

BENEFITS LAW

JOURNAL

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DOL Proposal Regulation Would (Somewhat) Expand Access to MEPs But Why Is It All So Complicated?

The three Cs of retirement plans—they're complex, costly, and confusing—have kept many employers from offering a plan. Also, the unfortunate one-third of private sector workers whose employer doesn't offer a plan are unlikely to save anything on their own. Why not make it easier for employers to do what's right for their workers?

One solution that has been around for a while is the multiple employer plan (MEP). An MEP allows a group of unrelated businesses to join forces and adopt a single plan for their respective workers. The MEP would enjoy a higher asset base generating the lower investment and recordkeeping fees and access to more investment products and services. Perhaps more important, joining an MEP would allow employers to offload most of the heavy regulatory and administrative lifting to the MEP's sponsor. All the business owner would have to do is choose the MEP, enroll its workers, process salary withholdings, and make any company contributions. [Note: While it is technically possible to have a traditional defined benefit MEP, as a practical matter it is not doable, and this column only covers 401(k) and other defined contribution plans.]

Yet MEPs have never gotten much traction. The DOL estimates that there are fewer than 5,000 MEPs covering roughly 1.4 million workers with some \$232 billion in assets, a drop in the nation's retirement bucket. One reason for the low take-up is guidance by the Department of Labor (DOL) restricting MEP membership to employers that are "tied together" by "genuine economic or representational interest." That strict standard has made it difficult to find enough employers eligible to join forces in an MEP.

On August 31, the White House issued an executive order directing the DOL to make it better. In record time, the DOL proposed a regulation expanding the types of organizations that can sponsor and participate in a MEP. To understand the proposal, we need to first look at where the DOL is coming from.

ERISA only allows an employer or someone acting "indirectly in the interests of an employer" to sponsor a retirement plan. For an employer willing and able to do it alone, this is an easy test to meet: they simply sponsor their own retirement plan covering only their workers. Of course, a regular single employer plan sponsor would not take on extra responsibility and liability by opening its plan to another business's workers. That leaves a nonemployer as the only possible

Please check the edits made to the sentence "For an employer willing and ..." and amend if necessary.

candidate to sponsor an MEP. The obvious candidates would be a company in the investment or recordkeeping business; a not-for-profit organization, such as a chamber of commerce or business association, with a goal of assisting businesses; or a state or local governmental body wishing to promote retirement security of its citizens.

The DOL has always been suspicious of MEPS. The fear is that unsophisticated, overworked, multitasking employers will join an MEP without proper vetting and, once in, will fail to adequately monitor the plan. The DOL is particularly concerned that commercial sponsors would create MEPs with high fees and stocked with in-house or otherwise inappropriate investments benefiting the sponsor, not the workers. Or, worse, the MEPs could be sponsored by outright fraudsters who will abscond with participants' savings. Fraud and mismanagement have been serious problems with MEPs' ugly cousin, multiple employee health associations, and the DOL has regulated MEPs with rules intended to protect health plan participants. The bottom line is that the DOL has not allowed commercial sponsors, limiting MEPs to related affinity groups and, recently, certain state and local governments.

The proposed regulations would open the door a bit, allowing any "bona fide" group of employers to sponsor a defined contribution MEP. To the DOL, bona fide means the employers are in the same trade or business, or the same state or municipal region. So, a nationwide group of plumbers could start an MEP or all employers in the state of Vermont could start an MEP, while the plumbers and bakers of the United States could not. The DOL's thinking is that the organization sponsor will be neutral, fair, and impartial in organizing and running the MEP. But there's a bit more: the group must have at least one purpose for existing besides the MEP—say to promote general business interests—as well as a formal organizational structure in which the employer-members select leadership. Importantly, while nonmembers could not adopt the MEP, self-employed and gig workers could join. Under the proposed regulation, companies in the recordkeeping or investment business and other commercial entities still would not be able to sponsor an MEP.

The DOL considers MEPs to be more vulnerable to abuse because members of a group tend to rely on the others to handle the due diligence. In one sense, the DOL has been successful; there has been little reported MEP abuse. Of course, that success may be unrelated to the strict DOL standards, and instead be successful simply because MEPs are not as vulnerable as feared. Indeed, abuses can occur just as easily when an employer establishes its own plan.

Not mentioned in the proposed regulations is whether a state or local government could sponsor a MEP for private sector businesses within its borders. In 2015, the DOL issued guidance that states and

local governments, because of their concern for their citizens' welfare, also could sponsor an MEP, regardless of whether the participating employers otherwise had anything else in common. The proposed regulations do not mention government-sponsored MEPs at all. This silence may be because the regulations are intended to only cover which employer groups are MEP-worthy; state and local governments would still be able to sponsor MEPs without the needed extra protections applicable to other entities. Indeed, informal comments by DOL officials express this view. Still, more formal guidance on this question would be helpful.

What would be really helpful would be a complete regulatory rethink why MEPs have to be so complicated. Isn't the plethora of existing ERISA fiduciary and prohibited transactions rules enough to protect MEP participants? It's high time to revisit the layers of well-intended ERISA and Tax Code rules intended to protect savers from abuse to see if they help or hurt.

The President's executive order also directed the IRS to action. Also, the IRS's own strict regulations also have stymied MEPs. Particularly troublesome is the "bad apple rule," that a violation of a Tax Code qualification requirement by one employer participating in a MEP can infect all employers. There is simply no reason to punish the innocent with the guilty. In responding to the executive order, the IRS should extend its plan correction procedures to give an automatic pass to all nonoffending employers in the MEP.

What's really called for is an attitude change by the regulators in favor of simplicity. Of course, it would be even better if Congress lead the way by finally passing reform legislation simplifying the rules and making retirement plans user-friendly for both employers and employees.

The views set forth herein are the personal views of the author and do not necessarily reflect those of the law firm with which he is associated.

David E. Morse
Editor-in-Chief
K&L Gates LLP
New York, NY

Modernizing the American Private Pension System Plan for the Future of Work

Teresa Ghilarducci

The nation needs to modernize its “built environment” of how Americans save for retirement. A good retirement savings system helps people adequately accumulate assets, invest those assets well, and receive those assets as a lifelong benefit. A universal, government-administered plan would provide adequate, advanced-funded retirement annuities for all—and, converting the tax deductions to a refundable tax credit is a key feature of fairness and efficiency. Guaranteed Retirement Accounts supplement Social Security and are mandated and a public option to current commercial IRAs and 401(k) plans.

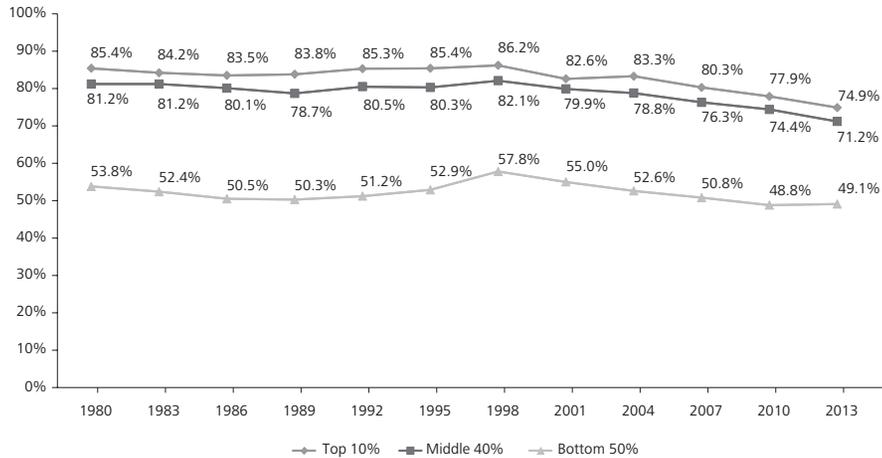
Modernization of America’s current voluntary, commercial, individual-directed do-it-yourself retirement savings system is required because the system has failed most workers. Though 401(k)-type plans were hailed as cheaper and more popular than defined benefit plans, coverage in any type of retirement plan has fallen since the 1980s and since the Great Recession ended in June 2009. See Chart 1.

Modernizing America’s retirement security system requires two steps:

- First, the nation needs a retirement system with a “built environment” that ensures every American has a secure source of income to supplement Social Security adequately.

Teresa Ghilarducci holds the Bernard L. and Irene Schwartz Chair in economic policy analysis at the New School in New York. In books published by Princeton University Press, MIT University Press, and in a new book by Columbia University Press, co authored with Tony James of the Blackstone Group, she argues that the current financialized pension system destabilizes the macro economy and fails to provide equitable, adequate, and efficiently delivered retirement income. Her research areas concern automatic stabilizers, financialization, and labor market dynamics. Ghilarducci holds a Ph.D from the University of California Berkeley. She served as Wurf fellow at the Labor and Worklife Program at Harvard Law School and is a court-appointed trustee to the UAW Medical Trust Board, which manages \$60 billion dollars for over 800,000 members. She is a member of the General Accounting Office Retirement Policy Advisory Panel. Ghilarducci joined The New School after 25 years as professor of economics at the University of Notre Dame.

Chart 1. Retirement Plan Coverage for Full-Time Employees Ages 25–64, by Income Category, Selected Years 1980–2013



Source: Schwartz Center for Economic Policy Analysis (SCEPA) calculations based on Annual and Economic Supplement of Current Population Survey (CPS), extracted from IPUMS-CPS, University of Minnesota, www.ipums.org.

- Second, the nation needs an expanded and strengthened Social Security system to lift up the lowest income workers and prevent poverty among elderly Americans.

A universal, government-administered plan would provide adequate, advanced-funded retirement annuities for all.¹ Reforming the tax expenditures for retirement accounts is a key feature. Add-on individual accounts—which supplement Social Security—need to be mandated and be an option to current individual retirement accounts (IRAs) and 401(k)s.

I describe such a plan, which I call a Guaranteed Retirement Account (GRA). The GRA is a joint proposal from Blackstone Group Executive Vice Chairman Hamilton “Tony” James and myself, and is described in our new book, *Rescuing Retirement*. (An alternative could be mandating a Thrift Savings Plan account for every worker with no preretirement withdrawals and annuitized through the Social Security system. That plan has not been developed as far as I know.)

We do not propose just expanding Social Security. A mixed system of pay as you go (PAYGO) and advanced-funded retirement plans is more efficient and effective—administrative costs are smaller and economic and demographic shocks are smoothed better—than would be a single PAYGO or a totally advanced-funded capitalized system.² A GRA, or any supplemental advanced-funded retirement system, however, needs a strong base. Social Security needs more revenue or benefits will be cut, on average, by 19 percent in 20 years.

HOW TO MODERNIZE THE AMERICAN RETIREMENT SECURITY SYSTEM

We know what works and what doesn't work with advanced-funded pension systems, and modernization requires bypassing known barriers to comprehensive retirement security:

- Voluntary doesn't work;
- Individually directed doesn't work;
- Lump sums to be deaccumulated by the individual doesn't work;
- Governance with trustees who operate without enforceable guidelines, best practices, and positive regulation doesn't work; and
- Top-heavy tax subsidies don't work.

