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For Your Benefit

A newsletter on current legal issues impacting employee benefits and executive compensation

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Rollovers for Business Startup: On the Endangered List?

By Susan Foreman Jordan

Over the last few years, a strategy has been promoted whereby accumulations in 401(k) plans and/or IRAs are used as the source of financing business acquisition and startup. The strategy, which has been dubbed by the IRS as Rollovers for Business Startups (ROBS, for short) has been marketed, in particular, to individuals seeking to acquire franchise interests, but recent announcements by the IRS and Department of Labor have raised concerns as to the ongoing viability of the approach.

How It Works

The individual forms a new corporation; that corporation immediately implements a profit sharing or 401(k) plan. The individual then rolls into that new plan his accumulated account balance (either from an existing IRA or from the qualified retirement plan of his prior employer) and directs the investment of those rollover monies in stock of the new corporation. The corporation, in turn, uses the proceeds of the stock sale to fund the acquisition of the franchise and/or cover business startup costs. The expectation, of course, is that as the business begins to generate cash flow, the corporation will repurchase shares of stock from the plan, enabling the plan to diversify its investments. In the right circumstances, this strategy can be used quite effectively. For many who have seen their mid- or upper-level management positions eliminated and now are scrambling to re-establish themselves in business, accumulated retirement benefits are the most readily available source of financing.

Governmental Attacks

Because the strategy has been marketed so aggressively and somewhat indiscriminately, governmental agencies have sounded the alarm. In late May, both the Department of Labor and the IRS reiterated their concerns and announced they are developing new guidance addressing ROBS. Earlier IRS scrutiny resulted in the issuance, on October 1, 2008, of a formal memorandum directed to its reviewing agents. While the IRS acknowledged, at that time, not all of these ROBS transactions are necessarily non-compliant, agents examining them have been directed to apply specific guidelines focusing, in particular, on potential discrimination in operation and violation of the prohibited transaction rules.

Discrimination

These arrangements are ripe for claims of discrimination, in that they are designed to take advantage of a one-time-only stock offering, making it highly unlikely that employees, other than the original investor, will have an opportunity to acquire employer stock. This means the employer stock feature is one that will not be "effectively available" to all plan participants, as required by law.

Prohibited Transaction Issues

The prohibited transaction rules restrict various transactions between a qualified retirement plan and certain interested parties, including the employer and plan participants. An exemption from the prohibited transaction rules is available for acquisitions or sales of qualifying employer securities, provided that the acquisition or sale is for adequate consideration. To avoid allegations of self-dealing, a bona fide appraisal of the new company, which supports the transaction, is crucial. Admittedly, this is not the easiest task, inasmuch as one is being asked to project future business success and cash flow, but the credibility is questionable when the value placed on the venture is precisely equal to the available funds. The cost of such an appraisal can be considerable, so care and due diligence must be exercised in selecting an appraiser.

Another one of the prohibited transaction rules forbids a plan fiduciary from dealing with the assets of the plan in his own interest or his own account. The IRS notes that in many cases in which the plan invests in employer stock, the employer immediately pays the professional fees due to the promoter from the proceeds of the sale. If the promoter is deemed to be a fiduciary, the payment may result in a prohibited transaction.

Prohibited transactions are subject to excise taxes, which continue to compound and

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can escalate to 100 percent, unless and until unwound. If prohibited transactions continue unchecked, they can result in disqualification of the retirement plan and the loss of all tax deferral.

General Qualification Concerns

Apart from the discrimination and prohibited transaction concerns, the IRS also questions the legitimacy of many plans created under ROBS arrangements for alleged failure to satisfy general plan qualification rules. Among the requirements applicable to qualified retirement plans is permanence; that is, the plan sponsor must intend that the plan will remain in existence for an indefinite period of time, with substantial and recurring contributions. If the only contribution made to the retirement plan is the initial rollover, it is difficult to argue that the permanency requirement has been satisfied. Unless, within a short time after the plan is established, there are other plan participants, the entire transaction may be perceived as a sham and the principal taxed as if he or she had withdrawn all of the funds from the IRA and then reinvested them. Obviously, special care should be taken to assure the plan documents and administration conform, in all respects, to the requirements of law, and all of the formalities of corporate structure are observed.

