poor investment options, or on a pension fund that might run out of money. For individuals tasked with managing the plan, the stakes are even higher. Section 409 of the Employee Retirement Income Security Act of 1974, as amended (ERISA), holds plan fiduciaries personally liable for losses associated with imprudent plan investing, improper plan administration, and other violations of ERISA's fiduciary duties.³ An employer that is not prepared to commit the time and resources needed to make prudent financial choices and facilitate accurate plan administration should not offer a retirement plan.

What Do You Hope to Accomplish by Offering a Retirement Plan?

An employer may have a variety of reasons for offering a retirement plan. Those goals, and the employer's other priorities, will shape the decision to offer a plan and the eventual plan design. Even once the plan is operational, the employer will want to revisit its goals periodically, and evaluate the success (or lack thereof) of the plan in its current incarnation at meeting those goals. If the goals have changed, or the plan is not meeting those goals, the employer may need to make changes to the plan design.

Recruitment and Retention

If recruitment and retention are important motivations, the employer needs to consider first of all whether its current or desired workforce will value retirement benefits, and consider as well how best to market the plan as a valuable employee benefit. On a related note, the employer needs to analyze what level of benefits it will have to offer to inspire employee appreciation for the plan, and whether it can afford to meet that threshold. If other benefits or compensation will be lower as the result of establishing a plan or increasing benefits under an existing retirement plan, the employer will need to take into account employees' likely reaction to the trade-off.

Retirement Savings for Company Leadership

If members of the company leadership want to maximize their current tax deferral and future retirement savings, a qualified retirement plan is a prime candidate to accomplish that goal. However, when Congress designed the provisions governing tax-favored employee retirement savings vehicles, it granted amounts contributed to those plans favorable tax treatment *if* the plan extended its benefits to the rank-and-file in rough proportion to the manner in which it made benefits available to company owners and executives.

Accordingly, the company needs to bear in mind that the extent to which the plan provides retirement benefits to rank-and-file employees will affect the extent to which company leadership can obtain maximum benefit from the plan. Ensuring the requisite parity for the rank-and-file may require some level of company contributions, and may also require investment in participant outreach and education. Those costs need to be factored into the analysis of whether a retirement plan will be advantageous for company leadership.

Employee Retirement Readiness

Offering a plan provides valuable assistance to employees who might not otherwise be willing or able to save for retirement. If the employer provides automatic benefits (as in the case of most defined benefit plans and some defined contribution plans), participants are guaranteed some level of retirement savings once they satisfy the plan's vesting requirements. If the plan requires or permits contributions by employees, the availability of payroll deduction, matching contributions (if any), and the reassurance of knowing the employer is keeping an eye on the plan can encourage employees to save when they otherwise would not, and restrictions on withdrawals and distributions foster a savings mentality and limit the risk of casual spending. However, the mere presence of a plan may not be sufficient to build the necessary level of retirement savings, particularly if the plan requires contributions by employees. The employer will need to consider the utility of making a plan available in light of its particular workforce demographics and employee culture.

Are You Prepared for the Responsibilities Associated with Sponsoring a Retirement Plan?

Setting up a plan often is not that difficult. Many vendors offer plan documents that the Internal Revenue Service (IRS) has preapproved as satisfying the legal rules for plan documents, and can quickly

(sometimes too quickly) walk the employer through the process of selecting among the various optional features and establishing an investment and administrative platform. Before signing on the dotted line, however, the employer's benefits personnel should consider:

- Do I understand the plan document and service agreement?
- Do I know how much the company will need to contribute to the plan, and how much it will cost to operate the plan?
- Do I know what administrative services are not provided by the plan vendor, and where the company can obtain them if they cannot be provided in-house? Conversely, do I understand the responsibilities of company personnel in connection with administering the plan?
- Do I know how much employees can expect to receive from the plan and when?
- Will the plan be professionally managed, or will participants select their own investments? Does the company have the in-house expertise to manage the plan's assets or select the plan's investment option menu? If not, is the company prepared to commit the resources to hire employees and/or vendors with the requisite skills?

So, You Want a Retirement Plan. What Type of Plan Do You Want?

Currently, the most popular type of plan is the "401(k) plan," designed to allow employees to contribute on a pre-tax basis in accordance with Section 401(k) of the Internal Revenue Code of 1986, as amended. There are many other options, however. Smaller employers can consider individual retirement account (IRA)-based options, and formal retirement plans of a variety of types are available to all sizes of employers. Most employers prefer a "defined contribution" model, under which the employer's only obligation is to contribute whatever amounts were promised for the year, but some employers still offer "defined benefit" plans, which promise participants a specified level of benefits and thus place the investment risk on the employer. The IRS maintains a website to assist potential plan sponsors with exploring their options.⁴

SEPs and SIMPLEs

In the first place, a smaller employer⁵ should consider whether a full-fledged plan is the best option. IRA-based options such as Simplified Employee Pensions (SEPs) and Savings Incentive Match

Plans for Employees (SIMPLEs) typically require less employer involvement and little or no administrative infrastructure other than selection of the IRA vendor. However, they also are subject to lower contribution limits, and SIMPLEs in particular tend to be much less flexible.⁶ The discussion in the remainder of this article focuses on full-fledged plans rather than SEPs and SIMPLEs.

Defined Benefit and Defined Contribution Plans

The retirement plan universe divides into two types of plans: defined benefit plans and defined contribution plans. Defined contribution plans place investment risk on the employee. If the plan's investments fare poorly, the employee will have less money for retirement. Defined benefit plans place the investment risk on the employer. The employer must contribute enough money so that, when contributions are coupled with investment returns, the plan can pay the promised benefits. Although there are many plan design rules that are different for the two types of plans, the placement of the investment risk is the key differentiator.

Some plans attempt to combine features of both types, but these plans ultimately still fall into one category or the other. For example, a "hybrid" defined benefit plan (typically a plan with a "cash balance" or "pension equity" formula) expresses a participant's benefit in terms of a fixed amount, perhaps adjusted for notional earnings, similar to a defined contribution plan account balance. However, at the end of the day, these plans are subject to defined benefit plan funding rules, placing the ultimate investment risk on the employer. In contrast, a "target benefit" money purchase pension plan uses a contribution formula designed to enable an employee to receive a specified level of benefits, but the employee's actual benefits will be limited to the account balance, placing the ultimate investment risk on the employee.⁷

Both defined benefit plans and defined contribution plans have their advantages and disadvantages.

Defined Contribution Plans

Defined contribution plans offer employees control of their retirement savings, particularly if the plan permits employees to make contributions and select their own investments. They are more portable (an advantage for today's mobile workforce) and easier for employees to understand.

These plans also give the employer the advantage of a fixed financial obligation. The employer must make the contributions (if any) that it has promised for a given year, but it is not obligated to ensure that employees have any particular level of retirement

income. In addition, an employer generally can reduce or eliminate contributions to a defined contribution plan for future periods,⁸ although the IRS has increasingly required “safe harbor” 401(k) and 403(b) plans to adopt most amendments prior to the start of the plan year.

However, defined contribution plans have a darker side. In exchange for the control and flexibility available under a participant-managed defined contribution plan, participants assume responsibility for savings and investment decisions they may lack the inclination or knowledge to make. Almost all employers have at least some employees who are ill-suited to making their own financial decisions, and a participant-managed defined contribution plan may not offer these individuals enough of a safety net. If plan benefits depend on voluntary contributions from employees, participants who do not set aside sufficient funds will not have sufficient retirement assets when the time comes. Even if the participants save enough (on their own or with the aid of employer contributions), poor or just unlucky investment choices can decimate the participants’ retirement savings at the worst possible time.

Selecting quality investment options can help, but funds in the most carefully selected investment array will go through periods of investment losses. Furthermore, a high-quality investment array cannot protect a participant who invests in higher-risk, more volatile investments despite being close to his or her retirement date against the consequences of a decline in those investments at the wrong time. The employer can mitigate the risk of poor participant management by opting to have some or all of the plan’s assets professionally managed, but this is increasingly uncommon. Assigning responsibility for investment management to the plan fiduciary increases the fiduciary’s risk of liability. This in turn increases the risk to the company, which may be a fiduciary itself or responsible for indemnifying fiduciaries and vendors serving in that role. In addition, many participants want investment control, and may be disenchanted by the plan if they have no say in its investments.

Defined Benefit Plans

From the employer’s perspective, the fundamental disadvantage of defined benefit plans is the funding obligation. The employer is responsible for putting in enough money to enable the plan to pay benefits and cover its operating expenses. Defined benefit plan contribution obligations tend to increase when the economy is doing poorly, since low interest rates and poor investment returns increase the gap between anticipated benefit obligations and anticipated available assets. This means that companies’ costs tend to go up when they can least afford it.

In recent years, a variety of funding risk management and de-risking techniques have gained in popularity, and new plan designs have evolved that better enable employers to predict their costs and fund accordingly. However, the financial obligations associated with defined benefit plans remain considerable. Furthermore, once an employer has established a defined benefit plan, the plan typically cannot be terminated unless the employer has funded all promised benefits and purchased annuity contracts for payment of those benefits from a reputable insurance company. Even reducing or freezing benefit accruals requires advance notice.⁹

Defined benefit plans also are more expensive to administer than a typical defined contribution plan. A defined benefit plan needs an actuarial valuation each year, and also requires actuarial support to calculate benefit payments as they come due. Defined benefit plans also must pay insurance premiums to the Pension Benefit Guaranty Corporation (PBGC), a federal agency that guarantees payment of plan benefits in the event of plan and employer insolvency (up to certain limits), and must report certain events to the PBGC.