GRAs correct the above problems caused by the voluntary, commercial, individual-directed retirement income security system partially funded by top-heavy tax breaks. The GRAs provide universal coverage, ensure employer and employee contributions, protect participants from financial market volatility, and reform tax preferences to help everyone—especially middle-class and low-income workers—accumulate retirement savings. Creating a refundable tax credit and limiting current deductions is an essential part of the plan. Top earners now get the most subsidy³ from the federal and most states' income tax preference for qualified retirement accounts. The tax expenditure for retirement accounts is one of the most unequal in the federal and state tax system.⁴

THE GRA MEETS THE REQUIREMENTS OF AN EFFECTIVE RETIREMENT PLAN

Accumulation

The first task of well-run advanced-funded retirement system is to accumulate retirement assets for all workers. As Graph 1 illustrates, voluntary doesn't work, as coverage has not topped half of the workforce for decades. Without mandated contributions, even those with access to retirement plans have little saved⁵ and face the risk their own contributions or their employers' contributions will be insufficient. In

the voluntary system, workers also face the risk of early withdrawal due to economic shocks. In the GRA, no hardship withdrawals would be allowed.

There are many reasons why people may not save enough for retirement; but lack of financial education is not a primary one because the task of saving for retirement—as Nobelist Robert Merton remarked—is one of the most difficult human and math problems to solve.

Consumer education is often proposed as a remedy, but to my mind it's a real stretch to ask people to acquire sufficient financial expertise to manage all the investment steps needed to get to their pension goals. That's a challenge even for professionals. You'd no more require employees to make those kinds of decisions than an automaker would dump a pile of car parts and a technical manual in the buyer's driveway with a note that says, "Here's what you need to put the car together. If it doesn't work, that's your problem."⁶

Calculating the appropriate saving rate requires guessing how long you and your spouse will live and how much investments will earn. Deciding how much to save and deaccumulate and how to invest in the face of investment and longevity risk is beyond the capacity of almost all households.

Some risks are more efficiently pooled, but private annuity and long-term care insurance markets function poorly, due to adverse selection and high-expense loads. More important, lifetime income shocks outside of the control of individuals—such as a health crisis, a divorce, or job loss—are difficult to assess for oneself. Households dip into their voluntary accounts directly or indirectly by reducing retirement account contributions as a form of self-insurance against these risks.⁷ Households generally need more insurance than capital: unemployment insurance, home equity, long-term care insurance. Also, 20 percent of employers stopped contributing to their 401(k) in 2009. How can an individual assess that? Last, in the face of these risks, the household may turn to unreliable financial advisors, which could erode their savings even more.

The GRA proposal mandates a contribution of 3 percent of earnings up to \$250,000 for all participants, evenly divided between an employer contribution of 1.5 percent and an employee contribution of 1.5 percent; lower-wage employees would receive a minimum employer contribution of 15 cents an hour. The mandated contribution would apply to all workers eligible for Social Security, including public employees (there would be a five-year transition period for small employers). Self-employed individuals and partnerships would have to pay both employer and employee contributions (similar to Social Security for owners and partners).

Contributions would be automatically deducted from payroll. The 1.5 percent employee contributions would be offset by a \$600 refundable tax credit provided to all participants. The \$600 tax credit would replace current tax deductibility for the required 1.5 percent contribution, and investment earnings would not be taxed prior to retirement; however, interest earned on IRAs in excess of \$5 million would be subject to taxation. Employer and employee voluntary contributions could be made on top of the mandatory contributions, subject to current 401(k) limits (including catch-up contribution limits) and they would be tax deductible.

Accounts would be fully portable. Employers converting existing 401(k) plans to GRAs would be prohibited from reducing current employer contribution levels for two years.

Investments

The second task of an advanced-funded pensions is to invest the accumulated funds well. Investment pooling works well because the portfolio can be diversified and professionally managed. Individuals do not have the capacity to self-direct their investments as well as professionals who are covered by fiduciary laws do.

The federal government, through the Social Security Administration, would administer the GRA. A panel of low-cost professional managers, approved by a federal agency (housed in the Department of Treasury, Department of Labor, Social Security Administration, or Federal Reserve) would manage the pooled assets. We expect only large not-for-profit plans (such as the Wisconsin or Florida state pension systems) would meet regulator criteria. Each person's GRA would be legally owned by the individual. The funds would be invested through pooled strategies, combining the individual's account with other GRAs across the country. Individuals would choose their own GRA manager from a panel and could change managers at the beginning of each year. Managers could include traditional money management firms, state agencies that manage public pensions, or possibly a self-funded federal entity.

Everyone would have their GRA managed by professional portfolio managers, with lifelong, postretirement annuity payments administered within the existing Social Security infrastructure. The federal government would be the guarantor of this protection of principal and could charge a modest insurance premium to cover this cost. Premiums could start low and then be phased out over time as an appropriate reserve is established. It would not safeguard against a loss in a particular year or multiple years. The plan would provide for a guarantee of principal (cumulative contributions over one's career

up to the 401(k) limits plus employer match) by applying a one-time test at the time of benefit commencement.⁸

Deaccumulation:

Deaccumulation is the third task of a pension system. Only (mostly) government-sponsored annuities provide an effective way to pay secure annuities that are insulated from market timing and default risk. New research shows that annuities are important in calming the anxieties of elders.⁹

GRAs would provide lifelong, postretirement annuity payments administered within the existing Social Security infrastructure. Individuals could elect to take up to 25 percent of their accumulated mandatory GRA balance as a lump sum, provided the resulting annuity, when combined with Social Security, results in a lifetime income greater than the poverty line (about \$900 a month in 2017 for a median-income worker). Annuities would be purchased from the U.S. government, with longevity risk borne by the government.

Individuals could annuitize their GRA at the age of Social Security eligibility, which could be upon disability or upon retirement eligibility starting at age 62, up until age 70 when Social Security benefits are at their maximum. (Annuities would be determined based on a trailing five-year average of long-term bond rates to minimize investment risk. Using this discount rate will smooth volatility in the conversion rate around the timing of the conversion.)

GRA benefits could commence whether the individual is collecting Social Security or not, and individuals could create bridge annuities that pay benefits to a higher Social Security benefit. Bridge annuities purchased by the GRA would be an effective way to boost Social Security lifelong inflation indexed annuities.¹⁰ Delayed claiming is generally good for everyone.¹¹ GRA accounts that have not yet been annuitized would be inherited by a surviving spouse or other designated beneficiary.

All withdrawals would be subject to taxation. The voluntary contributions, if any, could be taken as a lump sum.

FINANCIAL PREDATION

The GRA could help workers in another important way: by lowering financial abuse. When households manage the deaccumulation of a lump sum instead of buying an annuity, predator risk is high. Our retirement system is one cause of America's growing problem with the financial exploitation of the elderly.¹² Americans suffer five times

the risk of financial abuse of our European counterparts because US citizens are expected to handle large sums of money in self-directed retirement accounts—alone. The problem is worsened by a lack of regulation of the financial advisement industry. The recently overturned fiduciary rule would have helped ensure financial advisors act in their clients' best interest.

CONCLUSION

The GRA could easily be budget neutral. Employee contributions are completely or partly subsidized by a tax credit, and these credits are paid for by eliminating tax breaks for higher-income earners. Then the net cost to the U.S. Treasury would be zero.

Unlike Social Security, GRAs rely on actual cash in each person's individually owned retirement savings account. When this real capital is pooled in large GRA accounts, plan managers are able to choose high-performing investments, which will close the retirement wealth gap without adding costs for anyone. We believe that regulators, CEOs, labor representatives, and asset managers could form a broad consensus to support GRAs.

NOTES

1. Expanding PAYGO Social Security to provide workers at all income levels with enough retirement savings is not practical. Meeting the retirement needs of all but the lowest-wage workers by expanding Social Security alone would cost more than 30 percent of payroll.
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7. No One is Safe: Americans Use Retirement Savings to Cover Hardships Long Before Retirement. *NEFE Digest 2017*. National Endowment for Financial Education. Denver, CO.

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Giving Nonqualified Deferred Compensation Plans their Due Diligence in M&As: Part II—Top-Hat and FICA Fitness

Henrik P. Patel and Dominick Pizzano

Last issue we described how Internal Revenue Code (IRC) Section 409A¹ compliance presented perhaps the most challenging question for sponsors of nonqualified deferred compensation plans (NDCPs) during a merger and acquisition (M&A) due diligence test. However, even if all the NDCPs pass this potential problem, there are still other challenges to solve before this critical examination is completed. Two such questions are “fit” related: (1) will the NDCPs still fit within the top-hat exemption post-merger; and (2) are the NDCPs Federal Insurance Contributions Act (FICA) taxes been properly applied to the benefits? This article prepares NDCP sponsors to answer these two important topics and alert them to any trick questions they may pose.

WILL THE TOP-HAT EXEMPTION STILL “FIT” POST-MERGER/ACQUISITION?

NDCP sponsors must be careful to restrict participation in their NDCPs so that they remain “primarily for the purpose of providing deferred compensation for a select group of management or highly compensated employees”² (i.e., a “top-hat group”). Maintaining this restriction is necessary in order for the NDCPs to continue to be exempt from coverage under the qualified plan rules of the Employee Retirement Income Security Act of 1974 (ERISA) governing participation,

Henrik Patel, Global Head of White & Case’s Employment, Compensation and Benefits practice, advises clients on the full spectrum of executive compensation and employee benefits issues. His significant experience and knowledge in this area has made him a valued resource for a range of US and international clients, including public and private companies, boards of directors and executives. He is based in New York. Dominick Pizzano, CEBS is an employee benefits consultant in the compliance department at Milliman. He consults clients in both the corporate and tax-exempt sectors on employee benefit plan issues while specializing in nonqualified deferred compensation. The authors would like to express their sincere thanks and appreciation to White & Case counsel Jeffrey li who also contributed to this article.

vesting, funding, and fiduciary requirements.³ Since NDCPs are typically designed and administered in a manner that would not satisfy these ERISA requirements, losing the top-hat exemption would result in a myriad of adverse consequences, including exposing the plan and sponsor to the severe penalties that result from ERISA noncompliance. The key question in this analysis is always where can sponsors safely draw the participation line? That is, identifying the right rung on the corporate ladder that sufficiently secures the NDCP's top-hat footing so as to prevent an inadvertent free fall into ERISA coverage?

