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For Your Benefit

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

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The Final Fee Disclosure Rules Finally Arrive

By Harvey M. Katz and Daniel N. Kuperstein

Earlier this month, the Department of Labor (DOL) released the long-awaited final service provider fee disclosure regulation under Section 408(b)(2) of ERISA.

Section 408(b)(2) of ERISA sets forth an exemption from ERISA's so-called "prohibited transaction" rules enabling service providers to perform multiple services for ERISA-covered retirement plans. In general, to qualify for the exemption, service providers must disclose the nature and cost of their proposed arrangement. In recent years, the DOL became increasingly concerned that the existing regulations were not sufficient to ensure that all fees were disclosed in a manner that would enable plan fiduciaries to make informed decisions, particularity in light of the proliferation of fee sharing arrangements.

The redesigned 408(b)(2) regulation requires covered service providers receiving direct or indirect fees from a plan to make written disclosures of their services, their status with respect to the plan and the amount of their direct and indirect compensation. The DOL initially proposed the regulation in 2007 and then released it as an interim final regulation in July 2010.

In the 2010 release, the DOL invited comments on several issues, and it was widely anticipated that amendments would be made to the regulation. Among the most important changes in the final 408(b)(2) regulation are the following:

- Extension of the deadline for providing the covered disclosures by three months, from April 1, 2012, to July 1, 2012.
- Clarification that service providers are not required to provide a summary of the disclosures (although the DOL did provide a "Sample Guide" as an appendix to the final rule to encourage service providers to assist plan fiduciaries with their review of required disclosures).
- The addition of a requirement to describe to a specified "responsible plan fiduciary" the arrangement between the service provider and payer of indirect compensation.
- Clarification that electronic disclosure of the required disclosures is permitted.
- Relief from the disclosure requirements for certain 403(b) contracts.
- Changes to the disclosure requirements with respect to certain investment-related disclosures.
- The addition of a requirement that plan sponsors terminate the relationship with a service provider that fails or refuses to provide information on request.

The last requirement noted is somewhat unexpected and is likely to have a significant effect upon fiduciary conduct. Fiduciaries that do not terminate arrangements with non-compliant providers will face exposure to DOL enforcement activities, as well as participant lawsuits, and potential liability for prohibited transaction excise taxes. Many industry practitioners agree that the 408(b)(2) regulation is one piece – albeit a rather large, landscape-shifting piece – of a larger effort by the DOL and the Securities and Exchange Commission to regulate hidden fees and other self-interested and conflicted arrangements between retirement plans and their service providers.

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ERISA Lawyers: The Exceptionally Privileged Few

By Mark H. Hess and Brian D. Sullivan

Many litigators take two things for granted beyond death and taxes: first, that under the attorney-client privilege, they can freely communicate with their clients either electronically or in writing without fear of having to turn over their communications to other parties in litigation; and second, that under the attorney work-product privilege, the notes or memoranda created by the attorney need not be produced at the request of an opposing litigant. However, those who have handled ERISA fiduciary litigation matters recently might have learned that blind faith in the efficacy of these privileges may lead to disaster in the courtroom and to uncomfortable conversations with malpractice carriers.

Attorney-Client Privilege

The attorney-client privilege shields from third parties confidential communications between an attorney and client for the purposes of seeking and obtaining legal advice. It is the oldest of the privileges for confidential communications known to common law. Its purpose is to encourage full and frank communication between attorneys and their clients and thereby promote broader public interest in the observance of law and administration of justice. The privilege recognizes that sound legal advice or advocacy serves public ends and that such advice or advocacy depends upon the lawyer being fully informed by the client

Attorney Work-Product Privilege

In *Hickman v. Taylor*, 329 U.S. 495 (1947), the U.S. Supreme Court recognized the attorney work-product privilege, whereby information obtained or produced by or for attorneys in anticipation of litigation may be protected from discovery under the Federal Rules of Civil Procedure. The privilege enables attorneys to prepare for and pursue litigation without fear that their strategy and preparation will be available to their adversaries. The plaintiff in *Hickman* sought, without asserting necessity or justification, to secure written statements, private memoranda and personal recollections prepared or formed by an adverse party's counsel in the course of his legal duties. As such, the court held that it falls outside the arena of discovery and contravenes the public policy underlying the orderly prosecution and defense of legal claims. In performing his or her various duties, however, it is essential that a lawyer work with a certain degree of privacy, free from unnecessary intrusion by opposing parties and their counsel.