Conversely, however, defined benefit plans may be a less expensive way to provide a specified level of benefits. Because the employer only has to put in enough money to fund benefits, strong investment returns can reduce the contribution obligation. Defined benefit plans may also offer superior tax deferral opportunities. For 2014, Section 415 of the Code caps annual contributions to a defined contribution plan at \$52,000 (\$57,500 for individuals 50 or over, if the plan offers “catch-up” contributions under Code Section 414(v) and the individual takes advantage of that opportunity). For 2014, in contrast, the maximum annual benefit payable from a defined benefit plan is \$210,000.¹⁰ For this reason, defined benefit designs are of increasing interest to high-revenue professional practices, such as medical groups and law firms.

From a participant’s perspective, defined benefit plans likewise have both positive and negative features. Principally, defined benefit plans protect employees against adverse investment results. They also are more likely to offer cost-effective lifetime payment options that prevent employees from outliving their savings, mitigating longevity risk. However, many defined benefit plans are better-designed for a long-term workforce, and are ill-suited to today’s culture in which individuals often change jobs (voluntarily or involuntarily) every few years. Traditional defined benefit plan formulas tend to calculate benefits in a way that favors long service, with the annual increase in a benefit higher in later years of service than in earlier ones. Many plans prohibit distributions until the age of 55 or even later, and may also limit payment to monthly pension payments rather than lump sums, preventing participants from consolidating their retirement savings. Although designs allowing earlier payment and rollover-eligible lump sums have increased in prominence, those features undercut

the traditional advantages of defined benefit plans as hedges against longevity risk and the risk of imprudent early expenditure of assets meant for retirement.

You've Chosen Your Plan Type. What Features Should Your Plan Offer?

All plans are required to address certain key issues, and employers have the flexibility to offer a variety of optional features. Plan documents preapproved by the IRS will include the required features, and typically offer the employer some level of discretion with respect to various optional features, although different documents offer different levels of flexibility. If the employer wants a type of plan not available in preapproved form, or cannot locate a preapproved document with design features it considers important, it can pay for a customized document and submit the document for an IRS determination that it contains all required features and that the optional features have been drafted in a manner acceptable to the IRS.

Whether the employer uses a preapproved or customized document, however, it needs to make at least some design decisions.

Eligibility

Section 410(a) of the Code and Section 202 of ERISA prohibit a plan from requiring an employee to complete more than one year of service (two, in the case of fully vested employer contributions),¹¹ and also prohibit exclusion of employees 21 or older on the grounds of age. Within these parameters, however, employers have numerous options.

For example, an employer may choose to be more generous, and allow employees to enter immediately, or after a period of service less than the maximum, for some or all contributions. Some plans allow employees to contribute from their own paychecks immediately, but require a period of service before the employees can be eligible for employer contributions.¹² Some plans impose different eligibility requirements on different groups of employees, or on specific types of employer contributions. An employer must remember, however, that the more variations its plan includes, the more complex the plan is to administer and the higher the risk of error, especially if employees may change from a group covered by one set of rules to a group covered by another.

The employer must also decide when an employee who has satisfied any relevant age and service requirements can begin to participate. Although a number of employers allow immediate entry once age and service requirements are satisfied, many employers prefer to consolidate new entrants to the plan, such as by allowing entry only on the first day of the month. The earlier of the first day of the plan year or six months from satisfaction of the eligibility rules is

the maximum permissible waiting period once the age and service requirements are met.

Furthermore, an employer does not have to allow all employees to participate, even if they satisfy the age and service rules. Employers commonly exclude various classifications of employees. For example, an employer might offer a plan to individuals in one location but not in another, offer separate plans to salaried and hourly workers, or maintain a separate plan for union employees.¹³ It is important to note, however, that an employee's service with the employer (and entities aggregated with the employer under Section 414 of the Code)¹⁴ counts towards satisfaction of service requirements, even if he or she is working in an ineligible classification. If a plan covers Division A and requires a year of service, an employee who works a year in Division B would be eligible if he or she switched to Division A thereafter.

In addition, eligibility classifications must satisfy the Code's prohibitions on discrimination in favor of highly compensated employees.¹⁵ Section 410(b) of the Code allows a plan to demonstrate that participation is available to a nondiscriminatory group using various methods,¹⁶ but the employer should bear in mind that the workforces of all entities related to it under Section 414 of the Code must be taken into account. For example, a parent company with a subsidiary related to it under Section 414 of the Code would have to take that subsidiary's workforce into account, and the subsidiary likewise would need to consider the parent's workforce.¹⁷ For this reason, maintenance of multiple plans within a group can be disadvantageous. Since maintenance of multiple plans also increases administrative costs and effort, employers generally should seek to consolidate retirement benefits as much as possible. Even if different benefit structures for different groups are necessary for business reasons, a single plan often is sufficient. Many preapproved plan documents can now accommodate multiple benefit designs under a single umbrella, and a customized document certainly can do so.

Even if an employer's eligibility classifications are nondiscriminatory, the employer must bear in mind that eligibility classifications cannot be used as an end run around the rules regulating age and service conditions. Thus, the IRS generally does not permit exclusionary classifications based on "temporary" or "part-time" employment status, unless individuals in those classifications are permitted to participate if they satisfy Section 410(a) of the Code.¹⁸

Benefit Structure

The Options

Like an employer's eligibility classifications, a plan's benefit or contribution formula, must satisfy rules designed to ensure approximate parity of benefits (in proportion to compensation) when rank-and-file

employees are compared to highly compensated employees. Many employers choose to offer a single benefit or contribution design, though some employers offer different designs to different groups of employees, or even to particular employees.¹⁹ There is a fair amount of flexibility, so long as nondiscrimination tests are satisfied. However, the more different benefit or contribution structures a plan contains, the more complicated it is to administer. Accordingly, employers should consider carefully before opting for different plan designs for different employee groups.

If the plan is a defined benefit plan, the employer can permit or require employees to contribute on an after-tax basis, but such plans are uncommon in the private sector. Likewise, some defined contribution plans permit after-tax employee contributions, but most do not. In contrast, employers commonly opt to include a 401(k) or 403(b) elective deferral feature in a defined contribution plan.²⁰ Under a 401(k) or 403(b) arrangement, an employee can elect to have amounts withheld from his or her paycheck and contributed to the plan, up to an annual statutory limit (\$17,500 in 2014, with employees turning 50 or older during the year allowed to make an additional \$5,500 in “catch-up contributions” if the plan so permits, and enhanced amounts permissible for some 403(b) plan participants). Traditionally, these amounts were disregarded for purposes of calculating the employee’s taxable income for the year of the contribution, but if the plan permits, an employee has the option of designating some or all of these elective deferrals as “Roth” contributions. Roth contributions are taxed when contributed, but can be withdrawn tax-free once the employee has attained age 59½, died, or become disabled, so long as at least five taxable years have elapsed since the initial Roth contribution was made to the plan (or a prior employer’s plan, if Roth amounts were directly rolled over from that plan to the new plan).

If the employer maintains a 401(k) or 403(b) elective deferral plan and/or permits after-tax contributions to a defined contribution plan, the employer may opt to “match” some or all of a participant’s deferrals. A defined contribution plan sponsor may also make nonelective contributions, which are employer contributions that do not require employees to contribute, often called “profit-sharing contributions.” A defined contribution plan may specify the manner in which the employer will calculate some or all contributions each year, or may leave the contribution amount to the employer’s discretion.

In addition to deciding on the amount of contributions or benefits, the employer needs to specify what employees must do to earn a contribution or benefit for the year. Many employers do not impose any requirements on receipt of a matching contribution other than contribution of elective deferrals (or after-tax employee contributions, in some cases), but some require employees to be employed on a

specified date (typically the last day of a plan year, or the last day of a plan quarter) and/or to have completed a specified number (no more than 1,000) of hours of service. Requirements of this type are more common for nonelective contributions. Defined benefit plans often require completion of a specified number of hours of service in a year in order for a benefit to accrue.²¹

Compensation

Most plans use employee compensation in their benefit calculations. For example, a defined benefit plan might calculate the employee's benefit as a specified percentage of compensation times years of service. Many defined contribution plans calculate contributions as a percentage of compensation. Even if the plan uses a benefit formula that does not base benefits on compensation, the employer will still need to look to a participant's compensation for purposes of nondiscrimination testing and certain limits on plan contributions and benefits. When selecting a definition of compensation, the employer should consider whether the definition satisfies legal requirements, and whether it is readily administrable by the employer's payroll personnel.

With respect to the first consideration, the IRS has identified four definitions that will automatically satisfy Section 415 of the Code. A plan using one of those definitions, or using one of those definitions with certain variations authorized by regulations under Section 414(s) of the Code, automatically qualifies as having a nondiscriminatory definition of compensation for purposes of the nondiscrimination testing rules applicable to plan benefits or contributions. Using one of the preapproved definitions avoids the need to test the definition of compensation to demonstrate that it is nondiscriminatory under Section 414(s) before tests on benefits or contributions can be run.

However, the employer may find a customized definition easier to administer, or may feel that the preapproved definitions do not meet its needs for other reasons. Customizing the definition allows the employer to specify the treatment of the particular types of compensation it pays in familiar terminology, and offers the flexibility to address specific situations (such as the handling of trailing compensation to terminated employees) in more detail than the IRS's regulatory definitions allow. Since the IRS has identified erroneous application of plan definitions of compensation as among the most common plan errors,²² clarity is important, as is regular review of payroll practices.

Testing

Defined benefit plans, defined contribution plan employer non-elective contributions, availability of each matching contribution

formula (if more than one), and certain other plan features must satisfy the requirements of Section 401(a)(4) of the Code. The regulations under Section 401(a)(4) allow employers to select from several designs that automatically pass this test, but an employer can also opt for a different design and run a more elaborate test to demonstrate that a benefit or contribution formula, or availability of a feature, falls within acceptable parameters.