Presently there is no formal bright-line definition of what constitutes a "select group of management or highly compensated employees" or, in other words, which employees may be covered under a top-hat plan. While the IRC has defined "highly compensated employee"⁴ (generally earning at least \$120,000 [2018 limit] as indexed) for qualified retirement plan purposes, an NDCP sponsor that uses this mark as its plan's eligibility cut-off will not be guaranteed that its covered group is "top hat." The Department of Labor (DOL) has the authority to impose ERISA penalties and, thus, it is the DOL definition that tends to govern. Generally, the IRC's definition is much less restrictive and nuanced than what the DOL has in mind for these plans. The DOL wants sponsors to focus on a more restrictive group of employees who are in a position to negotiate their own plan provisions and, thus, not be in need of the protections offered under ERISA.⁵ The DOL, however, has never issued regulations formalizing its position on this matter.

In the absence of DOL regulatory guidance on this issue, this eligibility determination process has often been viewed as more of an art than a science, with sponsors and their advisors left to construe their own definitions based on case law versus the dated DOL advisory opinion⁶ (which have no precedential value). Over the years, some commonly used benchmarks include:

1. Those individuals with significant managerial duties;
2. A group representing 5 percent or less of the employee population (though there have been some court cases where higher percentages have been deemed to meet the exemption); and
3. The average compensation of the covered group is three times the average of the noncovered group.

As recently as May 28, 2015,⁷ the DOL reiterated its staunch belief that true "bargaining power" be a prerequisite to participation in NDCPs. The DOL filed a lengthy amicus brief in a case challenging a top-hat group in an attempt to see this view supported by a favorable

ruling; however, the court did not concur in the case.⁸ While a comprehensive review of the legal landscape surrounding this topic is beyond the scope of this article, an analysis of recent court decisions can be found in the prior edition of the *Benefits Law Journal*,⁹ which raises an issue regarding the geographical split that has emerged between the various circuits, one that is particularly relevant in the M&A context: “an identical employees benefits plan, covering an identical amount and type of employees, could be subject to the requirements of ERISA if used by an employer in Cincinnati but completely exempt when used by a Philadelphia employer.”¹⁰ Accordingly, unless future rulings resolve this rift, employers engaged in M&As that unite companies from regions covered by separate circuit courts may need to assess the individual applicable rulings when reviewing their respective NDCP’s top-hat groups in order to ascertain whether they are likely to withstand a future challenge.

So, what are the potential challenges to an NDCP’s top-hat status? While the most obvious would be a DOL audit of the plan, the far more common threat comes from disgruntled participants who are adversely affected by one of the plan’s “non-ERISA” plan provisions or by one of the limitations of NDCPs. Examples of the former would be a vesting schedule longer than the minimum years permitted under ERISA or perhaps a vesting schedule with a noncompete attached to it. The most prevalent illustration of the latter would be the requirement that benefits owed participants remain “unfunded” (*i.e.*, subject to the creditors of the plan sponsor in the event of its insolvency). In this scenario, the negatively affected participants seek recovery of the benefits they lost in the bankruptcy based on the argument that such benefits should have been protected by an ERISA trust because the plan includes participants who are not “top-hat” employees.

Because the prospect of a disgruntled participant poses such a danger to a borderline top-hat NDCP, vetting such plan’s eligible group during the due diligence process is crucial, considering the fact that the M&A itself may increase the odds of some participants becoming upset (especially in cases where the acquired executives may be terminated). Even if the NDCPs of each company involved in the deal independently met the top-hat group requirements for their respective plan sponsors, this may not be the case post-merger. For example, assume that a large company acquires a smaller company along with the smaller company’s executives and the NDCP in which they participate. All of the executives of the smaller company may have fallen well within the top-hat standard based on the facts and circumstances of their employment with the small company; however, their position in the combined company may no longer justify top-hat status. If this is the case, they may very well also fall into that “disgruntled

participant” status by virtue of their diminished status in the new company, thereby increasing the potential for a top-hat legal challenge.

Some potential solutions for this situation include freezing the questionable NDCPs, terminating and liquidating them, or, in an asset sale transaction, not accepting the NDCP. Each of these options has its limitations and may not be feasible depending on various circumstances (*e.g.*, most notably timing issues and the applicability of the Section 409A rules).

HAVE ALL REQUIRED TOP-HAT FILINGS BEEN MADE?

Even if the acquired NDCPs and their participants will still meet the top-hat exemption post-merger, the surviving company could be at risk if the acquired company failed to file the one-time top-hat statement¹¹ for each plan with the DOL. This filing is required in order for the NDCP to be exempt from the qualified plan reporting and disclosure requirements (most importantly the annual Form 5500 filings) and the severe penalties assessed for failing to timely make these filings:

- IRS penalties of \$25 per day up to \$15,000,¹² and
- Maximum DOL penalties of \$2,097 per day with no limit.¹³

The good news is that even if the acquired company failed to timely file its top-hat statement, there is an amnesty program available through the DOL. Failures to file can be easily and electronically corrected by:

- Submitting the required DOL filing;
- Completing a submission under the DOL’s Delinquent Filer Voluntary Compliance Program (DFVCP); and
- paying the penalty (*i.e.*, \$750 regardless of the number of plans maintained by the sponsor or the degree of lateness).¹⁴

It is also important to note that even if a previous filing *was made* by the acquired company, a new filing may be required because:

- An employer may become a sponsor of NDCPs through acquisitions of organizations that sponsored such programs.
- A subsidiary that is spun off from a parent or sold may become the direct sponsor of the portion of the NDCP that applies

to the subsidiary's employees that was previously covered under the parent's DOL filing but which is not covered by a DOL filing after the spinoff or sale.

The DOL guidance letter on this topic states as follows:

Where one of the participating employers is the plan administrator, the plan administrator could identify the employer that serves as the plan administrator by name, employer identification number (EIN), and address. If a participating employer is an authorized person from whom the Department may request plan documents under 29 C.F.R. Section 2520.104-23(b)(2), including documents regarding the other participating employers, the statement could identify that authorized employer as the "employer." In cases where only one participating employer is identified as the "employer," the registration statement should include some general identifying information regarding the group of participating employers that maintain the plan. The addition or removal of individual participating employers from the group would not necessitate the filing of an updated registration statement as long as the employer identified in the original registration statement continues to be an employer of employees covered by the plan and continues to be an authorized person from whom the Department could request documents regarding the plan.¹⁵

ASSESSING FICA FITNESS

If an employee receives compensation that qualifies as "wages" under IRC Section 3121, such pay is generally subject to FICA tax when it is "paid or otherwise made available" to the employee.¹⁶ There, however, are separate provisions for NDCPs that provide that amounts deferred under such plans are subject to both a "special timing" rule and a "nonduplication" rule.¹⁷

The special timing rule enables NDCP sponsors to apply FICA taxes at the later of the performance of services or the lapse of any substantial risk of forfeiture (*i.e.*, when vesting occurs) instead of waiting until the time the amounts are actually distributed from the plan.¹⁸ This special timing rule generally yields favorable results for NDCP participants because most or all of them will already exceed the FICA wage base (*e.g.*, \$128,400 for 2018¹⁹) for imposition of the 6.2 percent Social Security tax in the year of performing services due to their regular wages. Consequently, such participants' NDCP amounts would therefore not be subject to the 6.2 percent Social Security tax, and only

the 1.45 percent Medicare tax would apply in the year of deferral. In addition, thanks to the nonduplication rule, any subsequent earnings on the deferred amounts that were FICA taxed in accordance with the special timing rule would never be subject to FICA taxes. In contrast, had the special timing rule not been used, FICA taxes would apply years later when the NDCP distributions actually occur. This alternative would potentially result in two negative outcomes for the participants: (1) the FICA tax would be applied to the total distribution (*i.e.*, the sum of the allocations plus any earnings); and (2) the application the FICA tax would occur postemployment when the participants may not have regular wages in excess of the FICA wage base, thereby exposing the entire distribution to full FICA taxation.

While employers, with the assistance of their payroll system administrators (whether internal or external), typically have little trouble correctly calculating, withholding and paying the federal employment taxes that are due on the *current* compensation that they pay their employees each year, the same is not always true when it comes to the more complex rules applicable to the calculation and payment of FICA taxes on some amounts deferred under their NDCPs. “Some” is the operative word here because NDCP *employee* deferrals, whether from base pay or bonuses, are normally not a problem; just like 401(k) deferrals, such amounts are 100-percent vested when made and, thus, they are simply run through a payroll system, which already contains a built-in mechanism for withholding and paying FICA on amounts of this type.

NDCP sponsors and their payroll providers, however, may struggle in determining the timing of NDCP *employer* allocations. If the NDCP is a defined contribution plan, such amounts could be subject to FICA taxation under the special timing rule when they become vested. This is fairly simple when a cliff vesting (*i.e.*, full vesting occurs after a specified number of years of service are completed) schedule is used. For example, assume a participant receives an employer annual allocation of \$10,000 a year for five years under an NDCP with a five-year cliff vesting schedule. The participant remains employed by the sponsor for the entire vesting period and, at the date upon which 100-percent vesting occurs, the account balance is \$52,600 (*i.e.*, the sum of the five allocations of \$10,000 plus \$2,600 in earnings). If the special timing rule is used, the \$52,600 will be subject to FICA taxation in the year of vesting—but since such taxation occurs while the participant is still receiving a full salary, odds are that only the 1.45-percent Medicare tax would apply, since the participant’s salary will most likely be over the wage base. Assuming that the same allocations are made each year and the employer continues to apply the special timing rule, going forward, the participant will only owe FICA tax on the \$10,000 allocated each year, and future investment earnings on such

amounts, as well as on the existing, already-taxed 52,600, will escape FICA taxation.

This calculation becomes much more complicated in cases where the NDCP utilizes a graded vesting schedule in lieu of the above-described cliff vesting schedule. In addition, there are separate rules for determining the timing of FICA taxation for NDCP defined benefit plans. A complete analysis of these rules is beyond the scope of this article; however, to summarize, they add another date to the mix with respect to the latest date that FICA taxation must be applied. Instead of just the later of the performance of services or the lapse of any substantial risk of forfeiture (*i.e.*, when vesting occurs), defined benefit plans can wait until the date on which the amounts become “readily ascertainable.”²⁰ This provision is primarily intended to address those NDCPs that provide benefits that are linked to a qualified defined benefit plan. Since the ultimate NDCP benefit is not really ascertainable until the qualified plan becomes fixed, the rule allows NDCP defined benefit plan sponsors to have the option of delaying FICA taxation until such time or applying it sooner under an early inclusion rule and then truing up the tax later once the amount becomes readily ascertainable.

In any event, whether an NDCP sponsor elects to apply the special timing rule, or the sponsor and its payroll provider are just not aware of the rule, failure to use the rules does not result in a violation of tax law because the FICA taxes would then be applied at the time of distribution. Nevertheless, this is still an area that should be examined during the M&A due diligence process so that the companies involved in the deal can assess the respective FICA situations of each other’s NDCPs and know what, if any, action may be needed in the future should they assume sponsorship of these plans (*i.e.*, has the FICA tax already been withheld or must it be withheld upon distribution?). In addition, if the decision reached in a recent court case is any indication of future verdicts, a thorough review of this issue could serve to protect the surviving company from being named in a future suit and perhaps having to pay damages to participants.