Fiduciary Exception to Privileges

In *Riggs Nat. Bank of Washington, D.C. v. Zimmer*, 355 A. 2d 709 (Del. Ch. 1976), which has been followed in the federal circuit courts of appeal, the Delaware Chancery Court held that trust beneficiaries could compel trustees to produce a legal memorandum related to the trust's administration because: (1) the trustees had obtained the legal advice as "mere representative[s]" of the beneficiaries, who were the "real clients" of the attorney; and (2) the fiduciary duty to furnish trust-related information to the beneficiaries outweighed the trustees' interest in the attorney-client privilege. The court relied on well-established English common law that when a trustee obtained legal advice to guide his trust administration - and not for his own defense in litigation - the beneficiaries were entitled to the production of documents related to that advice on the rationale that the advice was sought for their benefit and obtained at their expense in that trust funds were used to pay the attorney.

Application to ERISA Litigation

The rationale of the *Riggs* decision has been held applicable in the ERISA litigation context. See, e.g., *In re Long Island Lighting Co.*, 129 F.3d 268 (2d Cir. 1997); *Wildbur v. Arco Chem. Co.*, 974 F.2d 631 (5th Cir. 1992); and *Geissal v. Moore Med. Corp.*, 192 F.R.D. 620 (E.D. Mo. 2000). When an ERISA fiduciary seeks legal advice, she typically does so in carrying out her duties as a fiduciary, and thus is seeking legal advice on behalf of the plan participants and their beneficiaries. Thus, the fiduciary exception applies in such circumstances and allows a litigating participant to obtain the substance of such communications between a fiduciary and an attorney because the attorney-client and attorney work-product privileges are outweighed by the need of the plan participants and beneficiaries to have the otherwise protected information. The exception does not apply, however, to settlor functions, such as decisions to establish or terminate a plan, or to advice sought by a fiduciary in connection with the fiduciary's personal defense of a breach of fiduciary duty claim. Thus, a fiduciary who is accused of having breached her fiduciary duties may consult with an attorney in defending against such allegations, and her communications with her attorney should be privileged. (In such circumstances, however, the fiduciary should consult counsel other than the attorneys representing the plan in order to avoid conflicts of interest.)

Whether the participants and beneficiaries have to prove they have good cause for obtaining the information is in dispute, but a number of courts have held that good cause is not required in light of the rationale for the exception. At least one court, in *Donovan v. Fitzsimmons*, 90 F.R.D. 583 (N.D. Ill. 1981), has also found that, in litigating alleged breaches of fiduciary duty, the U.S. Department of Labor effectively steps into the shoes of the plan participants and beneficiaries, entitling the federal agency to obtain documents that would otherwise be protected by the attorney-client and work-product privileges.

Recent Litigation Interpreting the Exception

These ERISA exceptions were interpreted and applied recently in *Carr v. Anheuser-Busch Companies*, Civ. Action No. 4:10-CV-1729, an unreported 2011 decision in the

United States District Court for the Eastern District of Missouri. Mr. Carr was a former Anheuser-Busch employee whose employment had been involuntarily terminated. Mr. Carr brought suit under ERISA after his former employer denied his claim for severance benefits on the grounds that his termination was for "willful misconduct in violation of company policy." The District Court decision resolved a dispute between the parties regarding whether the former employer would be required to produce certain documents in discovery relating to the denial of his claim for severance benefits.

The plaintiff sought production of certain e-mails regarding his claim that had been exchanged between the plan administrator and an associate general counsel in the defendant's legal department. The first e-mail was sent by the attorney while the plan administrator was adjudicating the plaintiff's administrative appeal of the initial denial of his claim for severance benefits. It contained general guidance from the attorney for use by the plan administrator while reviewing the appeal of the denied claim. The second set of e-mails had been generated approximately two months later, after a determination had been made to deny the appeal, but before this denial had been communicated to the plaintiff. This second set of e-mails did not contain advice as to the general procedural duties owed to each beneficiary, but rather related to the substantive merits of the plaintiff's specific claim for severance benefits and the content of the final decision letter denying the severance benefits that was to be transmitted to the participant.