Pretax and Roth elective deferrals must pass the Actual Deferral Percentage (ADP) test set forth in Section 401(k) of the Code. Employee after-tax contributions to defined contribution plans and matching contributions made on account of elective deferrals or after-tax contributions must pass the similar Actual Contribution Percentage (ACP) test under Section 401(m) of the Code. A plan can satisfy these tests automatically if the employer commits to a “safe harbor” design providing specified levels of employer contributions, and otherwise must run these tests each year.

Top Heavy Plans

If an employer’s plan, combined in some cases with other retirement plans sponsored by that employer and its affiliates, has more than 60 percent of benefits (in the case of a defined benefit plan) or account balances (in the case of a defined contribution plan) allocated to certain owners and highly paid officers, the plan is considered “top heavy.” In that case, the employer is required to provide a certain minimum level of benefits. Smaller employers and professional firms tend to be the most at-risk of top-heavy status.

Disability

An employer can provide for continued contributions to a defined contribution plan, or continued accruals under a defined benefit plan, for disabled employees. An employer should be aware, however, that IRC Section 415 may limit its ability to stop making these disability accruals or contributions available.

Vesting

Plan benefits are “vested” when an employee can leave the employer without forfeiting the entitlement to eventual receipt of those benefits. Section 411 of the Code and Section 203 of ERISA set forth minimum vesting standards. Naturally, contributions made by employees must be fully vested when made. For employer contributions, defined contribution plans cannot require employees to complete more than three years of service to be fully vested, or six years of service if participants vest at least 20 percent per year starting after two years of service. Defined benefit plans cannot require employees to complete more

than five years of service to be fully vested, or seven years of service if participants vest at least 20 percent per year starting after three years of service. Hybrid defined benefit plans such as cash balance plans and pension equity plans must adhere to the defined contribution plan rules, as must top heavy plans. Years of service are calculated as a specified number of hours (no more than 1,000) in either the plan year or the 12-month period measured from the employee's employment date or anniversary thereof, unless the employer opts to use the "elapsed time" method. The elapsed time method avoids the need to track hours, but has its own complexities, especially for rehired employees.

A plan must also provide for full vesting if a participant reaches normal retirement age while still employed. Normal retirement age cannot be after the later of the participant's attainment of age 65 or the fifth anniversary of the participant's commencement of plan participation, though an employer may establish an earlier age.²³ Many plans also provide for full vesting upon disability and/or death while employed, and some employers provide for additional vesting triggers. Termination of the plan requires full vesting (to the extent benefits are funded, in the case of a defined benefit plan), and participants affected by permanent cessation of contributions to a defined contribution plan (other than a money purchase pension plan) or a partial termination also are entitled to full vesting.

Before selecting a vesting schedule, the employer should give serious thought to whether it wants to impose a vesting requirement at all. Historically, vesting schedules were intended to offer an inducement to employees to stay with an employer for the long term, as well as to allow employers to redirect money originally contributed on behalf of nonvested former employees to still-active employees or towards payment of plan expenses. However, the maximum permissible vesting schedules have shortened over the past few decades, reducing the potential benefit of a vesting schedule. If the employer contributions are modest, the value of a vesting schedule is further reduced. Since vesting schedules require monitoring of service for active employees and reinstatement of returning employees' forfeited balances and past service if the requisite conditions are met, having a vesting schedule means additional administrative effort and risk of error. The employer will need to decide whether the benefits of delaying employees' vesting are worth these costs. If the employer concludes that a vesting schedule will be worthwhile, it must then select a schedule within the permissible parameters.

Distributions

Under Section 401(a)(14) of the Code, a plan must make distributions available no later than 60 days after the end of the plan year in which occurs the participant's normal retirement age (or 65, if

earlier), the tenth anniversary of the participant's commencement of participation in the plan, or the participant's termination of employment, whichever comes latest. Even if a participant does not request payment, Section 401(a)(9) of the Code requires the plan to begin distributions no later than April 1st after the year in which the participant turns 70½ (or, if later and if the participant is not a more-than-five-percent owner of the employer, the year in which the participant's employment terminates).

Defined benefit plans often require a terminated participant to wait until reaching early or normal retirement age to commence payment, and generally are not permitted to allow in-service payments prior to age 62. In contrast, some defined benefit plans and most defined contribution plans allow payment whenever a participant terminates employment, regardless of age. Many defined contribution plans also permit in-service withdrawals of some or all contributions under certain conditions, although money purchase pension plans generally cannot offer in-service distributions for any reason prior to age 62. For those plans that do allow in-service payment, the most common circumstances are the participant's attainment of age 59½ (the earliest permissible date for elective deferrals and certain types of employer contributions) and in cases of financial hardships described in Section 1.401(k)-1(d)(3) of the Treasury Regulations. Many defined contribution plans also permit participants to take loans against their account balances, up to limits established by Section 72(p) of the Code. Although loans and in-service distribution options are popular, and may encourage participants to save since they can access funds when necessary, both features also increase the risk of premature use of money intended for retirement, often with detrimental tax consequences.

Once payments are available, the plan needs to know how to make payment. Most defined contribution plans offer payment in the form of a lump sum, and some also allow payment in the form of installments or life annuity contracts, particularly for terminated participants. In contrast, under Section 401(a)(11) and Section 417 of the Code, defined benefit plans and some defined contribution plans are required to offer payment in the form of a single life annuity for an unmarried participant, and a qualified joint and survivor annuity for a married participant.²⁴

A qualified joint and survivor annuity offers payment for the participant's lifetime, with benefits continuing to the surviving spouse in a specified percentage. The survivor percentage must be at least 50 percent of the amount payable to the participant, with an option for a 75 percent survivor percentage; if the plan's presumptive survivor percentage is 75 percent or more, the participant must have an option for a 50 percent spousal survivor percentage. If a participant's

monthly payment is reduced as a result of the cost of the survivor benefit, the participant must have the right to waive the qualified joint and survivor annuity and opt for a single life annuity instead, if the participant's spouse consents. Many plans also offer additional elective distribution options, subject to spousal consent if the distribution option does not provide the spouse at least a 50 percent survivor benefit. A defined contribution plan that is not required to use the annuity rules can be designed to do so, or can offer annuities as an optional payment form. In the latter case, the participant must have spousal consent to select a life annuity that does not offer the spouse at least the requisite 50 percent survivor benefit, but does not need spousal consent for a nonannuity distribution.

In any event, however, most plans require automatic cash-out payments to participants whose benefits do not exceed a specified amount. A plan can select a cash-out threshold of up to \$5,000, excluding amounts attributable to rollover contributions, but must automatically roll payments in excess of \$1,000 to an IRA, unless the participant elects otherwise.²⁵

If the plan is using the annuity rules, the participant's spouse must have the right to a 50 percent survivor annuity, if the participant dies before commencing payment.²⁶ If a defined contribution plan does not use the annuity rules, the participant's spouse must be entitled to 100 percent of the participant's vested account balance if the participant dies before commencing payment. In both cases, the plan can allow a nonspousal beneficiary if the spouse consents, though many defined benefit plans offer pre-retirement death benefits only to spouses.

Offering a range of payment forms gives participants flexibility, but adds to the cost and complexity of the plan. Annuity options, in particular, require detailed disclosures. Furthermore, the associated spousal consent requirements present compliance risks due to the increased possibilities for erroneous failure to obtain consent, as well as the potential fraudulent signatures and after-the-fact spousal objections that generate costs even when resolved in favor of the plan. Annuity options are also seldom used when a lump sum option is available, especially in the defined contribution plan context, meaning that a plan sponsor may take on additional burdens to make annuities available without providing a meaningful additional benefit to plan participants. A participant who wants an annuity or an installment payment option can roll a lump sum into an IRA and establish his or her own payment schedule.

Conversely, however, as concern about longevity risk grows, there has been correspondingly increased interest in defined contribution investment products that permit participants to elect lifetime income payments. Those products are still developing, and a number of issues

remain unsettled despite some preliminary guidance from the IRS.²⁷ This is an area that is likely to see continued growth, but one that plan sponsors and fiduciaries should approach with caution.²⁸ For example, annuity and other lifetime income products generally involve additional costs, and may limit flexibility and portability. Spousal consent rules may not be clear. The product provider's creditworthiness and the performance of the investment product may decline, presenting fiduciary risk. If a lifetime income product is under consideration, the plan fiduciaries should review the specific product details carefully with counsel and their investment advisers, and be sure that their ongoing oversight and participant disclosure practices are adequate.

Employer Stock

Normally, plan investments are the domain of the plan's fiduciaries once the plan is operational, and not a matter for the employer in its capacity as plan sponsor. Employer stock, however, can be an exception to this rule. An employer can choose to designate a defined contribution plan as an employee stock ownership plan (ESOP), which is specifically designed to invest primarily in employer securities and which is eligible for certain tax breaks not available to other plans. An employer also can specify that a non-ESOP defined contribution plan must or may invest (or permit participants to invest) in employer stock. Under current case law, plan provisions mandating investment in employer stock offer protection to plan fiduciaries in the event of a decline in the value of employer stock, as discussed below. That said, an employer should consider carefully before deciding to offer employer stock, and should explore alternatives (such as employee stock purchase plans or stock options) not governed by ERISA. Plans with employer stock have generated significant litigation in recent years, even for companies whose stock experienced only temporary declines and in some cases even for companies whose stock increased after participants had opted or been required to sell it.²⁹

OPERATING YOUR PLAN

Section 404 of ERISA requires the fiduciaries responsible for a plan to conduct their duties in accordance with the plan documents and ERISA, for the exclusive benefit of plan participants and beneficiaries, and with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with such matters would use in the conduct of a like enterprise and with like aims. A breach of this obligation carries personal liability under Section 409 of ERISA, and hence appropriate fiduciary insurance coverage is essential.