In the case of *Davidson v. Henkel Corp.*,²¹ current and former employees who were participants of the plan sponsor’s NDCP filed a class action lawsuit against the sponsor and the plan when the sponsor withheld required FICA tax payments from their NDCP distributions. The court found that the employer’s failure to apply the special timing rule under its top-hat plan violated the plan’s terms and thereby created an impermissible reduction of the participant’s benefits. The NDCP under review contained the following provision:

Taxes. For each Plan Year in which a Deferral is being withheld or a Match is credited to a Participant’s Account, the company shall

ratably withhold from that portion of the Participant's compensation that is not being deferred the Participant's share of all applicable Federal, state or local taxes. If necessary, the Committee may reduce a Participant's Deferral in order to comply with this Section."²²

According to the court's ruling, the above provision required the employer "to properly withhold the [p]articipants' taxes" when the NDCP contributions were credited. Two important factors to remember in this case, and which may distinguish it from future results, are two actions taken by the NDCP that significantly hampered its ability to defend the claim against it:

1. The NDCP sponsor was effectively its own "whistle blower" by sending letters to the participants admitting that FICA taxes had "not been properly withheld."
2. Even though the use of the special timing rule may be optional under the FICA regulations, the fact that the use of such rule was hard coded into the document made it a plan provision that the sponsor was thereby contractually bound to follow.

This ruling creates an even more pressing need for companies in a possible M&A transaction to conduct a thorough review of their respective NDCP documents and administrative procedures in order to ascertain whether FICA tax withholding was addressed. It is quite possible that future plaintiffs may argue that, even without the inclusion of specific language in the NDCP document, the *Henkel* ruling creates a de facto obligation on NDCP sponsors to administer their plans in accordance with the special timing rule so as to best protect NDCP participants from the adverse tax consequences of failing to do so. Accordingly, at the very least, if there are any NDCPs that have language similar to the language found in the plan in the *Henkel* case (*i.e.*, committing to the use of the special timing rule) and FICA taxes have not been withheld on a timely basis, that fact pattern should create a red flag to be discussed during the M&A negotiations. Some companies may choose to be even more proactive and insist on the use of the special timing rule as the best defensive administrative practice.

WHY IS IT SO CRUCIAL TO FIX OR AT LEAST FOCUS ON FICA BEFORE CLOSING THE DEAL?

The *Henkel* case highlights one of the worst-case scenarios of an NDCP sponsor's failure to follow FICA withholding rules. There are

several reasons as to why this issue should be fully examined and, if needed, corrected during the due diligence period:

1. Whether it is self-induced turnover as the result of pre-merger rumors that lead employees to seek other employment for fear of not having a position postmerger or actual postmerger layoffs, human resource and payroll staff may very well be considered redundant and thus not survive the merger. Depending on whether the company adequately documented its administrative practices, these individuals may be the only reliable sources on how FICA withholding was handled prior to closing. Accordingly, there will be a much better chance of retrieving the necessary information while this staff is still accessible.
2. There will be sufficient time to assess if there is an underwithholding problem and, if so, how much.
3. If there is an underwithholding problem, the cost of correction will only grow as more time passes (*i.e.*, if not discovered until later, the surviving entity may face future underwithholding penalties and/or lawsuits from participants).
4. Obtaining this knowledge in advance may influence decisions to be made regarding the affected NDCP.

MAINTAINING TOP-HAT AND FICA FITNESS A MUST IN M&AS

As discussed last issue in Part I of this article, IRC Section 409A compliance deservedly garners the lion's share of attention when bringing NDCPs into the M&A due diligence den. When reviewing existing NDCPs prior to closing a deal, the analysis, however, cannot be limited solely to IRC Section 409A. In order to ensure that the NDCPs all-important ERISA exemptions remain intact, the respective plan populations must be reviewed to determine whether any relevant NDCPs will still fit into the top-hat exemption group postmerger. The results of such review may influence which plans survive the merger and may even affect the negotiations of the deal itself. Efforts must also be taken to ensure that all NDCP required filings are complete and whether any corrective action (under the DOL amnesty program) or new filings (due to a postmerger change in the NDCP sponsor) will be needed. Furthermore, there is a time-sensitive need to ascertain if and how the NDCP documents and administrative practices

have addressed payroll tax withholding regarding the NDCPs, because companies forgetting FICA withholding requirements could also find themselves facing future financial exposure, especially given the far-reaching *Henkel* decision. As a result, in order to fully give NDCPs their due diligence in M&As, plan sponsors should work with their employee benefit advisors and legal counsel to establish a complete compliance regimen that will ensure that the surviving company emerges in not only fine IRC Section 409A shape but also top-hat and FICA-withholding fit.

NOTES

1. IRC § 409A and Treas. Reg. § 1.409A-1 through 6.
2. 29 U.S.C. §§ 1101(a), 1051(2), 1081(a)(3).
3. *Id.*
4. IRC §414(q).
5. DOL Advisory Opinion 90-14A (May 8, 1990).
6. *Id.*
7. Amicus brief filed by the DOL re: *Bond v. Marriott International, Inc.*, 637 Fed. Appx. 726, 61 EBC 1005 (4th Cir. 2016).
8. *Id.*
9. “The Top-Hat Exemption After *Sikora*”, Elizabeth Rowe and J. Christian Nemeth, *Benefits Law Journal*, Vol. 31, No. 3, Autumn 2018.
10. *Id.*
11. 29 CFR § 2520.104-23(a)-(d).
12. IRC §§ 6652(d), 6652(e) and 6692
13. Fed. Reg., Vol. 83, No. 1, 30 CFR, Part 100.
14. <https://www.dol.gov/sites/default/files/ebsa/about-ebsa/our-activities/resource-center/fact-sheets/dfvcp.pdf>.
15. December 19, 2008, DOL Memorandum, 2008-08A, ERISA § 104.
16. Treas. Reg. § 31.2121(v)(2)-1(a)(1).
17. Treas. Reg. § 31.2121(v)(2)-1(a)(2).
18. *Id.*
19. <https://www.ssa.gov/news/press/factsheets/colafacts2018.pdf>.
20. Treas. Reg. § 31.2121(v)(2)-1(c)(2)(iii).
21. *Davidson v. Henkel Corp.*, E.D. Mich. No. 12-CV-14103, 2015 U.S. Dist. LEXIS 722.
22. *Id.*

The Collapse of the Fiduciary Rule

Erika M. Medina

This article explores the complications created by the collapse of the Fiduciary Rule and its reversion to the 1975 regulation focusing on retained fiduciary status, renewed prohibited transactions, and the unsettled regulatory landscape.

In 2016, the Department of Labor (DOL) finalized the Fiduciary Rule, a collective regulation that redefined fiduciary status, introduced prohibited transaction exemptions, and revised existing prohibited transaction exemptions. The DOL's action expanded the definition of investment advice to incorporate recommendations provided by advisers, brokers, consultants, and valuation firms whose roles had expanded over the years but that remained unaccountable under the Employee Retirement Income Security Act (ERISA) and the Internal Revenue Code (the Code). In particular, the DOL noted that the shift from defined benefit plans to defined contribution plans and individual retirement accounts (IRAs) increased the role of third parties engaging in transactions that would be prohibited except for the third parties' lack of fiduciary status. Two years later, the Fifth Circuit Court of Appeals¹ ordered a decision vacating the Fiduciary Rule in its entirety, finding that the DOL violated the Administrative Procedures Act (APA) by acting in a manner that was "arbitrary and capricious." Since the DOL did not seek review of the decision from the Supreme Court, the Fifth Circuit's decision is binding nationwide. As such, fiduciary status and applicable exemptions reverted to the 1975 regulation pending additional guidance² from the DOL. The reversion to the 1975 regulation creates a labyrinth of regulatory compliance concerns that need to be reviewed and addressed. Specifically, entities that implemented or modified programs based on the Fiduciary Rule will want to review fiduciary status and prohibited transaction exemptions for the effect of the changes to service arrangements and compensation structures.

Erika M. Medina is an ERISA attorney who counsels clients on the operation and administration of plans. She focuses her practice on fiduciary duties, plan design, governance and administration, and prohibited transactions. Her experience includes working for a boutique law firm, a national consultant/brokerage company, and at the US Department of Labor.

FIDUCIARY STATUS

Under the 1975 regulation, a party may be a fiduciary if:

- A determination is made that the party provided investment advice for a fee (the five-part test);
- Acts as a functional fiduciary (exercises control over plan assets or plan administration); or
- Is a named fiduciary (acceptance of status under the terms of the agreement or document).

Under both the 1975 regulation and the Fiduciary Rule,³ a fiduciary is defined as a person that either exercises discretionary authority or control regarding the management and disposition of plan assets, renders investment advice for a fee, or has discretionary authority over the administration of the plan.⁴ A person attains fiduciary status functionally, by exercising authority or control over plan assets or through the terms of the plan document (*e.g.*, direct responsibility or delegation of authority). Brokers or dealers registered under the Securities and Exchange Act of 1934 and banks, supervised by the United States or a state, are excluded from the definition of fiduciary to the extent the broker, dealer, or bank execute transactions for the purchase or sale of securities pursuant to fiduciary instructions.

The 1975 regulation defines “investment advice” as advice rendered regarding the value of securities or other property or a recommendation regarding the investment, purchase, or sale of securities or other property. A person⁵ rendering investment advice⁶ is a fiduciary only if it either directly or indirectly has discretionary authority or control over the purchase or sale of securities or other property of the plan⁷ or renders individualized investment advice on a regular basis pursuant to a mutual agreement that provides the services will be the primary basis for investment decisions. The second part of this test is commonly referred as the five-part test.⁸ Absent direct or indirect discretionary⁹ authority or control over plan assets, establishing fiduciary status is difficult because all elements of the five-part test must be met. Thus, the review of fiduciary status for a person providing investment advice is fact-sensitive.

In contrast, the Fiduciary Rule broadened the term “investment advice” to include services provided to self-directed plans and IRAs.¹⁰ Under the Fiduciary Rule, a person rendered investment advice with “respect to moneys or other property of a plan or IRA...” if the person:

1. Acknowledged fiduciary status;
2. Rendered individualized investment advice under agreement or provided directed advice regarding the advisability of a particular investment or management decision; and
3. Provided advice regarding the acquisition, disposition, or exchange of securities or other investment property in a plan or IRA, provided recommendations regarding the management of securities or other investment property, or provided recommendations regarding rollovers, transfers, or distributions from a plan or IRA.

Furthermore, the Fiduciary Rule generally defined “recommendation” as any advice provided to a recipient to engage or refrain from a particular action.¹¹ Specifically, recommendations under the Fiduciary Rule included communication to switch from an account charging commission to an account charging a fee; providing a list of securities, even if no specific recommendation is made; communications regarding proxy voting; and rollover recommendations, including the account type. Conversely, recommendation excluded communications by platform providers (not applicable to IRAs); general communications; investment education information and materials,¹² and advertising materials.