After conducting an in-camera review of the documents in dispute, the court directed the defendant to produce the first e-mail, but held that the second set of e-mails was protected by the attorney-client privilege. With respect to the first e-mail, the court determined that it is related directly to how the plan administrator interprets and conducts the appeals procedure contained in the severance plan and did not constitute advice to the plan and its beneficiaries as parties adverse to the plaintiff. Rather, the court concluded that the first e-mail constituted advice to the plan administrator as to the fiduciary duties owed to all beneficiaries, including, but not limited to, the plaintiff.

The court distinguished the second set of e-mails and held that they were protected from disclosure under the attorney-client and work-product privileges. Unlike the first e-mail, the second set of e-mails related to the substantive merits of the plaintiff's individual claim and the content of the final decision letter denying the severance benefits he was seeking. At that point, the decision to deny the plaintiff's appeal had already been made and the plaintiff's only recourse was litigation. The court concluded that the second set of e-mails was protected from disclosure under the attorney-client and work-product privileges because, by the time they were prepared, the plaintiff's interests had become sufficiently adverse to those of the plan administrator.

Conclusion

As noted above, the court in *Carr* conducted an in-camera review of the disputed documents, and it is likely that the specific content of those documents informed the court's decision regarding disclosure of their contents. The authors caution that not all federal judges may be as protective of the interests of plan fiduciaries as was the case in *Carr*.

Fiduciaries and attorneys providing advice to plan fiduciaries should proceed with caution and assume that communications regarding their administration the plan, including their adjudication of specific claims, will be subject to disclosure. Accordingly, trustees and other fiduciaries should remain ever mindful that, when acting as fiduciaries, they must act solely in the interest of the participants and beneficiaries of the plan and disregard other considerations. If the fiduciary and her advisor proceed in this matter, their communications will reflect this fact and disclosure of such communications will be of less concern.

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The Tax Man Cometh for 2010 In-Plan Rollovers

By Susan Foreman Jordan

If you were one of many who took advantage of the special tax treatment available for in-plan Roth rollovers in 2010, now is the time to pay the piper! Thanks to a special tax rule that was made available to in-plan Roth rollovers occurring in 2010 (after September 27), one-half of the taxable income realized by virtue of the rollover is includable in your gross income for 2011, and the other half will be includable in 2012 (unless you elected to report all of the income on your 2010 return).

The entire taxable amount resulting from the in-plan Roth rollover, and the amount subject to tax in each year, should have been reported on a Form 8606 (Part III) filed with your 2010 return. The IRS recently issued guidance as to how to handle the reporting on your 2011 and 2012 returns.

If no part of the in-plan Roth rollover was distributed to you in 2010, the amount shown on Line 25(a) of the 2010 Form 8606 is to be reported on Line 16(b) of your 2011 Form 1040. On the other hand, if any part of the 2010 in-plan Roth rollover was distributed to you in 2010 and reported on your 2010 tax return, then you are to report on Line 16(b) of your 2011 Form 1040, the lesser of (a) the amount from Line 25(a) of the 2010 Form 8606, or (b) the remaining taxable amount of the 2010 in-plan Roth rollover.

If you received a distribution from the in-plan Roth rollover account in 2011, you may have to include in your 2011 income all or some of the taxable amount that otherwise would have been deferred to 2012. The amount to be reported in 2011, if any, is computed on Form 8606 (Part IV).

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Avoiding a DOL Audit of an Employee Benefit Plan Annual Report

By Harvey M. Katz and Michelle M. Stimson

Requirements under ERISA mandate that an administrator of an employee benefit plan, subject to Part 1 of Title I of ERISA, file an annual report with the Secretary of the Department of Labor (DOL). The annual report generally must include a Form 5500 Annual Return/Report of Employee Benefit Plan (Form 5500), along with the requisite statements and schedules.