Section 402 of ERISA requires a plan to have at least one “named fiduciary” charged with operating the plan in accordance with this standard. ERISA also requires a “plan administrator” (the employer, unless someone else has been designated) to perform certain tasks, file an annual report (Form 5500) with the government and prepare and circulate certain participant communications. Accordingly, operating a benefit plan requires investment expertise, administrative attention to detail, appropriate administrative resources, and familiarity with the legal requirements governing employee benefit plan operations.

Plan Fiduciaries

The plan administrator may be the only named fiduciary, or the plan may designate additional named fiduciaries for certain functions. Under Section 3(21) of ERISA, a “fiduciary” is anyone with discretionary authority or control over the administration of the plan, anyone with control over plan assets, and anyone who regularly offers investment advice for a fee with respect to the plan’s assets. Under Section 405 of ERISA, if there is more than one fiduciary, each fiduciary is responsible for the tasks assigned to it and will not be liable for the actions or omissions of the other fiduciaries, so long as the first fiduciary did not aid or enable the other fiduciary in committing or concealing a breach of fiduciary duty.

The plan administrator or other named fiduciary may hire additional fiduciaries, although fiduciary duties regarding investments cannot be delegated to anyone other than a named fiduciary, an investment manager qualified under Section 3(38) of ERISA, or the plan trustee.³⁰ In addition, the plan administrator usually retains one or more individuals or vendors to perform day-to-day tasks that do not require fiduciary authority or discretion. In either case, delegation is permissible, but the delegating fiduciary must act prudently when delegating.

Selecting Plan Personnel and Vendors

A plan requires human effort to operate. Some of the necessary support typically comes from the employer’s staff. Third-party vendors may agree to assume certain responsibilities, but the employer, an employee of the employer, or a committee of the employer’s employees typically acts as plan administrator and named fiduciary, and in that capacity is responsible for the selection of third-party vendors and the oversight of services by in-house staff.

When selecting a plan service provider, a fiduciary must be sure the provider is competent, and that any compensation paid to the

provider from the plan is reasonable.³¹ The latter has been a source of increasing concern, and regulations intended to provide fiduciaries (and participants in participant-directed defined contribution plans) with more information about plan costs and services went into effect in 2012.³² A plan's fiduciaries must know which vendors are subject to the disclosure rules and be sure all required information is provided, because significant liability can attach to a violation.³³ When they have the information, the fiduciaries should confirm that the disclosures align with their expectations, and revisit the plan's contracts periodically to be sure that the services promised remain appropriate for the plan and are being provided with acceptable quality for a reasonable price. As the plan's asset base increases, the plan typically can qualify for better prices and more extensive services.

Selecting the Named Fiduciary and Plan Administrator

By default, the employer will be the named fiduciary and plan administrator, unless the employer names someone else. Although it is common for the employer to retain both these roles, and many off-the-shelf documents effectively mandate this structure, the employer must understand the implications of holding these positions itself versus naming someone else.

The "plan administrator" is personally responsible for discharging the duties assigned to it. Failing to perform some of those duties, such as a failure to file the annual report (Form 5500) or to provide plan documents requested by a participant within 30 days, carries potentially significant financial penalties. Having the employer serve as plan administrator prevents individual employees from incurring these personal liabilities, but an employer wishing to appoint an alternative plan administrator can ameliorate that concern with appropriate insurance and indemnity coverage.

If the employer is named or acts as a plan fiduciary (including, but not limited to, situations in which the employer is the named plan administrator), the individual members of the employer's governing body typically are also fiduciaries, since they select the employees and vendors who carry out plan functions and hence are in the fiduciary chain of command.³⁴ Under Section 409 of ERISA, the individual members therefore have personal liability for the proper discharge of fiduciary duties. In this situation, the board should require periodic reporting on plan operations and investments, even if it has delegated the bulk of the day-to-day duties and investment discretion to others. If it does not do so, it may be in breach of its fiduciary duty to exercise appropriate oversight.

If the board is not prepared to accept that level of responsibility, the plan document should avoid identifying the employer as a fiduciary. If the plan document names the employer as a fiduciary, or fails

to name an alternative to the employer as a fiduciary, the employer (and its governing body) will have residual fiduciary liability even if the employer adopts a resolution, enters into a contract, or otherwise seeks to designate an alternative fiduciary, because the board remains in the chain of command. Providing in the plan document for a specified officer to name the members of the plan fiduciary committees and avoiding the assignment of any fiduciary duties to the employer places the responsibility to oversee the appointed fiduciaries with the officer.³⁵

If a defined contribution plan holds investments in employer stock, ensuring that board members, senior officers and other individuals likely to have inside information regarding the employer's business are *not* plan fiduciaries can help prevent potential conflicts between ERISA's requirement that fiduciaries act prudently in the participants' exclusive interest, on the one hand, and insider trading rules, on the other hand.³⁶ On a related note, since courts have also, when they deem the circumstances to warrant, permitted claims based on incorporation of inaccurate SEC filings into plan communications, even nonfiduciary corporate officers should understand the ERISA implications of any securities filings so incorporated.³⁷ Plan fiduciaries should be cautious about incorporating securities filings into ERISA documents and should identify any such documents accompanying or cited by ERISA communications as distinct from the ERISA communication.

Ministerial Service Providers

Nonfiduciary ministerial duties are split between the employer's own staff and one or more vendors, but the division of responsibility varies widely among different plans.

Participant-Directed Defined Contribution Plan Recordkeepers

A participant-directed defined contribution plan requires access to an investment trading platform and a way for participants to give instructions to the plan. Most participant-directed plans use a professional plan recordkeeper, which will arrange for professional custody of assets, process investment, contribution and distribution elections, and offer compliance support with respect to non-discrimination testing, government reporting, and participant disclosure. Recordkeepers usually offer plan documents preapproved by the IRS, and may provide some level of consulting services with respect to plan design, plan operation, and participant education.

Selecting the right 401(k) plan recordkeeper can be a key to the success of the retirement plan, particularly when the employer does

not have an involved and sophisticated in-house benefits staff. In all cases, the plan administrator must monitor the quality of the recordkeeper's overall performance, accuracy of administration, and the quality of the support provided to in-house staff and plan participants. The recordkeeper will generally be the face of the plan from the participants' perspective, so friendly and knowledgeable representatives should be a priority.

Especially in the case of a large plan, drafting a service agreement that encompasses quality control benchmarks and periodically auditing the recordkeeper's performance regarding Web site access, call center service, contribution processing, vesting monitoring, and so forth can help to ensure the expected quality of service. Even if a formal arrangement is not established, the plan administrator should set aside time periodically to consider the recordkeeper's performance and confirm that it remains satisfactory.

Other Vendors

Defined benefit plans and professionally invested defined contribution plans are more likely to be administered at least partially in-house. However, these plans typically receive some outside assistance as well. Benefits consultants may assist with testing or plan communications, for example, and a defined benefit plan will typically rely on actuaries to calculate benefits, or to review calculations produced by the plan.

Trustee

Under Section 403 of ERISA, a plan's assets must be held in trust, protected from the creditors of the employer.³⁸ A trustee can be given the authority to control plan investments (a "discretionary trustee"), or can be a "directed trustee" retained to act as directed by the plan's named fiduciary and to follow the investment elections of participants in a participant-directed plan).³⁹ A trustee generally must be an individual, or an institution with trust powers.

Investment Fiduciaries

A plan may retain one or more investment consultants or advisers, who offer investment recommendations but leave the final decision to the plan's trustee or named fiduciary. A plan may also or instead retain one or more investment managers or discretionary trustees to make investment decisions and oversee the plan's assets on a discretionary basis. The named fiduciary responsible for appointment of the investment professionals must, however, monitor their performance, and take action if they fail to meet appropriate standards.

Counsel

In accordance with the advice typically emblazoned on the front cover or near the signature line of mass-marketed plan documents, an employer should consult with counsel before setting up a retirement plan, and periodically during the life of the plan. An attorney with employee benefits experience can review the plan document with the employer to be sure the employer understands the implications of its design decisions (and to confirm the accuracy of a document conversion, if the employer is switching to a new plan document vendor),⁴⁰ review the summary plan description to be sure it meets legal requirements and accurately reflects the plan document, train the employer's staff who will serve as plan fiduciaries to understand their responsibilities and carry them out in accordance with best practices, review the service contracts for plan vendors, advise regarding resolution of the occasional problems or errors that are the inevitable corollary of operating a retirement plan, and offer other assistance as needed.

Counsel can also assist the plan fiduciaries in setting up a process that will facilitate prudent oversight of plan administration and investment, assist with the review of benefit claims, advise regarding defensive features such as contractual statutes of limitations and arbitration clauses, and meet with the fiduciaries regularly to help keep the fiduciary process functioning properly and ensure that fiduciaries are up to date on legal developments. It is, however, important for the fiduciaries to understand that their communications with counsel may not be privileged when it comes to matters involving the plan, since case law recognizes an exception to attorney-client privilege in a number of situations involving employee benefit plans.⁴¹

Keeping the Plan Operating

General Best Practices

Fiduciaries should meet at appropriate intervals to review plan investments, the performance of vendors, and various other aspects of plan administration (including participant communications and required filings). Since the most appropriate schedule for periodic reviews will vary depending on the size and complexity of the plan, the sophistication of in-house benefits staff, the level of support available from vendors, and other factors, counsel can help the plan fiduciaries set the most appropriate timeline for their activities. Many plans follow a quarterly schedule for fiduciary committee meetings, with one or more individuals tasked to notify the committee if circumstances require an interim meeting. For example, a committee may direct its investment adviser to monitor market developments and call an interim meeting when necessary, or may hold a special meeting to deal with a claim.