Under the 1975 regulation, recommendations would rarely be investment advice absent the factors specified in the five-factor test. For example, the recommendation would have to be provided on a regular basis and be the primary basis for the investment decisions. An analysis of fiduciary status under the 1975 regulation is fact-sensitive and narrow. As a result, those who were classified as fiduciaries under the Fiduciary Rule may no longer bear the risk of being a fiduciary under the 1975 regulation.

Nevertheless, both the 1975 regulation and the Fiduciary Rule retained fiduciary status for those either designated as a fiduciary or those acting as a functional fiduciary. Generally, a plan document or contract will name a fiduciary by role (*e.g.*, Trustee); delegation of authority (*e.g.*, Plan Administrator); or through acknowledgment of fiduciary status within an agreement. Under the 1975 regulation many failed to acknowledge fiduciary status and, therefore, the analysis of fiduciary status turned to a review of other factors. In contrast, the Fiduciary Rule required the acknowledgment of fiduciary status in agreements for services. Thus, entities that took efforts to comply with the Fiduciary Rule by modifying agreements would continue to be fiduciaries under the 1975 regulation unless they amend the language acknowledging fiduciary status in the agreement.

However, even if a fiduciary designation is modified within an agreement, a person may still be a functional fiduciary. The functional fiduciary test rests on a review of the party's control over the plan. Control over the plan is not mere recommendations that influence the plan, but, rather, the party must make a recommendation and effectuate its implementation, either without oversight from the plan or with blanket endorsement.¹³ Prior to the introduction of the Fiduciary Rule, the functional fiduciary test was also difficult to prove. Nevertheless, because business models were changed over the last two years to comply with the Fiduciary Rule, persons that absorbed additional duties or provided additional services may continue to be fiduciaries. Specifically, even if an agreement is modified to remove the fiduciary status designation, the performance of additional services may create a functional fiduciary.

The reversion of the Fiduciary Rule does not immediately retract a person's fiduciary status. Under the 1975 regulation, a person may be a named fiduciary, functional fiduciary, or provide investment advice pursuant to the five-part test. Although the named fiduciary status may be easily revoked by modifying contract language, the person may still retain fiduciary status either by meeting the five-part test or by performing services that rise to the level of functional fiduciary. Thus, entities cannot rely on a mere revocation of fiduciary status in contract language and must instead analyze the services provided, including service arrangements, compensation, and disclosure to ensure that the person does not retain fiduciary status under the 1975 regulation.

PROHIBITED TRANSACTION EXEMPTIONS

Pursuant to ERISA and the Code, certain transactions between the plan and a party in interest are prohibited absent an exemption. Exemptions are either administrative, granted to a person or class of persons pursuant to regulatory authority, or statutory, enumerated within ERISA or the Code. Under the 1975 regulation, certain compensation was strictly prohibited because its receipt established a conflict of interest. In particular, the receipt of commissions, 12b-1 fees, and revenue sharing would ordinarily establish a prohibited transaction, for which no exemption exists. The Fiduciary Rule introduced two new exemptions and modified others to inculcate the best interest of the client in persons providing services and to permit the receipt of compensation that would otherwise establish a prohibited transaction. With the collapse of the Fiduciary Rule, introduced exemptions are nullified and amended exemptions revert to prior status. Those that relied on the introduced or amended exemptions must now analyze transactions to: 1) determine if a prohibited transaction exists (*i.e.*,

a nonexempted transaction between a plan and a party in interest); and 2) if an exemption permits the transaction. Furthermore, to the extent requirements under the Fiduciary Rule introduced or amended exemptions may be maintained (*e.g.*, conflict of interest policies or procedures or fee disclosure), entities should consider keeping such requirements to establish transparency or prevent accusations of impropriety (*i.e.*, through civil actions or DOL investigations).

The BICE and the Principal Transaction Exemptions

The Fiduciary Rule introduced the Best Interest Contract Exemption¹⁴ (BICE) and Principal Transaction Exemption¹⁵ to permit certain transactions otherwise prohibited. The BICE permitted the receipt of certain compensation if the person providing services acknowledged fiduciary status, provided prudent advice, charged no more than reasonable compensation, and made no misleading statements about investment transactions, compensation, and conflicts of interest. The BICE also included streamlined requirements for “level-fee” fiduciaries: fiduciaries receiving a fee disclosed in advance that is a fixed percentage of the value of assets or an unvaried set fee. Under the streamlined requirements, level-fee fiduciaries were not required to notify the DOL in advance of its intent to comply with the exemption, establish a contract, or provide written disclosure when the transaction is effectuated.

The Principal Transaction Exemption permitted investment-advice fiduciaries to engage in the purchase and sale of certain investments out of their inventory with plan, participant, or beneficiary accounts and IRAs, under certain conditions. To comply with the exemption, the person providing services must acknowledge fiduciary status, adhere to the impartial conducts standards, disclose material conflicts of interest, and obtain the consent of the plan or IRA. Furthermore, persons relying on the exemption were required to establish policies and procedures to comply with the exemptive and record-keeping requirements.

While the BICE and Principal Transaction Exemption provided new exemptive relief, the 1975 regulation continues to provide exemptive relief through subregulatory guidance and administrative and statutory exemptions for certain transactions. Relating to the BICE, PTE 1977-4 (“Prohibited Transaction Class Exemption for Certain Transactions Between Investment Companies and Employee Benefit Plans”) permits proprietary mutual fund investments so long as the exemptive notice and fee requirements are met; Advisory Opinion 97-15A permits the receipt of certain fees, if entirely offset; and Advisory Opinion 2001-09A permits independent third-party advice. Furthermore, the Pension

Protection Act (PPA) introduced statutory exemptions that may apply to certain transactions included in the Principal Transaction Exemption. In particular, ERISA Section 408(b)(14) permits the receipt of compensation for the provision of investment advice regarding the acquisition, holding, or sale of securities or other property; ERISA Section 408(b)(16) permits the purchase or sale of securities or other property executed through an electronic communications network or similar system; and ERISA Section 408(g)(1) permits the provision of investment advice under a fee level arrangements or a computer model.

To the extent entities complied with BICE and the Principal Transaction Exemption, the arrangements should be analyzed to ensure it meets the exemptions introduced by the PPA or other applicable exemptions. To the extent no exemption exists for the arrangement, the arrangement should be modified to prevent a prohibited transaction by reviewing Departmental subregulatory guidance.

Amended Prohibited Transaction Exemptions

The Fiduciary Rule amended various PTEs to incorporate the *impartial conduct standards*, consumer protection standards that ensure advisers adhere to “fiduciary norms and standards of fair dealing.”¹⁶ The standards require advisers and financial institutions to give advice in the best interest of the retirement investor, charge no more than reasonable compensation, and make no misleading statements about investment transactions, compensation, and conflicts of interest. This standard was incorporated into PTEs 1975-1, 1977-4, 1980-83, 1983-1, 1984-24, and 1986-128,¹⁷ as shown in Table 1. The impartial conduct standards would now be revoked in each of these PTEs. Nevertheless, the DOL may re-introduce the impartial conduct standards to amend each of these exemptions in either full form or a revised, shortened form.

The Fiduciary rule also extensively amended PTEs 1975-1 and 1984-24.¹⁸ Regarding PTE 1984-24, the Fiduciary Rule revoked relief under the exemption for annuity contracts other than fixed rate annuity contracts.¹⁹ However, with the revocation of the Fiduciary Rule, PTE 1984-24 would now provide relief for all annuity contracts. Regarding PTE 1975-1, the Fiduciary Rule revoked various provisions, which would now continue to provide relief, as shown in Table 2.

THE UNSETTLED REGULATORY LANDSCAPE

Prior to the collapse of the Fiduciary Rule, many expressed concern over the expanded role of consultants and similar persons and the

Table 1. PTEs Addressing the Impartial Conduct Standards

1975-1	Permits certain principal transactions, underwritings, market-making, and extensions of credit between plans and IRAs and broker-dealers, reporting dealers, and banks as long as the conditions are satisfied.
1977-4	Permits the purchase and sale of open-end mutual fund shares by a plan or IRA when a fiduciary is also the investment adviser for the investment company marketing the mutual fund, as long as the conditions are satisfied.
1980-83	Permits purchases of securities by plans when proceeds may be used by the issuer to reduce or retire indebtedness to parties in interest, as long as the conditions are satisfied.
1983-1	Replaces and amends PTE 81-7, and expands the coverage to include pools containing loans secured by mortgages or deeds of trust that are other than first lien loans, and issuance of forward delivery commitments by investing plans to purchase pool certificates under certain circumstances, as long as the conditions are satisfied
1984-24	Permits certain transactions involving insurance contracts, annuities, and securities of investment companies registered under the Investment Company Act of 1940, between plans and IRAs and insurance agents and brokers, pension consultants, insurance companies and investment company principal underwriters who are parties in interest or fiduciaries, as long as the conditions, including the impartial conduct standards, are satisfied. Amends PTE 77-09.
1986-128	Permits certain fiduciaries to receive compensation in connection with certain securities transactions entered into by plans and IRAs as long as the conditions are satisfied. Replaces and revokes PTEs 79-1 and 84-46.

limited recourse for consumers. Various states and the Securities and Exchange Commission (SEC) introduced regulation to establish standards of conduct and prevent nondisclosure of certain fees. Moreover, the DOL had progressively pursued compensation attained through conflicted transactions through national enforcement projects. The collapse of the Fiduciary Rule creates regulatory ambivalence as different standards are pursued by different parties.

State Regulation

To date, a handful of states have adopted or introduced regulation imposing fiduciary standards on varied transactions. The state regulations lack uniformity and depending on its applicability, may be preempted by federal regulation.²⁰ Entities conducting business in the following states should closely follow regulatory changes that may affect its business structures. Table 3 summarizes the state regulation introduced.

Table 2. PTE 1975-1

PTE 1975-1: Permits certain principal transactions, underwritings, market-making, and extensions of credit between plans and IRAs, and broker-dealers, reporting dealers, and banks, as long as the conditions are satisfied.		
Section	Fiduciary Rule Changes	Reversion
Part I (b)	Revoked. Provided relief for securities transactions incidental to effecting the transactions by parties in interest; provides exemptive relief for certain nonfiduciary services provided by broker dealers in securities transactions.	No longer revoked, but because the DOL cited other regulation as the reason for the revocation (i.e., 408(b)(2)), the provision may be revoked in the future.
	Because Section 408(b)(2) of ERISA and 4975(d)(2) have clarified the scope of relief for service providers to plans and IRAs, exemptions no longer required.	
Part I (c)	Revoked. Provided relief for the furnishing of advice regarding securities or other property to a plan or IRA by a party in interest or disqualified person.	No longer revoked.
Part II (1)	Imposes recordkeeping requirement on the broker-dealer, reporting dealer, or bank engaging in the transaction with the Plan or IRA instead of the Plan or IRA itself.	Revoked; recordkeeping requirement shifts back to the plan or IRA.
Part II (2)	Incorporated into PTE 86-128.	No longer revoked; may be incorporated into another PTE in the future.
Part III	Impartial conduct standard.	Revoked.
Part IV	Impartial conduct standard.	Revoked.
Part V	Permits investment advice fiduciaries to receive compensation for extending credit to a plan or IRA to avoid a failed securities transaction;	Revoked. The exemption would revert to its narrow application and would no longer permit certain compensation, even with disclosure.
	Expands the scope of the exemption and allows investment advice fiduciaries to receive compensation for such transactions if they provide disclosures in advance regarding the interest that will be charged.	