The Future of ROBS

Thus far, there is no indication that ROBS transactions will be barred completely, but it is likely that the rules will be tightened. Professional guidance will remain essential to determine *when* it is appropriate and advisable to employ the strategy and *how* to do so in a manner most likely to withstand IRS scrutiny and avoid unintended tax consequences.

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ESOPs: The Undiscovered Estate Planning Tool

By Harvey M. Katz

Business owners, like most other baby boomers, will be retiring in large numbers in the next 10 to 15 years. However, few have considered the effect of supply and demand when it comes time to sell their businesses. Simply put, demographic trends are likely to result in more sellers than buyers with commensurate decreases in sale prices. As a result of these trends, Employee Stock Ownership Plans (ESOPs) are a more viable alternative than ever as a business succession technique, and one that should be seriously considered by every business owner contemplating retirement.

In concept, a sale to an ESOP is simple. Instead of the owner selling his business to a third party, a business owner sells to a trust established and operated by the company. In order to purchase the shares, the plan borrows from a financial institution or from the business owner himself. The shares of the company serve as collateral for the loan. As the company continues to operate, it makes contributions to the ESOP and the loan is repaid. As the principal of the loan is reduced, part of the collateral is released and allocated to the accounts of participants. With few exceptions, participation may be extended to all of the non-union employees of the company. However, the ESOP may be structured so employees never directly own company shares and are never entitled to access to the company's finances.

In order to encourage broader employee ownership, Congress has enacted powerful tax incentives for employers that establish ESOPs and for the owners who sell their shares to ESOPs. In a properly structured transaction, the owner can avoid payment of capital gains tax that would normally occur upon the sale of the business. The values of this incentive will be enhanced when the capital gains rates rise in 2011. In addition, both principal and interest on the loan to purchase the company is repaid with pre-tax dollars because the repayments are made by the ESOP itself, which is funded with tax-deductible company contributions. In other words, the government is paying 40 percent of the cost of the sale in the form of enhanced tax deductions. But that is not the end of the tax benefits. Once the ESOP owns all of the stock in the company, it can elect Subchapter S status. By doing so, the company can pass through its profits to its tax-exempt ESOP shareholder and operate as a tax-free company.

With all of the available tax incentives, it is surprising that ESOPs are not more common. In all probability, it is because the benefits of selling company shares to an ESOP are not widely known or understood by business owners and their business advisors. Undoubtedly, ESOPs are subject to numerous statutory and regulatory requirements. A sale of company stock to an ESOP must be handled as an arm's length transaction. However, the complexity should not necessarily deter a business owner from implementing an ESOP if it is the correct strategy. However a set of knowledgeable professionals are a must for any company interested in adopting an ESOP.

So when should an ESOP be considered by a business owner? There is no one-size-fits-all answer to that question, but the following factors should be considered:

- The company should have a management team or at least two to three individuals (other than the owner) capable of transitioning the role of operating the company.
- The company should be of a sufficient size (usually, minimum of $2 million value).
- The current owner(s) want to remain involved in the business and slowly transition to less active status.

- The owner is psychologically able to relinquish control of the business.
- The owner wants to reward employees for their loyal years of service by giving them control over the business.
- The business has been profitable in recent years and/or has strong prospects of achieving and maintaining profitability in future years.
- The company has a workforce that would be incentivized by ownership in the company.

Again, the factors listed above are not a comprehensive list, and no one factor or set of factors is determinative as to whether an ESOP is appropriate. What is clear is that most business owners contemplating retirement in the next five to 10 years should consider whether an ESOP is right for them. Fox Rothschild's Employee Benefits & Compensation Planning Practice Group is thoroughly familiar with ESOPs and ready to assist any business owner contemplating a sale.