Special Issues Presented by Employer Stock

Section 404(a)(2) of ERISA exempts employer stock from the requirement that a plan's assets be diversified unless it is clearly prudent not to do so, although not from the general requirement that the plan be prudently administered. Courts therefore have held that investment in employer stock does not require the usual level of fiduciary scrutiny when a defined contribution plan document *requires* that such an investment be made. However, they differ in the details of the way they apply this "presumption of prudence" and the circumstances in which they consider fiduciary action to be necessary for the plan's protection notwithstanding an employer's mandate that the plan invest (or permit investment) in employer stock.⁴²

If the plan requires or permits investment in employer stock, special precautions are advisable. Steps should be taken to avoid conflicts between fiduciary obligations and insider trading rules. The fiduciaries should understand the evolving state of the law with respect to their obligations to oversee the employer stock investment, and if applicable also need to know how the presence of a plan document provision requiring investment in employer stock (or in the case of a participant-directed plan, requiring that employer stock be an available investment option) affects their obligations. Given the special risks associated with investment in a single stock, particularly when that stock's issuer also provides the employee's paycheck, fiduciaries would be well-advised to offer participant investment education and clear risk-disclosure documents.

As a corollary, fiduciaries need to bear in mind that if the employer stock is publicly traded, Section 401(a)(35) of the Code requires that participants be able to divest the stock (and that they have a sufficiently broad selection of alternatives), except in the case of ESOPs with no elective deferral or matching contribution components.⁴³ Participants must be informed of this right. More limited diversification rights apply in other situations involving plan ownership of employer stock, and fiduciaries must be sure those rules are properly administered, if applicable. If the plan is participant-directed, fiduciaries must maintain and communicate a confidentiality policy protecting participant employer stock investment and voting decisions in order to claim protection against liability for participant investment decisions.⁴⁴

CONCLUSION

Establishing and operating a retirement plan is not for the faint of heart, but it can be well worth the effort. Taking the time and hiring the expertise necessary to make the right decisions in the first place

is likely to pay dividends over the life of the plan, but periodic review of both plan design and plan administration is essential for the plan to accomplish the desired goals of providing retirement benefits to employees without unexpected liabilities for the plan sponsor and fiduciaries.

NOTES

1. See Deloitte, the International Foundation of Employee Benefit Plans (IFEBP) and the International Society of Certified Employee Benefit Specialists (ISCEBS), *Annual 401(k) Benchmarking Survey (2012 edition)* (last visited January 24, 2014) <http://www.deloitte.com/view/en_US/us/Services/consulting/human-capital/c9bd901987c5e310VgnVCM1000003256f70aRCRD.htm>.

2. Steve Nyce, *Attraction and Retention: What Employees Value Most*. Towers Watson Insider (March 2012) (citing Towers Watson 2011 Retirement Attitudes Survey) (last visited January 24, 2014) <<http://www.towerswatson.com/en-US/Insights/Newsletters/Americas/insider/2012/Attraction-and-Retention-What-Employees-Value-Most-March-2012>>.

3. Retirement plans offered only to a select group of management and highly compensated employees (often referred to as “top hat plans”) are exempt from ERISA’s fiduciary obligations and most of ERISA’s other requirements. Governmental plans, church plans, some 403(b) plans, and certain other arrangements also qualify for exemptions from some or all of ERISA’s requirements. This article focuses on broad-based plans subject to ERISA.

4. Internal Revenue Service, *Help With Choosing a Retirement Plan* <<http://www.irs.gov/Retirement-Plans/Help-with-Choosing-a-Retirement-Plan>> (last visited January 24, 2014).

5. Section 408(p)(2)(C) of the Code restricts SIMPLEs to employers with no more than 100 employees (taking into account all entities related under Section 414 of the Code) receiving at least \$5,000 in compensation during the year, and Section 408(p)(2)(D) of the Code prevents employers from sponsoring SIMPLEs if they also maintain other plans. SEPs are not size-restricted, but a larger employer generally will find the lack of flexibility and lower limits associated with a SEP reason enough to justify the added complexity of maintaining a full-fledged plan.

6. Section 408(p) of the Code requires a SIMPLE to satisfy one of two employer contribution designs, and generally prohibits amendment or termination of the contribution structure during the year. Both SEPs and SIMPLEs generally must cover all employees of the employer’s group, with only a few permitted exceptions.

7. The Pension Protection Act of 2006 authorized a “DB/401(k)” plan for smaller employers (no more than 500 employees), but these arrangements are uncommon. Likewise, Section 414(k) defined contribution accounts within a defined benefit plan are unusual.

8. Some plans can even reduce or eliminate contributions for past periods to the extent participants have not yet completed all the requirements to receive contributions. For example, if a plan requires participants to be employed on the last day of the plan year to receive a contribution, the employer could amend the plan at any point prior to that last day to reduce or eliminate the contribution. In contrast, if a plan provides for a contribution of a specified percentage of compensation for any

participant employed during the year, the employer could amend the plan to disregard all future compensation, but would have to make the contribution on compensation paid prior to the approval of the amendment.

9. ERISA §204(h); Code §4980F. 45 days is the normal advance notice requirement. Failure to provide a compliant notice results in an excise tax, and in egregious circumstances can invalidate the amendment reducing or freezing benefits.

10. *COLA Increases for Dollar Limitations on Benefits and Contributions* <http://www.irs.gov/Retirement-Plans/COLA-Increases-for-Dollar-Limitations-on-Benefits-and-Contributions> (last visited January 24, 2014). An individual's compensation will also limit the maximum permissible contribution or benefit.

11. An employer cannot require more than 1,000 hours of service in a specified 12-month period for a year of service. The hours can be measured by actual hours worked, or using certain assumptions set by regulations. The initial 12 months is measured from the employee's date of hire, and an employer can opt to measure subsequent 12-month periods from the anniversary of the date of hire, or to switch to the plan year (starting with the plan year beginning after the individual's date of hire). An employer that does not want to track hours can instead measure service on an "elapsed time" basis, so that an employee completes a year of service if employed for 12 months, counting periods of absence of less than a year. The elapsed time calculation rules can be complicated, particularly for employees who leave and are subsequently rehired. An employer must be sure it understands the way the calculation is required to work and that it tracks all covered service.

12. If the employer's plan is top heavy under Section 416 of the Code, the employer will not be able to use this option without making at least the minimum "top heavy" contribution.

13. Employers often draft their plans to exclude an individual not classified as an employee on the employer's payroll. Although this can be an important protection if the employer is later determined to be the common law employer of an individual paid through a third-party agency or as an independent contractor, this classification will not change the individual's classification for nondiscrimination testing or general tax purposes. Accordingly, proper classification of workers is important even when a plan contains this safeguard.

14. Generally, parents and subsidiaries with at least 80 percent common ownership are aggregated, as are businesses with the same five or fewer individuals, estates, or trusts as owners if certain requirements are met. Businesses owned by close relatives may have to be aggregated, depending on the circumstances. In addition, service or management oriented businesses with little or no common ownership but certain types of common operations or other entanglements may need to be combined. *See* Code Sections 414(b), (c) and (m).

15. As defined in Code Section 414(q) (employees with prior year compensation above specified threshold, or more than 5 percent ownership of the employer).

16. Defined benefit plans must also satisfy Section 401(a)(26) of the Code, which generally requires a plan to be available to the lesser of 50 employees or 40 percent of the employer's workforce.

17. Certain employees (most notably collective bargaining employees) can be disregarded for purposes of this nondiscrimination testing under Section 410(b) of the Code, making it easier to maintain a separate plan for these individuals or to exclude them from retirement plan participation entirely.

18. See *Employee Plans Determinations Quality Assurance Bulletin, Part-Time Employees Revisited*, FY 200 No. 3 February 14, 2006 http://www.irs.gov/pub/irs-tege/qab_021406.pdf (last visited January 17, 2014). Note that an employer can apply a year of service requirement (two years, with respect to participation in fully vested employer contributions) to a “temporary,” “part-time,” or similar classification even if other employees can participate sooner.

19. As with Section 410(b) of the Code, certain employees can be disregarded. Collectively bargained employees automatically pass nondiscrimination testing, with the exception of the ADP test under Section 401(k) of the Code, and thus can have their benefits negotiated separately.

20. Section 501(c)(3) organizations and public schools can utilize a Section 403(b) arrangement in lieu of a 401(k) plan. Governmental organizations can offer pretax and Roth deferrals under a Section 457(b) arrangement.

21. Generally, an hours-of-service requirement cannot require more than 1,000 hours of service, but a defined benefit plan can require a higher number for full benefit accrual if proportional accruals are available for employees with less than the full-accrual number.

22. *401(k) Compliance Check Questionnaire: a Review of the Interim Report, March 2012* <http://www.irs.gov/pub/irs-tege/401k_questionnaire_pboneforum_presentation.pdf (last visited January 24, 2014).

23. In the case of a defined benefit plan or a defined contribution plan subject to Section 412 of the Code (*i.e.*, a money purchase pension plan), normal retirement age generally cannot precede age 62, but an employer may be able to support use of an earlier age.

24. A defined contribution plan is required to follow the annuity rules if it is a money purchase pension plan (and thus subject to Section 412 of the Code), or if the employer has opted to design the plan to offer annuity payments. Money purchase pension plans are increasingly rare, since the tax advantages they previously had over other defined contribution plans were eliminated by the Economic Growth & Tax Relief Reconciliation Act of 2001. Many of these plans were merged into 401(k) plans. A plan is required to preserve the annuity distribution rules for the merged money purchase plan benefits even if the rest of the plan is not subject to those rules, but a plan with no money purchase pension plan benefits can cease to offer annuity options prospectively if the employer amends the plan to that effect.

25. See Code Section 401(a)(31)(B). A cash-out threshold of \$1,000 or less avoids the need to make arrangements for an automatic rollover IRA, but a higher cash-out threshold can reduce plan costs and the administrative hassle of missing participants by facilitating removal of small balances.