Moreover, under ERISA, a plan administrator is required to engage, on behalf of the plan participants, an independent qualified public accountant (IQPA) to conduct the examination of the plan's financial statements. Any individual who, under state law, is licensed or certified to practice public accounting is eligible to be a "qualified public accountant" for this purpose, and the examination is to be conducted in accordance with Generally Accepted Accounting Standards (GAAS). One of the purposes of this examination is to determine whether the plan's financial statements are presented in accordance with Generally Accepted Accounting Principles (GAAP).

The purpose of the IQPA is to provide plan participants with some assurance that the plan's financial statements have been subject to an annual independent examination and the plan's processes and financial controls supporting the financial statements have been examined. However, ERISA and DOL regulations impose additional requirements on the audit. The auditor must issue an opinion of the IQPA in connection with the audit, and the auditors have the following options with respect to the such opinion:

1) An Unqualified Opinion is issued when the IQPA concludes that the plan's financial statements present fairly the financial status of the plan as of the end of the period audited;
2) A Qualified Opinion is issued when the IQPA concludes that the plan's financial statements present fairly the financial status of the plan as of the end of the period audit, except for the effects of one or more matters described in the opinion;
3) A Disclaimer of Opinion is issued when the IQPA does not express an opinion on the financial statements because he or she has not performed an audit sufficient in scope to enable him or her to form an opinion on the financial statements; and
4) An Adverse Opinion is issued when the IQPA concludes that the plan's financial statements do not present fairly the financial status of the plan as of the end of the audit period.

In most cases, an unqualified opinion is the only option accepted by the DOL, with the most notable exception being the limited scope audit in which the auditor, generally, need not audit investment information certified by certain banks, brokerage houses or insurance carriers.

Auditors with limited plan audit experience often do not realize the limits on limited scope audit opinions and are under the false assumption that they may include any number of caveats, may fail to ascertain the fair market value of hard to value assets such as employer stock or real estate investments or do not verify participant data. Any one of these failures or caveats would cause the report to become noncompliant and could subject the plan to DOL audit and penalties.

Most often, the deficiencies in the opinion that bring it to the DOL's attention can be traced to auditors with limited employee benefit plan audit experience. The reasons for the failures often include: (1) the auditor's lack of technical training and knowledge; (2) the auditor's lack of familiarity with employee benefit plans; (3) inadequate quality control in the audit process; and (4) a failure by the auditor to understand the requirements for limited scope audits.

One of the most common reasons for a deficient accountants' report is the failure of the auditor to perform tests in areas unique to employee benefit plan audits. The more training and experience that an auditor has with employee benefit plan audits, the more familiar the auditor will be with benefit plan practices and operations, as well as the special auditing standards and rules that apply to such plans. Therefore, the selection of the plan auditor is an important task for any plan administrator. As noted above, federal law requires that an auditor engaged for an employee benefit plan audit be licensed or certified as a public accountant by a state regulatory authority. However, it is essential that the plan auditor have experience in auditing employee benefit plans.

Plan administrators have, perhaps, a more compelling reason to make certain that the plan audit satisfies the requirements set forth under ERISA; namely, to avoid a DOL audit. Audits of noncompliant opinions are conducted by the Office of the Chief Accountant (OCA) for the Employee Benefits Security Administration of the DOL. If the plan administrator fails to engage an auditor experienced in the plan audit process, there is a much higher likelihood that the plan annual report will be selected for audit by the DOL.

If the DOL finds that the annual report is incomplete or if there is a material qualification by the IQPA in the audit opinion, then the DOL will likely reject the annual report. It is critical that any plan administrator who receives a notice of rejection from the OCA act immediately to rectify the deficiency. Depending upon the nature of the deficiency, the DOL may grant extensions, but it is imperative that the extension be requested within the 45-day period, which is typically the time frame in which a response is required. If a satisfactory report is not received by the DOL within the 45-day (or extended) period, the DOL will likely advise the plan administrator of its intent to impose a penalty against the plan administrator. The most commonly imposed penalty is $50,000, although the DOL has the authority to impose a penalty of up to $1,100 per day. In order to prevent the DOL from imposing the penalty, the plan administrator must file a request for hearing and answer with the Office of Administrative Law Judges within 35 days of the Notice of Determination. Unless a hearing request is filed within the 35-day period, the penalty will become permanent and unappealable. The process is a formal legal proceeding, and it is essential that the plan administrator retain experienced counsel. Once the request for a hearing is filed, the plan administrator may negotiate with the DOL to reduce or waive the penalty as long as the audit opinion is revised to meet the requirements of the regulations.