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Supreme Court Decision on the Award of ERISA Attorneys' Fees

By Seth I. Corbin

A recent Supreme Court decision established a new standard for the award of attorneys' fees and costs in an ERISA action. In *Hardt v. Reliance Standard Life Ins. Co*, a disability claimant was entitled to attorneys' fees when she achieved "some degree of success on the merits" of her case. Previously, the standard for the award of attorneys' fees in an ERISA action was founded on the premise that only a "prevailing party" could be entitled to such an award.

Facts

In 2003, Bridget Hardt stopped working for Dan River, Inc. after developing carpal tunnel syndrome. Shortly thereafter, she applied for long-term disability benefits under Dan River's group long-term disability plan. Reliance Standard Life Insurance Co., the insurer, initially granted disability benefits for 24 months; however, Reliance ultimately denied her claim for permanent benefits as totally disabled and informed Hardt her benefits would expire at the end of the 24-month period.

As required under ERISA prior to filing a lawsuit, Hardt exhausted her administrative remedies under the plan before filing suit in a federal district court alleging that Reliance had violated ERISA by wrongfully denying her benefits claim. The district court denied Reliance's summary judgment motion, finding Reliance had acted on incomplete medical information and the benefits denial was not based on substantial evidence. However, the district court also denied Hardt's summary judgment motion, although the court found "compelling evidence" in the record that Hardt was totally disabled and was inclined to rule in her favor. Instead, the district court chose to give Reliance a chance to address the deficiencies in its approach. The court remanded the case to Reliance, giving it 30 days to consider all the evidence and give Hardt the review to which she was entitled under the law. After conducting that review, Reliance found Hardt eligible for long-term disability benefits and paid her $55,250 in accrued, past-due benefits.

Soon thereafter, Hardt filed a motion for attorneys' fees and costs under ERISA Section 502(g)(1), which provides discretionary authority to award attorneys' fees to either party. The district court granted the motion, determining she was a prevailing party, and awarded her $39,149 in attorneys' fees and costs.

Reliance appealed the award, and the Court of Appeals vacated the fees award, holding Hardt failed to establish she was a "prevailing party." The appellate court relied on a recent Supreme Court decision, which found that a fee claimant is a prevailing party only if she has obtained an "enforceable judgment on the merits" or a "court-ordered consent decree." The Court of Appeals reasoned that the district court's remand order did not constitute an enforceable judgment on the merits since the order did not require Reliance to award Hardt benefits and, therefore, it precluded Hardt from establishing prevailing party status. Hardt then filed a petition for a writ of certiorari, asking the Supreme Court to review the lower court's decision.

New Standard

In evaluating whether ERISA limits the award of attorneys' fees to a prevailing party, the Supreme Court stated it must enforce the plain and unambiguous language of ERISA Section 502(g)(1). The Court noted nowhere in ERISA, nor in ERISA's legislative history, is there any reference to the prevailing party standard. Accordingly, the Supreme Court ruled the lower court's failure to interpret the statute on its face, and its decision to add the "prevailing party" term to its interpretation of the statute, represented inventing a statute rather than interpreting one. As such, the Court made it clear that a party seeking fees does not need to be a prevailing party in order to be eligible for an award of attorneys' fees under Section 502(g)(1) and must simply establish "some success on the merits."

Conclusion

The Supreme Court's decision in *Hardt* establishes a new standard for the award of attorneys' fees in ERISA litigation. Going forward, litigants should be aware the "prevailing party" standard will no longer be applied in awarding fees. Rather, a party may be entitled to fees by simply achieving some degree of success based on the party's position.

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Sixth Circuit Expands Use of Estoppel Against Pension Plans

By Brian D. Sullivan

In May, the U.S. Court of Appeals for the Sixth Circuit held that a pension plan participant can invoke equitable estoppel in certain circumstances where the participant has received incorrect information about his benefits from those responsible for administering the plan. Equitable estoppel is the legal principle that protects one party that relied on another party's misrepresentations. In so ruling, the court joins the Second, Third, Fifth and Ninth Circuits in permitting the use of estoppel in the pension context. As a result, pension plan sponsors and administrators may find it more difficult to enforce the terms of the plan as written in instances where participants have received conflicting advice from plan officials.