26. Defined contribution plans typically either provide for a 100 percent spousal annuity, or for a 50 percent spousal annuity and the participant's free choice of beneficiary for the remainder of the account. Defined benefit plans often limit preretirement survivor benefits to the mandatory 50 percent (or the higher percentage offered by the plan's qualified joint and survivor annuity, if applicable), but some are more generous. Cash balance plans, in particular, often base the survivor benefit on the participant's entire benefit rather than on a 50 percent calculation. Some defined benefit plans require reduction of a participant's benefit if preretirement survivor protections were in force prior to the participant's commencement of payment, but most do not.

27. See *Lifetime Income Options: Recent Revenue Rulings and Proposed Regulations* <http://www.irs.gov/Retirement-Plans/Lifetime-Income-Options---Recent-Revenue-Rulings-and-Proposed-Regulations> (last visited January 24, 2014).

28. See Robert Steyer, "DC Plans Still Hesitant About Lifetime Income," *Pensions & Investments* (October 28, 2013) <<http://www.pionline.com/article/20131028/PRINT/310289976/dc-plans-still-hesitant-about-lifetime-income>> (last visited January 24, 2014).

29. See, e.g., *Tatum v. R.J. Reynolds Tobacco Co.*, 392 F.3d 636 (4th Cir. 2004).

30. See Section 405(c) of ERISA.

31. Individuals receiving full-time pay from the employer cannot receive compensation from the plan. See ERISA Section 408(c)(2).

32. See 29 C.F.R. 2550.408b-2(c); 2550.404(a)-5.

33. Failure to provide reported disclosures, or failing to report a service provider's known violation of the disclosure requirements, is a violation of the "prohibited transaction" rules, and imposes personal liability and potential excise taxes on the involved service provider and nonreporting fiduciary. See 29 C.F.R. 2550.408b-2;(c) Code Section 4975.

34. See, e.g., *Carr v. Int'l Game Tech.*, 770 F. Supp. 2d 1080 (D. Nev. 2011); *Tittle v. Enron Corp. (In re Enron Corp. Sec. Derivative & ERISA Litig.)*, 284 F. Supp. 2d 511 (S.D. 2003).

35. Case law continues to develop in this area, but this technique is now in use. See the cases cited *supra*, n.34, for the proposition that only board members with fiduciary authority are fiduciaries. Companies and their boards should bear in mind, however, that fiduciary authority must be entirely assigned to the desired fiduciaries, with no retention of authority by the company. See *Harris v. Amgen, Inc.*, 738 F.3d 1026 (9th Cir. 2013). In addition, fiduciary status is governed by facts, not documents, so companies must be sure their conduct aligns with the intended fiduciary hierarchy. Companies also should take into account the potential impact of the doctrine of *respondeat superior*, which some (though not all) courts have applied in the ERISA context. See, e.g., *Howell v. Motorola, Inc.*, 633 F.3d 552 (7th Cir. 2011) (recognizing the doctrine); *In re Bank of Am. Corp. Sec., Derivative, & ERISA Litigation*, 756 F. Supp. 2d 330 (S.D.N.Y. 2010) (noting circuit split and citing cases; finding factual premise not established in any event); *Tool v. Nat'l Empl. Benefit Servs.*, 957 F. Supp. 1114 (N.D. Cal. 1996) (rejecting applicability of doctrine).

36. The courts have yet to reach a definitive resolution to the potential conflict between ERISA's requirement that fiduciaries operate the plan in the best interests of participants and the restrictions imposed by insider trading rules. Courts have agreed that fiduciaries are not required to seek out information and then violate the law by trading on it. See, e.g., *Rinehart v. Akers*, 722 F.3d 137 (2d Cir. 2013) (noting, however, that this was not a case in which fiduciaries had inside information arising from their employment duties). In contrast, courts have also allowed claims to proceed on the grounds that other solutions to problems known via insider knowledge (suspension of additional purchases, disclosure of the information, etc.) potentially should have been explored (see, e.g., *Harris, supra*, n.35).

37. See, e.g., *Dudenboefer v. Fifth Third Bancorp*, 692 F.3d 410 (6th Cir. 2012), *cert. granted* on separate issue 187 L. Ed. 2d 623 (2013).

38. An insurer can hold plan assets in lieu of a trustee, if desired.

39. Even a directed trustee is considered to have fiduciary responsibilities, albeit very limited ones. See Field Assistance Bulletin 2004-03 (December 17, 2004).

40. The author's personal experience indicates that the document conversion process is a frequent source of errors and misunderstandings. Even if the new vendor has selected the proper options in the new document to align with the old document, he or she often does not identify differences in features not designed as choices. For example, an employer's new document may automatically allow in-service distributions at normal retirement age, while the old one did so only if a box was checked to activate this feature (or vice versa).

41. See L.E. DesMarteau, "Employee Benefits Exceptions to Attorney-Client Confidentiality (and the Exceptions to the Exceptions)," *Benefits Law Journal* Vol. 23 No. 3 (Autumn 2010).

42. See generally Corey Rosen, "Recent Trends in Litigation Over Employer Stock in Defined Contribution Plans," *Pension & Benefits Reporter*, pp. 2280-2283 (September 24, 2013); Annemarie McGavin, "Recent Developments in Stock Drop Cases: *Moench* Presumption," *Tax Management Memorandum*, pp. 39-47 (2013). The US Supreme Court recently granted certiorari in *Fifth Third Bancorp v. Dudenhoeffer*, 187 L. Ed. 2d 623 (U.S. 2013).

43. Participants can be required to complete three years of service before the divestiture right activates, in the case of employer contributions. However, it is generally advisable from a liability perspective (and easier to administer) to permit participants to divest publicly traded employer stock at any time.

44. 29 C.F.R. §2550.404c-1(d)(2)(ii)(E)(4)(vii)-(viii).

The FSA Carry-Forward: Is It Fabulous or Is It Flawed?

Karen R. McLeese

One of the requirements of an Internal Revenue Code (IRC) Section 125 cafeteria plan is that there can be no deferral of compensation from one plan year to the other.¹ The only exception is when there is a health savings account component plan or a 401(k) component plan tied to the cafeteria plan. For this reason, flexible spending accounts (FSAs) have been subject to what has become known as the “use it or lose it” rule² wherein any unused account balance remaining at the end of the plan year is lost. In 2005, the IRS relaxed the use it or lose it rule by offering a grace period option for plans that permits up to a two-and-one-half month period following the close of the plan year in which claims can be incurred and paid.³ For years, Congress has toyed with the idea of further modifying this use it or lose it rule.

To that end, on October 31, 2013, the Internal Revenue Service (IRS) issued Notice 2013-71.⁴ This IRS guidance modifies the use it or lose it rule to allow up to \$500 of unused dollars to be carried forward and used in the next plan year.

One of the requirements of this carry-forward is that the health FSA plan cannot include a grace period during which claims can be incurred and reimbursed from prior year funds. A *grace period* is distinguished from a *run-out period* in that for a run-out period, no new claims can be incurred. The grace period in an FSA plan would have to be eliminated in determining whether a carry-forward or grace period is more appropriate. The employer, as an FSA plan sponsor, should remember that the carry-forward is limited to \$500 or such lesser amount if the plan prescribes; whereas, the carry-forward into the grace period can be the amount available in the unused account balance, which may be a larger number.

Notably, the amount carried forward does not reduce the \$2,500 (indexed for 2014) salary reduction cap imposed on FSAs.⁵

With this column, we welcome Karen R. McLeese as our new Federal Benefits Developments columnist. She is Vice President of Employee Benefit Regulatory Affairs for CBIZ Benefits & Insurance Services, Inc., a division of CBIZ, Inc. She serves as in-house counsel, with particular emphasis on monitoring and interpreting state and federal employee benefits law. Ms. McLeese is based in the Leawood, Kansas, CBIZ office.

Ordering of Payment

Only the carry-forward can be used to pay expenses from a prior plan year during the run-out period. A current-year election cannot be used to pay for prior year expenses. It may be prudent for the plan document to specify the ordering rule.

Health Savings Account (HSA) Conflicts

In assessing whether to adopt the carry-forward feature, it is important to remember that a general purpose FSA causes an individual to be ineligible for a health savings account (HSA).⁶ If a carry-forward is provided, the individual would remain HSA-ineligible for the entire FSA plan year, even if the carry-forward is spent down. It is unclear at this time whether a participant could elect to have the carry-forward placed in an HSA-compatible plan such as a limited FSA. Informal non-binding IRS comments indicate that this could be done. It is also been informally indicated that an individual could forfeit the right to the carry-forward in order to preserve the right to an HSA.

FSA-Excepted Plan Conflicts

It is unclear at this point what impact a carry-forward would have on an FSA's status as an excepted plan. In 2014 and beyond, an FSA must be excepted in order to be compliant with the market reform provisions of the Affordable Care Act.⁷ To be an *excepted FSA*, the FSA must:

- Only reimburse dental or vision expenses;⁸
- Cover fewer than two participants who are active employees;⁹ or
- Meet the maximum benefit test, that is, the maximum benefit available cannot exceed two times the salary reduction election; or, the salary reduction election plus \$500, whichever is greater. In addition, the FSA must meet an availability test, that is, the participants in the FSA must also be eligible for a health plan that is subject to HIPAA.¹⁰

Adopting the Carry-Forward Option

A plan wishing to avail itself of the carry-forward feature would have to be amended to terminate a grace period provision, if any,

prior to the end of the plan year to which it applies. There may be some risk in doing so, in that participants may have relied on using the grace period, which could result in a contractual or differential reliance challenge. The plan would then have to be further amended to provide for the carry-forward provision, in any amount up to \$500.

The carry-forward feature must be available to all FSA plan participants. Further, participants must be notified in advance of the change.