Plan administrators are well advised to review their selection of auditors and the annual opinions that accompany the audit opinion. Their diligence will be rewarded by avoiding costly DOL audits. Those administrators who receive a notice from the OCA should react quickly and address the issues raised in the notice immediately. The assistance of experienced benefits counsel is essential in satisfactorily resolving these issues.

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New Determination Letter Guidelines: The Good, the Bad and the Yet To Be Resolved

By Susan Foreman Jordan

Each January, the IRS updates several Revenue Procedures that prescribe the process for requesting determination letters for qualified retirement plans. For the most part, these have changed very little from one year to the next, except for increases in the user fees charged. This year, the IRS made significant changes, which purportedly are intended to improve its efficiency. To understand why the new guidance involves both good news and bad news for plan sponsors necessitates a bit of background.

Several years ago, with the objective of leveling its workload, the IRS instituted a cyclical compliance system, with individually designed plans being assigned to a five-year remedial amendment cycle, based on the last digit of the plan sponsor's taxpayer identification number. When requesting a determination letter for such a plan, a Form 5300 application is submitted, and a user fee of $2,500 must be paid.

Pre-approved prototype and volume submitter plans, however, have a slightly longer life span, as the remedial amendment cycle for these plans is six years. Employers that adopt these plans seek a determination letter by filing a Form 5307 application and paying a user fee of just $300. As part of the application, the plan sponsor is required to identify those provisions of the plan that deviate from the pre-approved specimen language. Generally, the deviations are rather modest, but the IRS has allowed significant customization.

It has been our policy to recommend that adopters of prototype and volume submitter documents obtain a determination letter in all cases. By doing so, the plan sponsor is able to assure itself that all required interim amendments have been adopted on a timely basis, that any unique language in the plan document has been reviewed and approved, and that the plan document has received a "clean bill of health" through the date of the determination letter, making the plan documents subject to scrutiny only from that point forward. Most plan sponsors agree that the minimal cost of submitting the Form 5307 application is a small price to pay for peace of mind.

Effective as of May 1, 2012, the IRS will accept Form 5307 applications for determination from sponsors of pre-approved volume submitter plans, only when the pre-approved language has been modified and only when those modifications are relatively minor. If the IRS determines that the changes are more significant, the plan will be deemed to be an individually designed plan, subject to the five-year amendment cycle and the $2,500 user fee when submitting an application for determination.

That said, what is the good news and what is the bad news in all of this? Well, the good news is that, in most cases, no application for determination will be filed. This means the requalification process every six years is somewhat simpler and less expensive.

Unfortunately, the news is not all good. Because we have been provided with no guidance as to what is meant by "minor changes," every deviation from the pre-approved language entails some risk. Customization to any extent increases the likelihood that a plan will be deemed to be individually designed, which means more frequent restatements and higher user fees. Moreover, by the time a plan sponsor or the IRS concludes that the plan is individually designed, the five-year compliance cycle may have passed, putting plan qualification in jeopardy. Even in a best case scenario, when the pre-approved language has not been modified, the plan sponsor no longer will have the added assurance of a determination letter or the "clean slate" it provided.

Under prior determination application procedures, a plan sponsor could request that the IRS consider not only the form of the plan document but also operational compliance by the plan with the nondiscrimination, minimum coverage and minimum participation requirements. Such a request was accomplished by including a Schedule Q with the application, along with the data necessary to demonstrate compliance. In its 2012 guidance, the IRS announced that these elective demonstrations no longer will be accepted.

Plan sponsors may be impacted in different ways by these changes. Some may welcome the simplification; others will want to reassess how their plans are designed and operated. Clearly, though, what for decades has been routine now warrants careful consideration. The members of Fox Rothschild's Employee Benefits and Compensation Practice Group are available to clarify the changes and address your concerns.

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