The case is *Bloemker v. Laborers' Local 265 Pension Plan*. In 2005, after participating in the plan for nearly 28 years, the plaintiff contacted the plan office to discuss early retirement. In response, the plan sent him an application form that certified he was entitled to receive the retirement benefits described in the application materials.

The plaintiff decided to retire early on the basis of the written advice received from the plan. He completed the application form and began receiving benefits in the amount certified by the plan. Approximately 18 months later, the plan informed him that it had conducted an audit and discovered an error in the software used to compute benefits. The plaintiff's pension benefit had been calculated incorrectly. The plan reduced the plaintiff's monthly benefit and sought repayment of the excess amounts he had received. After exhausting his administrative remedies, the participant filed suit against the plan, its board of trustees and its third-party administrator. The court upheld the dismissal of the plaintiff's contract and breach of fiduciary claims but held that he could proceed with his equitable estoppel claim.

The court held that a pension plan participant can invoke promissory estoppel if he can show:

(1) Intended deception or gross negligence on the part of the plan;

(2) A written representation from the plan;

(3) Plan provisions that, although not ambiguous, do not allow for individual calculation of benefits; and

(4) Extraordinary circumstances in which the balance of equities strongly favors the application of equitable estoppel.

While the court had previously recognized equitable estoppel as an appropriate remedy in the context of welfare benefit claims, it had been reluctant to do so with claims for pension benefits. This reluctance stemmed from a concern for the actuarial integrity of pension plans and a concern that altering the terms of a plan based on transactions between officers of the plan and individual participants might prejudice the rights and legitimate expectations of other plan participants to retirement income. After considering recent decisions from other circuits, however, the court concluded these policy concerns are outweighed in situations where the representation at issue was made in writing and where the plaintiff can demonstrate extraordinary circumstances. The ruling will permit some pension plan participants to prevail on estoppel claims even where it will result in the participant receiving benefits in an amount contrary to the unambiguous terms of the plan documents.

The court did not elaborate on what will be required to prove all of these elements, but it did find the plaintiff had alleged facts in his complaint that, if true, would enable him to prevail and compel the plan to continue paying him the amount stated by the plan when he retired. There will be few, if any, situations in which plan sponsors and administrators are found to have deliberately misled a participant.

Accordingly, participants will need to show gross negligence to meet the first element of an estoppel claim. In this instance, the plaintiff alleged that the plan officials were aware of the correct facts and intended that he rely on their misrepresentation.

Similarly, it is unclear in what circumstances a court will find the written terms of a plan do not allow for individual calculation of benefits. The plaintiff in this case alleged that, given the complexity of the actuarial formulas on which his pension was based, it would have been "impossible" for him to calculate the benefit himself.

Following the lead of other federal appellate courts, the Sixth Circuit stated that in addition to satisfying the usual elements for an estoppel claim, a plaintiff must also show exceptional circumstances. It is not enough that a plaintiff reasonably relied on a written misrepresentation and suffered detriment as a result. A plaintiff seeking to invoke estoppel against a pension plan must show something more – a balancing of the equities that strongly favors the plaintiff. This requirement will give the courts some flexibility as they develop standards for the application of estoppel in the pension context. The court found the case before it presented exceptional circumstances, perhaps because the benefit calculation at issue had been certified by the plan's third-party administrator or because the participant had left the workforce and retired in reliance on the misrepresentation.

There appears to be a distinct trend away from the traditional rule that prevented pension plan participants from relying on misrepresentations about their benefits. Only the Fourth Circuit has expressly ruled that estoppel cannot be used against pension plans. Given the increasing receptiveness of the federal courts toward estoppel claims, plans may find it more difficult to disregard misrepresentations made to plan participants and especially difficult to reduce a retiree's monthly

pension benefit once it is in pay status. Plan sponsors and administrators seeking to avoid estoppel claims should step up their efforts to prevent the errors that lead to such claims, by testing the software and other procedures used to compute benefits and by taking steps to protect the integrity and accuracy of the data relied upon in computing benefits.