According to the IRS guidance, the plan must be amended prior to the end of the plan year to which the amendment applies, and the change must be made retroactive to the beginning of the plan year. Notice 2013-71 provides that an FSA plan commencing in 2013 can be amended in accordance with this guidance. A plan may be amended anytime prior to the end of the 2014 plan year, retroactive to the beginning of the 2013 plan year, as long as all of the conditions are satisfied.

Next Steps

- Review the FSA plan history. Are there significant forfeitures? If so, weigh the pros and cons of allowing the carry-forward versus the use of forfeitures for administrative expenses in accordance with the terms of the plan.
- Does the plan currently offer a grace period? If so, how has it been used? Weigh the pros and cons of implementing a grace period versus a carry-forward.
- Does the employer offer, or does it anticipate offering, HSA-compatible high deductible health coverage? If so, consider the implications of a carry-forward.
- Think about the excepted-FSA conundrum. Consider the importance of waiting for future guidance to ensure excepted-FSA status.
- If a carry-forward provision is adopted, then:
 - Amend the FSA plan to provide for it;
 - Eliminate the grace period, if applicable;
 - Provide the advance participant notice, and
 - Work out any administrative details with the FSA plan provider and payroll provider.

Notes

1. IRC § 125(d)(2)
2. Proposed Treas. Reg. § 1.125-5(c)
3. IRS Notice 2005-42, Modification of Application of Rule Prohibiting Deferred Compensation Under a Cafeteria Plan, published June 6, 2005.
4. IRS Notice 2013-71, Modification of “Use-or-Lose” Rule For Health Flexible Spending Arrangements (FSAs) and Clarification Regarding 2013–2014 Non-Calendar Year Salary Reduction Elections Under § 125 Cafeteria Plans, published October 31, 2013.
5. *Id.*
6. IRS Notice 2005-86, Health Savings Account Eligibility During A Cafeteria Plan Grace Period, published December 5, 2005.
7. DOL Technical Release No. 2013-03, Application of Market Reform and other Provisions of the Affordable Care Act to HRAs, Health FSAs, and Certain other Employer Healthcare Arrangements, issued September 13, 2013; and IRS Notice 2013-54, Certain other Employer Healthcare Arrangements, issued September 13, 2013.
8. Treas. Reg. § 54.9831-1(c)(3)(iii); DOL Reg. §2590.732(c)(3)(iii); HHS Reg. § 146.145(c)(3)(iii).
9. IRC § 9831(a)(2), ERISA § 732(a), and PHSA § 2721(a) (prior to amendment by PPACA). Treas. Reg. § 54.9831-1(b); DOL Reg. § 2590.732(b); HHS Reg. § 146.145(b).
10. Treas. Reg. § 54.9831-1(c)(3)(v); DOL Reg. §2590.732(c)(3)(v); HHS Reg. §146.145(c)(3)(v).

The Power of the Pen and the Decline of ERISA “Stock Drop” Class Actions

James P. Baker and Emily L. Garcia-Yow

Gandalf the Grey is not the only person who uses magic words. Lawyers ornament contracts with “boilerplate” phrases in the hope that the magic of shopworn phrases will ward off misfortune (lawsuits or, even worse, scary malpractice claims). The world of employee benefits is no different. Like other lawyers, we, too, have magic words. In the world of ERISA litigation, a 1989 US Supreme Court decision in *Firestone Tire & Rubber Co. v. Bruch* encouraged plan administrators to embed magic words within the terms of employee benefit plans so as to allow their decisions not to be second-guessed by a reviewing court. The Supreme Court explained that when an ERISA plan document gave the plan administrator the power to interpret the plan and to determine eligibility for benefits, a court reviewing an administrator’s denial was to defer to that decision unless the decision itself was arbitrary and capricious.¹

Once a company is hit with a class action lawsuit alleging violations under the Securities Exchange Act of 1934 due to a recent decline in that company’s stock price, it is likely that an ERISA class action will soon follow. These ERISA copycat class actions, commonly referred to as “stock drop” lawsuits, typically allege an ERISA Section 502(a)(2) statutory violation under the theory that fiduciaries—such as the company, members of the board of directors, or senior company officers—breached their ERISA fiduciary duty by continuing to invest in company stock when they knew or should have known it was no

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longer prudent to do so. A series of Circuit Courts of Appeals decisions indicate that although plan fiduciaries cannot immunize themselves entirely from ERISA stock drop class action fiduciary breach claims, they can take steps to ensure that their decisions about retaining company stock as a retirement plan investment vehicle are subject to *Firestone's* arbitrary and capricious standard of review.

Recent court decisions indicate that the key to unlocking the doors to the arbitrary and capricious standard of review (presumption of prudence) for the fiduciary decision to retain company stock in a retirement plan requires the retirement plan document to contain magic words.²

The Circuit Courts of Appeals have generally followed the Ninth Circuit's observation that "mere stock fluctuations, even those that trend downwards significantly, are insufficient to rebut the *Moench* presumption" that the decision to retain company stock in a retirement plan is prudent.³ So price gyrations alone do not state a claim. The developing law from the Circuit Courts of Appeals decisions is that a fiduciary has a duty to sell employer stock only when the fiduciary knows the employer faces imminent financial collapse or when the employer is experiencing a serious deterioration of its financial circumstances or other extreme circumstances.⁴ In *Moench v. Robertson*,⁵ the Third Circuit established what is now referred to as the "*Moench* presumption." The court held that "[a]n ESOP fiduciary who invests the assets in employer stock is entitled to a presumption that it acted consistently with ERISA by virtue of that decision. However, the plaintiff may overcome that presumption by establishing that the fiduciary abused its discretion by investing in employer securities."⁶ Fifteen years later, in *Quan v. Computer Sciences Corp.*,⁷ the Ninth Circuit adopted the "presumption of prudence" standard set forth in *Moench*. The court held that "when plan terms require or encourage [a] fiduciary to invest primarily in employer stock," that fiduciary is entitled to a presumption that he has been a prudent investor.⁸

In *Moench*, a drop in the price of company stock from \$18.25 to less than \$0.25 per share (a 99 percent decline) was not, by itself, enough to overcome the presumption of prudence.⁹ Similarly, in *Kuper v. Iovenko*,¹⁰ an 80 percent decline in value from \$50 per share to \$10 per share was rejected by the Sixth Circuit as insufficient.¹¹ In affirming the dismissal of a complaint, the Ninth Circuit in the *Wright* court found that the defendant fiduciaries were not imprudent by failing to allow plan participants to sell company stock when its price increased from \$23.44 per share to \$33.89 per share and then declined by roughly 75 percent to \$7.94 per share.¹² In *Edgar v. Avaya*,¹³ the Third Circuit followed the *Wright* court's rationale and dismissed the complaint, finding no fiduciary breach when the company's stock price fell by 25 percent, from \$10.69 to \$8.01, in one

day.¹⁴ A temporary 40 percent decline in the price of Reliant Energy, Inc. (REI), stock was also found by the Fifth Circuit to be an insufficient factual predicate to support the plaintiffs' imprudence claim.¹⁵ The Fifth Circuit explained:

Moench concluded it might have been imprudent for the fiduciaries to continue investing in company stock that steadily lost ninety-eight percent of its value over two years, falling from \$18.25 per share to \$0.25 per share. It was also relevant that the fiduciaries were aware of the company's impending collapse, and the employer ultimately filed for Chapter 11 bankruptcy protection. *Moench*, 62 F.3d at 557. In contrast to the company-wide failure evidenced in *Moench*, here Kirschbaum has alleged round-trip trading by a few employees and an initial drop in REI's stock value of approximately forty percent. There is no indication that REI's viability as a going concern was ever threatened, nor that REI's stock was in danger of becoming essentially worthless. This is a far cry from the downward spiral in *Moench*, and much less grave than facts other courts routinely conclude are insufficient to rebut the *Moench* presumption. As the Ninth Circuit has explained, "[m]ere stock fluctuations, even those that trend downward significantly, are insufficient to establish the requisite imprudence to rebut the *Moench* presumption." *Wright*, 360 F.3d at 1099.

Two recent cases demonstrate that whether the *Moench* presumption will apply depends on what the relevant plan says about company stock. The first case exemplifies what can happen when an ERISA-regulated plan fails to include language that "requires or encourages" investment in company stock. The second case shows how plan language was a powerful force in granting defendants' motion to dismiss plaintiffs' fiduciary breach claims.

Why the Words in the 401(k) Plan Really Matter: Harris v. Amgen

The plaintiffs in *Harris*¹⁶ were a class of participants in Amgen's 401(k) plans.¹⁷ The *Harris* plaintiffs had all made 401(k) plan investments in the Amgen Common Stock Fund.¹⁸

When a series of safety concerns were raised about an Amgen product and related marketing practices, the price of Amgen common stock plummeted.¹⁹ Plaintiffs sued, alleging breaches of fiduciary duty by Amgen, individuals on Amgen's board of directors, and the 401(k) plans' fiduciary committees.²⁰ Plaintiffs alleged that the defendants breached their fiduciary duty of prudence by permitting 401(k) plan participants to continue to invest in Amgen stock when the fiduciaries knew or should have known that Amgen stock was being sold to the 401(k) plan at artificially inflated prices.²¹ Defendants moved to

dismiss arguing that their decision to retain Amgen stock as a 401(k) plan investment was entitled to a presumption of prudence. The *Harris* plaintiffs' allegation that the price of Amgen stock temporarily declined could not overcome that presumption. The district court agreed and dismissed the complaint.²² The *Harris* plaintiffs appealed and the Ninth Circuit reversed.