Enforcement Projects

Over the years, the Department has introduced various enforcement projects aimed at reviewing compensation arrangements and conflicts of interest. Prior to 2010, the DOL introduced the Consultant Adviser Project (CAP), which focused on the receipt of compensation by

State Regulations

<p>Nevada²¹ Enacted July 1, 2017 (Senate Bill 383)</p>	<p>Amends the definition of financial planner to remove the exclusion of broker-dealer, sales representative, and investment adviser to subject the excluded persons to the provisions applicable to financial planners.²² Requires the financial planner to disclose all compensation when first retained, and authorizes the state to adopt regulations relating to fiduciary duty, penalties, and other related matters.</p>
<p>Connecticut²³ Enacted October 1, 2017 (Public Act No. 17-142)²⁴</p>	<p>Requires any company that administers a retirement plan offered by a political subdivision of the state to disclose to each participant 1) the fee ratio and return, net of fees, for each investment under the retirement plan; and 2) the fees paid to any person, who for compensation, engages in the business of providing investment advice to participants in the retirement plan directly or through publications or writings. The disclosure is required during initial enrollment and annually thereafter.</p>
<p>New York²⁵ Proposed December 27, 2017 (Suitability and Best Interests in Life Insurance and Annuity Transactions, Insurance Regulation 187)</p>	<p>Clarifies the duties and obligations of insurers providing life insurance and annuity transactions by requiring the establishment of standards and procedures for recommendations to consumers with respect to contracts delivered or issued in the state. The regulation prohibits stating the recommendation is part of financial or investment planning unless the producer has appropriate professional designation. The regulation does not limit the fees a producer or insurer may receive if permitted under insurance law.</p>
<p>New Jersey²⁶ Proposed September 17, 2018</p>	<p>New Jersey Bureau of Securities will issue a Notice of Pre-Proposal to solicit public input on the anticipated rulemaking. A bill was previously introduced in January 2018 but failed to move ahead. The introduced bill would have required nonfiduciary investment advisors to disclose orally and in writing the nonexistence of a fiduciary relationship. The New Jersey Governor's most recent announcement implies the regulation introduced may be more expansive than the one introduced in January.</p>
<p>Maryland²⁷ Proposed February 2018 (Financial Consumer Protection Act of 2018)</p>	<p>Required the study of the fiduciary rule on the federal level to determine if a state law is required. The provision has since been stricken by the Governor. No other regulation has been introduced.</p>

consultants and investment advisers. Specifically, the project reviewed compensation arrangements to determine whether the consultant or investment adviser was a fiduciary and, if so, whether it utilized its position to retain additional fees without notifying the plan.²⁸ Most recently,

the DOL established the Plan Investment Conflicts (PIC)²⁹ project, which reviews conflict of interests by fiduciary service providers related to plan asset vehicles. Although the projects reviewed different arrangements, the DOL's primary focus was on undisclosed compensation and conflict of interest. The collapse of the Fiduciary Rule will not prevent the review of compensation arrangement or conflicts of interests by the DOL. However, in some instances, it may make it difficult for the DOL to establish fiduciary status and to specify corrective action.

CONCLUSION

The collapse of the Fiduciary Rule creates varied problems for those institutions that took steps to comply with the regulation. Primarily, many entities have assumed fiduciary status by explicitly acknowledging such status in agreements, which subjects the entities to the prohibited transaction rules, absent revocation of the status. Even by revoking fiduciary status, entities may still become fiduciaries by retaining discretion over the administration of the plan or disposition of its assets (*i.e.*, functional fiduciary). Moreover, if the entity is a fiduciary, certain arrangements will be prohibited absent compliance with specific exemptions. Thus, it is important for entities to review exemptions and guidance in effect prior to the introduction of the Fiduciary Rule, and modify service arrangements, compensation structures, and disclosure accordingly.

NOTES

1. *Chamber of Commerce of United States of Am. v. United States Dep't of Labor*, 885 F.3d 360 (5th Cir. 2018).
2. See Field Assistance Bulletin No. 2018-02.
3. Employee Benefits Security Administration, 81 Fed.Reg. 20,945 (April 8, 2016) (codified 29 C.F.R. 2510).
4. *John Hancock Mut. Life Ins. Co. v. Harris Tr. & Sav. Bank*, 510 U.S. 86, 114 S. Ct. 517, 126 L. Ed. 2d 524 (1993).
5. 29 U.S.C. § 1002(9), defines the term "person" to include an individual or business entity.
6. See 29 C.F.R. § 2510.3-(c)(1)(i) (investment advice); and 29 C.F.R. § 2509.75-5 (fiduciary responsibility).
7. Discretion requires unilateral authority over plan assets. See *American Federation of Unions*, 841 F.2d at 662-663; *Benvenuto v. Connecticut General Life Ins.*, 643 F.Supp. 87, 90 (D.N.J.1986); *Brock v. Self*, 632 F.Supp. 1509, 1520 (W.D.La.1986); *Eaton v. D'Amato*, 581 F.Supp. 743, 749 (D.D.C.1980); and *Farm King Supply, Inc. Integrated Profit Sharing Plan & Tr. v. Edward D. Jones & Co.*, 884 F.2d 288, 292 (7th Cir. 1989).

8. See 29 C.F.R. § 2510.3-21(c)(1)(i), (ii), requiring 1) rendering investment advice; 2) that is individualized; 3) on a regular basis; 4) pursuant to a mutual agreement; and 5) the advice is the primary basis for investment decisions.
9. See Advisory Opinion 2005-23A (December 7, 2005), regarding the responsibility of plan fiduciaries regarding advice provided by financial planners or advisers to participants of the plan.
10. See IRC Section 4975(e)(1)(B)-(F), providing an IRA includes Archer MSAs, Health Savings Accounts and Coverdell Education Savings Accounts.
11. Conflict of Interest FAQs (Part II – Rule) (January 2017).
12. 29 C.F.R. § 2509.96-1 (participant investment education).
13. See *Schloegel vs. Boswell*, 994 F.2d 266, 271 (5th Cir. 1993); and *Stanton v. Shearson Lehman/American Express, Inc.* 631 F.Supp. 100, 103 (N.D. Ga. 1986).
14. Employee Benefits Security Administration, 81 Fed.Reg.21,002 (April 8,2016), as corrected by 81 Fed. Reg. 44773 (July 11, 2016) (codified as 29 C.F.R. 2550).
15. Employee Benefits Security Administration, 81 Fed.Reg. 21,089 (April 8, 2016), as corrected by 81 Fed.Reg. 44784 (July 11, 2016) (codified 29 C.F.R. 2550).
16. Conflict of Interest FAQs (Part I – Exemptions) (October 27, 2016).
17. See Employee Benefits Security Administration, 81 Fed.Reg. 21,147 (April 8, 2016) (relating to PTE 84-24); 81 Fed.Reg. 21,208 (April 8, 2016) (relating to PTEs 75-1, 77-4, 80-83 and 83-1); and 81 Fed.Reg. 21,181 (April 8, 2016) (relating to PTEs 86-128 and 75-1).
18. See Employee Benefits Security Administration, 81 Fed.Reg. 21,139 (April 8, 2016) (relating to PTE 75-1); 81 Fed.Reg. 21,147 (April 8, 2016) (relating to PTE 84-24); 81 Fed.Reg. 21,208 (April 8, 2016) (relating to PTEs 75-1); and 81 Fed.Reg. 21,181 (April 8, 2016) (relating to PTE 75-1).
19. Fixed index annuity contracts and variable annuity contracts.
20. See National Securities Markets Improvement Act (NSMIA), Pub. L. No. 104-290, 110 Stat. 3416, which preempts states from enacting regulations that impose requirements on covered securities; and 29 U.S.C., §1144(a), which provides ERISA preempts state laws that relate to any employee benefit plan.
21. https://www.leg.state.nv.us/Session/79th2017/Bills/SB/SB383_EN.pdf.
22. N.R.S. § 628A – Financial Planners.
23. State of Connecticut, Public Act No. 17-142.
24. *Ibid.*
25. 11 N.Y.C.R.R. § 60-3.
26. See New Jersey Senate No. 735; Governor Phil Murphy Announcement, available at: <https://nj.gov/governor/news/news/562018/approved/20180917c.shtml>.
27. Maryland House Bill No. 1634.
28. As part of the CAP project, the Department filed an action against Zenith Capital, LLC, see DOL Announcement of Civil Action, available at: <https://www.dol.gov/newsroom/releases/ebsa/ebsa20081024>.
29. See National Enforcement Projects, available at: <https://www.dol.gov/agencies/ebsa/about-ebsa/our-activities/enforcement#national-enforcement-projects>.

Is *Estate of Barton v. ADT Security Services Pension Plan* Good Law?

Rebecca Barker

*In 2016, the Ninth Circuit decided *Estate of Barton v. ADT Security Services Pension Plan* and introduced a new burden-shifting mechanism into cases about employee benefit denial decisions. This article takes a closer look at the bases for both the court's holding and the arguments of Judge Ikuta's dissent to investigate whether the holding is good law. It explores the backdrop for the court's decision, the arguments for and against the new rule, and its subsequent impact—both realized and potential—in lower courts.*

The Ninth Circuit's 2016 decision in *Estate of Barton v. ADT Security Services Pension Plan* introduced a new burden-shifting framework into Employee Retirement Income Security Act (ERISA) cases in which a claimant has made a prima facie case that he is owed pension benefits, but he does not have access to relevant employment information because his employer or plan administrator has not kept a detailed record. The majority opinion, penned by Judge Owens and joined by Judge Kozinski, elicited a scathing dissent from Judge Ikuta. The dissent characterizes the new burden-shifting rule as “off the rails” and directly in conflict with the Supreme Court's directive in *Conkright v. Frommert* not to make “ad hoc exceptions” to the abuse of discretion standard of review.¹

The facts in *Barton* are relatively straightforward. Barton claimed he worked for ADT or one of its affiliates from 1967 until 1986, and logged at least 10 years of continuous service doing so, which was the duration of employment required for an employee to be vested in a plan benefit.² During that time, two different pension plans governed his service: a 1968 plan and a 1985 plan.³ The 1985 plan defined a year

Rebecca Barker is a third-year law student at The University of Chicago Law School. She thanks Chuck Wolf for his guidance and comments throughout the revision process on this paper. This paper won the 2018 American College of Employee Benefits Counsel (ACEBC) Student Writing Competition. The ACEBC is dedicated to elevating the standards and advancing the public's understanding of the practice of employee benefits law. The College sponsors an annual writing competition for law students with the goal of encouraging students to learn about employee benefits. *Benefits Law Journal* is pleased to publish Ms. Barker's winning paper, which has been slightly edited for publication.

of “continuous service” as one in which an employee records 1,000 or more hours of service, and a “break of service” as a plan year in which an employee works 500 hours or less.⁴

In 2010, Barton attempted to begin collecting his pension benefits, but the pension record keeper deemed his employment documentation insufficient to establish that Barton had a vested pension, and categorized Barton as ineligible for pension benefits.⁵ Documentation that Barton provided included tax documents, personnel data forms, Social Security Administration documents showing Federal Insurance Contributions Act (FICA) withholding, pay stubs, copies of key cards, and employee identification issued by ADT, as well as a 1977 letter from the president of ADT congratulating Barton on ten years of service.⁶ The documents did not all span the entire duration of his employment.