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Pension Relief Signed Into Law Under "Preservation of Access to Care for Medicare Beneficiaries and Pension Relief Act of 2010"

By Daniel N. Kuperstein

On June 25, President Obama signed pension funding relief into law under the Preservation of Access to Care for Medicare Beneficiaries and Pension Relief Act of 2010. (Pub. L. No. 111-192). The new law applies to both single and multiemployer defined benefit plans. Such plans have seen their assets decline significantly since the 2008 economic downturn.

Under the new law, employers with such plans are given extensions of time to amortize pension funding shortfalls. The law also provides funding relief for eligible charity plans; extends the relief in the Worker, Retiree and Employer Recovery Act of 2008; and enacts measures dealing with Medicare payments to physicians.

Funding Relief for Single-Employer Plans

Under the new law's provisions relevant to single-employer plans, with certain exceptions, employers are offered to take one of two options for pension funding relief. Each option provides a way for employers to lower their annual required minimum contribution under the Pension Protection Act of 2006. The required minimum contribution is based, in part, on the difference between the assets and liabilities of the plan for a given plan year. The "shortfall amortization base" is a portion of this funding shortfall of the plan. Prior to the new law, the shortfall amortization base was generally amortized over a seven-year period.

The new law allows employers to change the amortization schedule of the shortfall amortization base in one of two ways. Employers can either: (1) change the amortization schedule to a "two plus seven" amortization schedule; or (2) extend the amortization schedule to a 15-year schedule. Under the "two plus seven" schedule, employers are allowed to pay interest-only payments for two years, after which a seven-year amortization schedule applies.

One drawback for employers, however, is that employers that adopt either of these types of relief must contribute extra money to the plan if they paid certain kinds of "extraordinary" payments or "excess" compensation to certain employees, such as payments in excess of $1 million.

Funding Relief for Multiemployer Plans

Under the new law, multiemployer plans that meet a certain "solvency" test are allowed to elect to treat the portion of any experience gain or loss attributable to "net investment losses" incurred in either or both of the first two plan years ending after August 31, 2008, as an item separate from other experience losses.

This portion of gain or loss is to be amortized in equal yearly installments over a period beginning with the plan year in which such portion is first recognized in the actuarial value of assets and ending with the last plan year in the 30-plan year period beginning with the plan year in which such net investment loss was incurred.

Although the new law is important to employers with both types of plans, it comes at an especially opportune time for employers with multiemployer plans. A recent report by the National Coordinating Committee for Multiemployer Plans, called the "NCCMP 2009 Survey of the Funded Status of Multiemployer Defined Benefit Plans," found the value of multiemployer plan assets declined by an average of 22.1 percent from the beginning of 2008 to 2009.

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Form 5500 Alert: Filing Deadline Extended for New Form 8955-SSA

By Susan Foreman Jordan

Until this year, plan administrators have used Schedule SSA of Form 5500 to report participants who separate from service with deferred vested benefits. Schedule SSA has been eliminated, beginning with returns for the 2009 plan year, because that form cannot be filed through the new EFAST2 electronic filing system, and the IRS had intended a new form, Form 8955-SSA, would replace Schedule SSA.

Due to delays in the release of the new form, the IRS just announced, in a special edition of *IRS Employee Plan News*, that plan administrators will not be required to file Form 8955-SSA for the 2009 plan year until the form, instructions and additional guidance are issued. It is expected the guidance will establish a special due date, presumably in 2011, for the 2009 Form 8955-SSA.

The information to be reported on the new form will be similar to that previously required by Schedule SSA. The IRS has indicated that reasonable time will be accorded to plan administrators, after the Form 8955-SSA and related instructions are made available, to complete and file the form by the special due date.

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