The question before the Ninth Circuit was whether the plan "required or encouraged" plan fiduciaries to invest in Amgen common stock.²³ The relevant Amgen 401(k) plan language stated:

All contributions to the Plan made pursuant to Articles 4 and 5 shall be paid to the Trust fund established under the Plan. All such contributions shall be invested as provided under the terms of the Trust Agreement, which may include provision for the separation of assets into separate Investment Funds, including a Company Stock Fund.²⁴

Defendants did not argue that Amgen's language made Amgen stock a "required" 401(k) investment vehicle.²⁵ They nonetheless argued that they were entitled to the *Quan* presumption of prudence because the plans "encouraged" Amgen's fiduciaries to maintain a Company Stock Fund.²⁶

The Amgen fiduciaries set forth four arguments in support of their position.²⁷ First, they argued that the 401(k) plans only refer to Amgen common stock as a permissible investment.²⁸ The Ninth Circuit was not persuaded. The 401(k)'s language was not mandatory but permissive. It says the plan "may include" an Amgen Stock Fund. The Ninth Circuit cited the Second Circuit's reasoning in *Taveras v. UBS AG*,²⁹ as dispositive:

If the presumption of prudence was triggered in every instance where the EIAP plan document, as here, simply (1) named and defined the employer's stock in the plan document's terms, and (2) allowed for the employer's stock to be offered by the plan's fiduciaries on a discretionary basis to plan participants, then we are hard pressed to imagine that there exists *any* EIAP that merely offered the option to participants to invest in their employer's stock whose fiduciaries would not be entitled to the presumption of prudence.³⁰

Defendants next pointed to plan language that regulated the purchase, transfer, and distribution of Amgen stock and provided voting rights to Amgen stockholders.³¹ The Ninth Circuit found this unpersuasive and noted some of the plan language cited by defendants cut against their own argument.³² For example, one provision defendants cited subjected a participant's Amgen common stock holdings to a cap of 50 percent of their total holdings but no other funds had any such cap.³³ The Ninth Circuit was also not persuaded by the

defendants' argument that Amgen's 2008 Amendment stating Amgen stock would not be eliminated as an investment as a "too little and too late," argument.³⁴ The *Harris* complaint had been filed in 2007, a year before Amgen adopted the "no elimination" amendment.³⁵ Finally, the Court rejected defendants' argument that the plans "would have to have been amended in order to make Amgen stock unavailable to plan participants" finding that there was simply nothing in the plans that supported defendants' contention.³⁶

A simple statement in the plans that the Amgen Stock Fund was a permanent investment vehicle of the plan would have invoked the presumption of prudence. Because the Amgen 401(k) plan's language about the Amgen Stock Fund was permissive, the defendants' investment decisions about retaining Amgen Stock were found to be subject to *de novo* review.³⁷

Good Retirement Plan Language = Good Litigation ***Results: In re: SunTrust Banks, Inc.***³⁸

The plaintiffs, participants in SunTrust Banks, Inc. 401(k) Savings Plan (the plan) who held company stock in their accounts, filed suit alleging the 401(k) plan's fiduciaries were imprudent for retaining Company Stock as a 401(k) plan investment when SunTrust's stock price suddenly dropped.³⁹ Plaintiffs made the typical claim that the plan suffered hundreds of millions of dollars in losses because the plan's fiduciaries maintained the plan's investment in company stock when they knew or should have known that the investment was imprudent.⁴⁰ According to plaintiffs, SunTrust became wrapped up in subprime lending despite warnings from experts that there were risks associated with these relaxed lending practices.⁴¹ The nub of plaintiffs' complaint was that because of SunTrust's involvement in the subprime market, company stock was an overly risky and inherently imprudent investment option for the 401(k) Savings Plan.⁴²

The defendants moved to dismiss, which motion the district court promptly denied.⁴³ Thereafter, in a case involving similar "stock drop" allegations, *Lanfear v. Home Depot, Inc.*,⁴⁴ the Eleventh Circuit came to the opposite conclusion.⁴⁵ The Eleventh Circuit ruled that the Home Depot ESOP's language requiring Home Depot stock to be a permanent investment vehicle entitled the ESOP fiduciaries to a presumption of prudence.⁴⁶ In light of *Lanfear*, the *SunTrust* court granted the defendants' second motion to dismiss:

[a]lthough a fiduciary is generally required to invest according to the terms of the plan, when circumstances arise such that continuing to do so would defeat or substantially impair the purpose of the plan, a prudent fiduciary should deviate from those terms

to the extent necessary. Because the purpose of a plan is set by its settlors (those who created it), that is the same thing as saying that *a fiduciary abuses his discretion by acting in compliance with the directions of the plan only when the fiduciary could not have reasonably believed that the settlors would have intended for him to do so under the circumstances.*⁴⁷

Because *Lanfear* had not been decided at the time plaintiffs filed their complaint in *Sun Trust*, the court did not initially afford the Sun Trust fiduciaries with a presumption of prudence.⁴⁸

In granting Sun Trust's second motion to dismiss, the court found that the settlor "fully understood and approved of the fact that the ESOP component of the 401(k) plan was a high-risk investment for plan participants."⁴⁹ The district court cited to numerous examples of plan documents that demonstrate the settlor's intent.⁵⁰

For example, the plan's policy statement provided:

Ordinarily, the Committee should assume that retaining Employer Stock as a Plan investment within the Employer Stock Fund is reasonable and prudent. Ordinary stock price fluctuations and declines in the value of Employer Stock are to be expected and those conditions alone are generally not sufficient for an ESOP fiduciary to consider suspending or ceasing Employer Stock investments within the Employer Stock Fund.

If the Committee becomes aware of extraordinary circumstances that indicate that continuing to provide an Employer Stock as an investment alternative would be an abuse of discretion (e.g., if the Committee were to become aware that the Company's dire financial situation would likely cause it to cease being a viable going concern), then the Committee should seek outside counsel's assistance and advice as to carrying out its fiduciary duties with respect to Plan participants and beneficiaries.⁵¹

And the summary plan description described the employer stock fund in no uncertain terms:

The 401(k) Plan includes the [Employer] Stock Fund, which is an employee stock ownership plan ("ESOP"). This Fund provides another way for you to be a SunTrust stockholder, sharing in the financial rewards that your efforts help produce for the company. *Keep in mind, however, that investing in a single stock of one company is a high risk investment. Consider diversifying your account to avoid large losses.*⁵²

In light of this plan language, the district court concluded that "[t]he settlor understood the dangers inherent in the Employer Stock Fund and was willing to allow the fully-informed plan participants to

take that risk if they chose to do so.”⁵³ The Sun Trust plaintiffs’ claims were dismissed.

Harris and *SunTrust* teach us that an ounce of prevention is worth a pound of cure. Good 401(k) plan language stating that company stock is a permanent investment vehicle and will only be divested in the event of imminent financial collapse are the magic words plan fiduciaries must use to unlock the doors to the presumption of prudence.

Conclusion

The magic, is of course, only as good as the magician. Sometimes magic words don’t work. Ask Voldemort. Because the Supreme Court has not yet weighed in on the *Moench* presumption, uncertainty continues to haunt the sugar plum dreams of ERISA fiduciaries.

Notes

1. *Firestone Tire & Rubber Co. v. Bruch*, 489 U.S. 101, 115 (1989).
2. ERISA § 404(a), 29 U.S.C. § 1104(a), sets forth the standard of care that applies to fiduciaries.
3. *Wright v. Oregon Metallurgical Corp.*, 360 F.3d 1090, 1099 (9th Cir. 2004), citing *Moench v. Robertson*, 62 F.3d 553 (3d Cir. 1995).
4. 360 F.3d at 1098.
5. *Moench v. Robertson*, 62 F.3d 553 (3rd Cir. 1995)
6. *Id.* at 572.
7. *Quan v. Computer Sciences Corp.*, 623 F.3d 870 (9th Cir. 2010)
8. *Id.* at 881.
9. 62 F.3d at 557.
10. 66 F.3d 1451 (6th Cir. 1995).
11. *Kuper v. Iovenko*, 66 F.3d at 1451, 1459–1460.
12. 360 F.3d at 1095–1096, 1099.
13. 503 F.3d 340 (3d Cir. 2007).
14. 503 F.3d at 348–349.
15. *Kirschbaum v. Reliant Energy*, 526 F.3d 243, 255 (5th Cir. 2008).
16. *Harris v. Amgen*, 738 F.3d 1026, (9th Cir. 2013).
17. *Id.* at *3.
18. *Id.*
19. *Id.* at *17.
20. *Id.* at *19.

21. *Id.* at *22.
22. *Id.* at *20.
23. *Id.* at *25.
24. *Id.* at *26
25. *Id.* at *27.
26. *Id.*
27. *Id.*
28. *Id.*
29. *Taveras v. UBS AG*, 107 F.3d 436, 445 (2d Cir. 2013) (emphasis in original).
30. *Id.* at 1054.
31. *Id.* at **28-29.
32. *Id.* at *29.
33. *Id.*
34. *Id.* at *30.
35. *Id.*
36. *Id.*
37. *Id.* at *31.
38. *In re: SunTrust Banks, Inc., ERISA Litigation*, 2013 U.S. Dist. LEXIS 137954 (N.D. Ga. 2013).
39. 2013 U.S. Dist. LEXIS 137954 at *7.
40. *Id.*
41. *Id.* at *9.
42. *Id.*
43. *Id.*
44. *Lanfear v. Home Depot, Inc.*, 679 F.3d 1267 (11th Cir. 2012).
45. *Id.* at 12.
46. *Lanfear*, 679 F.3d at 1279.
47. *Id.* at *13, citing *Lanfear*, 679 F.3d at 1280 (emphasis supplied unless otherwise indicated).
48. *Id.* at **14–15.
49. *Id.* at *19.
50. *Id.* at **18–23.
51. *Id.* at **18–19.
52. *Id.* at *20.
53. *Id.* at **22–23.

EDITORIAL GUIDELINES FOR AUTHORS

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