ADT’s Employee Benefits Committee denied Barton’s claim and subsequent appeal on the grounds that his documentation was insufficient to establish his claims.⁷ In the court’s words, “because Barton could not document that he worked 1,000 hours or more for each of the nearly twenty years he was employed by ADT and its affiliates, or that his employers participated in the plans, he could not prove he was entitled to a pension.”⁸ Barton’s claim was similarly stymied when he filed suit in the Central District of California, as the court upheld the Committee’s decision to deny Barton pension benefits.⁹

NINTH CIRCUIT MAJORITY HOLDING

On appeal, The Ninth Circuit panel declined to comment on Barton’s eligibility for pension benefits, and framed the case as one turning on where the burden of proof should lie.¹⁰ In situations where the claimant, having made a prima facie case for pension entitlement, “has no means except for information in the defendant’s control” to establish participation by her employer in the plan, the majority asserted that the burden of proof must shift to the defendant to show that the claimant should not receive benefits.¹¹ The court reversed the district court’s judgment and remanded the case for reexamination under this new burden shifting rule.¹²

The majority relies heavily on a normative argument that to place the burden of proving employer plan participation on a claimant is “illogical and unfair,” and that “nothing in ERISA [] supports such a Kafkaesque regime where corporate restructuring can license a plan administrator to throw up his hands and say ‘not my problem.’”¹³ The majority posits that because ERISA-compliant entities should be keeping proper and accurate records anyway, it should not be too cumbersome for an entity to meet that burden of proof. And if an entity has

not kept sufficient records, the court stresses that “the entity, not the claimant, should bear the risk.”¹⁴

BURDEN SHIFTING UNDER *BRICK MASONS*, *COMBS*, AND *ANDERSON*

To support its argument, the majority cites a section of *Brick Masons Pension Trust v. Industrial Fence & Supply, Inc.*, a Ninth Circuit case from 1988, which states that employers’ Fair Labor Standards Act (FLSA)- or ERISA-compliant records “may be the only evidence available to employees” seeking to prove claims under those statutes, and that “an employer cannot escape liability for his failure to pay his employees the wages and benefits due to them under the law by hiding behind his failure to keep records as statutorily required.”¹⁵ In *Brick Masons*, a company failed to make contractually-obligated contributions to two multi-employer welfare plans based on hours worked by covered employees.¹⁶ The welfare plans were unable to provide adequate evidence of how many hours of covered work were performed by covered employees without contributions because the company failed to maintain sufficiently detailed records, which the court held violated its reporting and disclosure requirements under ERISA.¹⁷ The *Brick Masons* court chose to follow the reasoning of an Eleventh Circuit case, *Combs v. King*, which held that once the claimant proved “the fact of damage” and the employer’s failure to keep adequate records under ERISA, the burden shifted to the employer to prove the extent of the work performed.¹⁸

The courts in *Brick Masons* and *Combs*, as well as the majority in *Barton*, derive this burden-shifting framework from *Anderson v. Mt. Clemens Pottery Co.*, a Supreme Court case from 1946 interpreting the FLSA).¹⁹ In *Anderson*, the Supreme Court held that in cases where an employer failed to keep records as required under the FLSA, an employee could meet her burden of proof by demonstrating that she had performed work for which she was improperly compensated and if she “produce[d] sufficient evidence to show the amount and extent of that work as a matter of reasonable inference.”²⁰ Once that burden of proof was met by the claimant, the burden would shift to the employer to establish the precise amount of work performed, or to provide evidence “to negative the reasonableness of the inference to be drawn from the employee’s evidence.”²¹

Anderson arrived at this burden shifting rule for FLSA cases through the same normative argument that the *Barton* majority and the *Brick Masons* court invoke for ERISA cases. The *Anderson* court notes that applying the burden of proof exclusively to the claimant “has the practical effect of impairing many of the benefits of the [FLSA],” and that

“the remedial nature of [the FLSA] and the great public policy which it embodies . . . militate against making that burden an impossible hurdle for the employee.”²² The *Barton* court similarly asserts that “requiring [the claimant] to prove his hours over the course of two decades is unreasonable and inconsistent with the goals of ERISA.”²³ Although *Anderson*’s burden shift was based on FLSA record-keeping requirements, the *Brick Masons* and *Barton* courts draw a parallel between the record-keeping requirements under the FLSA and ERISA’s record-keeping and disclosure requirements.

In *Brick Masons*, the court references the Eleventh Circuit’s discussion in *Combs*, concluding that “both the language and the legislative history of ERISA clearly require employers to keep records of their employees’ hours in order to permit the calculation of benefits due” under ERISA Section 209(a)(1).²⁴ The majority in *Barton* applies the same reasoning to ERISA Section 104(b)(4), which “mandates supplying participants with certain plan information, such as the summary plan description, annual report, or ‘other instruments under which the plan is established or operated.’”²⁵ The court argues that the legislative intent behind Section 104(b)(4) is to allow “the individual participant [to] know [] exactly where he stands with respect to the plan—what benefits he may be entitled to, what circumstances may preclude him from obtaining benefits, what procedures he must follow to obtain benefits, and who are the persons to whom the management and investment of his plan funds have been entrusted.”²⁶ The court further states that “what entities are covered under the [p]lans” is information required under Section 104(b)(4), and that “employers, plans, and plan administrators must . . . be able to identify covered employers and participating employees.”²⁷

DISTINGUISHING *BARTON* FROM THE *BRICK MASONS* LINE OF CASES

The *Barton* dissent argues that the majority overextends the holdings of *Brick Masons* and *Anderson* by applying them more broadly than just to questions of precise numbers of hours worked, and that in doing so, the majority creates a loophole in which an employer or plan administrator may fully comply with its reporting and disclosure requirements and still be vulnerable to the majority’s burden shifting rule, and thus vulnerable to an erroneous claim for benefits. Judge Ikuta notes that ERISA Section 104(b) “by its terms [] does not require a plan administrator to keep the sorts of records at issue here,” and that “the plan administrator here elected to fulfill its fiduciary duty by maintaining and updating a record of past and present employees who are entitled to pensions, rather than by listing covered companies.”²⁸

However, in order for the plan administrator to adequately maintain sufficiently detailed records of employees entitled to pensions, it would follow naturally that the administrator would need to establish whether those employees' employers participated in the plans. Furthermore, the majority's reasoning still holds that if an employer or plan administrator were keeping sufficiently detailed records of which employees were entitled to pensions, then it could easily supply those records when requested. In this case, Barton requested further documentation and was not provided with such.²⁹ From a policy perspective, this places Barton in a similar position to the plaintiffs in *Brick Masons*, *Combs*, and *Anderson*: unable to meet an impossible burden of proof due to their employers' lack of documentation.

Barton, however, is not in exactly the same position as the other plaintiffs, and the dissent is right to distinguish Barton's position. In *Brick Masons*, the plaintiff established that covered work had been performed without its corresponding plan contributions—proving “the fact of damage”—and that the employer had failed to keep accurate records, leaving the burden on the employer to disprove the estimated amount of covered work provided by the plaintiff.³⁰ Similarly, in *Anderson*, employees established they had performed overtime work under the FLSA and that the employer had failed to keep its FLSA-mandated adequate and accurate records, so “the burden shifted to the employer to disprove the employees' estimate of the work performed.”³¹

In *Barton*, the question of Barton's hours worked is only one part of the equation, and the majority applies its burden shift not just to proving the number of hours that Barton worked, but more to the question of whether his employers were plan participants at the time of his employment. This is conceptually distinct, because if Barton's employer did not participate in the plan, then the amounts of hours or years that he spent working there is meaningless to his claim. In the same vein, the employer either was or was not a participant in the benefit plan; that is not a question of precise degree or amount. To suggest that Barton has made a “prima facie case that he is entitled to a pension” without being able to establish that his employer participated in the pension plan at all is somewhat of a stretch.³²

VAGUENESS IN THE *BARTON* MAJORITY'S TEST FOR A PRIMA FACIE CASE

To limit spurious claims, the *Barton* majority notes that a plaintiff cannot succeed by “merely asserting that he is owed a pension,” and that he must “put forth objective evidence.”³³ But where to draw the line on what qualifies as a “reasonable inference” from the documents,

as required under *Anderson*, and what is a “mere assertion” is not defined. The majority cites *Motion Picture Industry Pension & Health Plans v. N.T. Audio Visual Supply, Inc.* to help set bounds on what constitutes a *prima facie* case by providing an example of a case where plaintiffs failed to make a *prima facie* case sufficient to induce *Brick Masons* burden-shifting.³⁴ In *Motion Picture*, to make their *prima facie* case, the plaintiffs needed to prove a) that the defendant had failed to keep adequate records, and b) that employees had performed covered work that was unreported to trust funds.³⁵ If they had successfully done so, the burden would have shifted to the defendant “to show the extent of the unreported covered work for those employees.”³⁶ The plaintiffs, however, failed to establish that the hours the defendant failed to report corresponded with covered work, so the court did not apply the *Brick Masons* burden shift and ruled in favor of the defendant.³⁷

Although the majority holds *Motion Picture* out as a supporting case meant to show that this burden shifting framework is not without boundaries, the case may actually cut against *Barton*’s facts. In *Anderson* and *Brick Masons*, the plaintiffs established that covered work had been performed, and the courts shifted the burden of proof onto the defendants when they could not provide documentation to establish exactly how much covered work was at issue. But in *Barton*, a significant part of the question is still whether *Barton*’s work was covered at all. The plaintiffs in *Motion Picture* failed because they could not establish that the unreported work was covered work. This is arguably a more similar fact pattern to *Barton* than *Brick Masons*.

The Ninth Circuit’s opinion on *Barton* does not consider the merits of *Barton*’s claim, and remands the case back to the district court to consider under its new burden-shifting framework, so it is possible that the district court may in fact find that *Barton* failed to establish a *prima facie* case. If he is found to have made a *prima facie* case, however, the burden-shifting rule may end up requiring the plan administrator to carry the burden not only of proving that *Barton* worked for employers who were not covered under the plans, but also, that even if he did work for covered employers, he did not work the requisite number of hours per year to qualify.

STANDARD OF REVIEW ISSUES IMPLICATED BY *BARTON*’S BURDEN SHIFT

The *Barton* dissent argues that to contemplate a burden shift at all is to go too far, and doing so makes an ad hoc exception in *Firestone*, as warned against in *Conkright v. Frommert*.³⁸ In *Barton*, the majority and the dissent agree that the district court appropriately examined

the Committee's decision under the abuse of discretion standard.^{39,40} Judge Ikuta, however, vehemently denies any space for a burden shift within an abuse of discretion review, writing that "the court must uphold the decision so long as it is logical, plausible, and supported by the record; there is no other burden of proof."⁴¹ Under the dissent's characterization, to address the burden of proof at all goes beyond the confines of deferential review.

Underlying all ERISA cases is the initial determination for the appropriate standard of review. In *Firestone Tire & Rubber Co. v. Bruch*, the Supreme Court held that the default standard of review for challenges to denials of benefits under ERISA-governed plans is de novo, "unless the benefit plan gives the administrator or fiduciary discretionary authority to determine eligibility for benefits or to construe the terms of the plan."⁴² If a plan does convey such discretionary authority, then abuse of discretion is the correct standard of review for a district court to apply.⁴³

Typically, in a deferential review, the court is limited to consider only the evidence in the administrative record.⁴⁴ Conversely, in a de novo review, the court may consider evidence outside the administrative record.⁴⁵ The *Barton* dissent centers on the idea that there can be no burden of proof allocated under an abuse of discretion standard of review because no additional evidence may be introduced to the court.

Barton, however, is not the first case to contemplate a burden-shifting framework within the abuse of discretion standard. In the Ninth Circuit, *Atwood v. Newmont Gold Co., Inc.* supplied the following burden-shifting framework for more than a decade in abuse of discretion cases: if a claimant presented "material, probative evidence" showing that a plan fiduciary's conflict of interest caused a breach of fiduciary duties owed to the claimant, the burden shifted to the administrator to prove that the conflict did not affect its decision to deny benefits to the claimant.⁴⁶ In the event that the plan administrator could not then meet its burden, the court would review the denial decision under a de novo standard, rather than an abuse of discretion standard.⁴⁷

In 2006, the Ninth Circuit pointedly eliminated the "Atwood Test" in *Abatie v. Alta Health & Life Insurance Co.*, holding that *Atwood* "misinterpreted *Firestone*" and that its "back-and-forth burden shifting disobey[ed] the Supreme Court's guidance."⁴⁸ In overruling *Atwood*, the court stressed that *Firestone* created an unyielding dichotomy: "Plans granting discretion to the administrator receive abuse of discretion review for their decisions denying benefits, while plans that do not confer discretion on the administrator have their decisions reviewed de novo."⁴⁹

The court in *Abatie* concluded that without shifting the burden of proof or the standard of review, district courts must make case-by-case

determinations regarding how much weight to give potential conflicts of interest in plan administrators' denial of benefits decisions under abuse of discretion review.⁵⁰ In order to assess the conflict of interest, "the district court may, in its discretion, consider evidence outside the administrative record," but "the decision on the merits [] must rest on the administrative record once the conflict (if any) has been established, by extrinsic evidence or otherwise."⁵¹

COMPARING *BARTON'S* BURDEN SHIFT TO *ABATIE* AND *ATWOOD*

The *Barton* majority, unlike the *Atwood* court, does not suggest that its burden-shifting framework ultimately switch the standard of review from abuse of discretion to de novo. The *Barton* majority's new framework would conceptually operate in the same space as *Abatie's* case-by-case conflict review: a space within the abuse of discretion standard of review that may (or may not—the majority does not specify) allow for extrinsic evidence to be considered at the discretion of the court. But is the burden shift (without a corresponding shift to de novo review) analogous to *Abatie's* mechanism, or does it look more like the overruled burden shift from *Atwood*?

The majority is not clear on whether this burden shift would effectively require evidence outside the administrative record to be submitted to the court in order for defendants to have any chance at prevailing. As the dissent notes, if no extrinsic evidence is introduced but the burden shift is still enforced, the district court may be compelled to conclude that the claimant is entitled to benefits based on a lack of evidence.⁵² But with extrinsic evidence included, *Barton's* burden shift begins to look a lot more like a de novo review than an abuse of discretion review. The majority may be asking the district court to consider extrinsic evidence in making decisions about: a) whether Barton's employers were plan participants, and b) whether Barton worked enough hours per year to qualify as entitled to pension plan benefits.⁵³ These decisions are not analogous to a conflict of interest review separate from the merits—indeed, they are the merits.

In many ways, it would seem more natural for the majority to have taken their burden-shifting framework a step further and established a subsequent shift in standard of review, like the *Atwood* Test. The conflicts carve-out under abuse of discretion review exists conceptually to give courts an opportunity to lessen deference for discretionary denials that are tainted by self-interest or other conflicts.⁵⁴ The conflicts analysis operates as somewhat of a side trip as the court makes its way to its substantive review for abuse of discretion by the administrator. In *Barton*, the court seeks to add another potential detour to the abuse

of discretion standard by instructing the court to reduce (or eliminate) its deference to the plan administrator's discretion, not because of an alleged conflict of interest but because of other intangibles: because it is unfair to expect the claimant to maintain documentation related to her benefits; because it is too "arduous" for the claimant to fully make her case; because the spirit of ERISA and "common sense" demand it.⁵⁵

POTENTIAL EFFECTS ON DE NOVO AND ABUSE OF DISCRETION REVIEW POST-BARTON

It is unclear why the *Barton* majority chose to position its burden shift as a detour within abuse of discretion review rather than an exit ramp to de novo review. It is possible that the majority foresaw a short life for a burden shift patterned too similarly after the late *Atwood* Test, and sought to avoid the comparisons. Furthermore, in the *Barton* dissent, Judge Ikuta notes that even under a de novo standard, Ninth Circuit precedent places the burden of proof firmly on the claimant.⁵⁶ In *Muniz v. Amec Construction Management*, the plaintiff "argue[d] that after he met the initial burden of proof of disability . . . the burden of proof should have shifted to [the plan administrator] to demonstrate its decision to terminate his benefits was justified."⁵⁷ The plaintiff based his claim on the burden-shift mechanism for conflicts in abuse of discretion cases then, despite the fact that his case was being reviewed de novo.⁵⁸ The *Muniz* court rejected this argument, stating that the Ninth Circuit had "clearly limited" the burden-shifting mechanism to abuse of discretion cases "where the administrator's potential conflict of interest was in question."⁵⁹ The court went on to note that under de novo review, the court "does not give deference to the claim administrator's decision, but rather determines in the first instance if the claimant has adequately established [their claim] under the terms of the plan."⁶⁰

Notably, this indicates that the current framework for de novo review creates a more stringent burden of proof for a claimant than that of an abuse of discretion review with the *Barton* burden shift in place, provided the plan administrator did not keep records that can specifically disprove the plaintiff's claim for entitlement to benefits. This creates its own "common sense" problem, which neither the majority nor the dissent in *Barton* directly address.

Looking at the public policy concerns from a commonsense perspective, it seems unlikely that many claimants seeking pension or disability benefits would find the time or financial resources to pursue multiple internal appeals and proceed into federal court on ERISA claims when faced with clear evidence from their plan administrators that they were not eligible for the benefits they sought. This means

that plaintiffs who do make it to the district court are much more likely to prevail if their cases are reviewed for an abuse of discretion rather than de novo, assuming they have some semblance of a case at all, and assuming that the plan administrator does not have the requisite records to prove otherwise. To create a situation where identically situated plaintiffs have an easier time prevailing under deferential review than under de novo review is to upend the dichotomy between abuse of discretion and de novo review set out in *Firestone*.

The ease with which plaintiffs may prevail under abuse of discretion review also leaves plans—and their valid participants—more vulnerable to spurious claims, particularly since the new rule is controversial enough to have gained attention from those in the field. As the dissent notes, the “new rule does not just shift a burden, but as a practical matter, *could* make the claimant eligible for benefits whenever the historical information is scanty or unavailable.”⁶¹ The dissent also points out that “protect[ing] the soundness and stability of plans with respect to adequate funds to pay promised benefits” is a core policy of ERISA, and that doing so requires plan administrators to deny improper claims in order to benefit true beneficiaries.⁶² Particularly at a time when so many pension plans are in crisis, the balance between potentially over-inclusive rules that protect plans and potentially over-inclusive rules that protect beneficiaries’ access is critical.⁶³

The controversy of the rule is highlighted in the dissent penned in response to the court’s denial for rehearing en banc. The dissent, joined by eight circuit judges, reiterates the position that the majority’s holding departs from the Supreme Court’s mandates for deference under the abuse of discretion standard in *Firestone* and *Conkright*, and further asserts that the holding “fails to maintain the uniformity of [the Ninth Circuit’s] decisions.”⁶⁴ In particular, the dissent stresses *Conkright*’s description of abuse of discretion deference under *Firestone* as “a broad standard of deference without any suggestion [of susceptibility] to ad hoc exceptions.”⁶⁵ Judge Smith concludes by questioning why the Supreme Court mandates standards of review “if judges can ignore them at any time they are so inclined,” and whether “each panel [can] decide the law on its own, provided enough active judges are willing to live with it.”⁶⁶

THE EBB AND FLOW OF ERISA PRECEDENT

Judge Smith, et al., are entitled to frustration with the majority’s decision as a departure from Ninth Circuit precedent and as a confusing rule in general, but these questions may border on melodrama given the inherent evolutionary nature of the common law. ERISA does not itself provide for a standard of review, and a number of cases

indicate that Congress intended for the courts to establish the rules and procedures necessary to address litigation under ERISA.⁶⁷ While *Firestone* is the Supreme Court's landmark holding on the matter, circuits have interpreted *Firestone* in different ways, leading to varied approaches to abuse of discretion review under ERISA depending on the circuit, particularly with respect to the level of deference necessary in the face of a conflict of interest. Along the way, the Supreme Court has wrangled the circuits back in line when they stray too far from one another or from the Supreme Court's intentions set by *Firestone*.

For example, while the Ninth Circuit rejected a "sliding scale" approach to deference with regard to conflict of interest in *Abatie*, many other circuits embraced such an interpretation of *Firestone* until otherwise directed by the Supreme Court in *Metropolitan Life Insurance Co. v. Glenn* 2008.⁶⁸ The Fourth Circuit addressed the issue in *Williams v. Metropolitan Life Insurance Co.*, describing its prior "modified abuse-of-discretion standard," in which conflicts of interest for plan administrators "modif[ied] the abuse-of-discretion standard according to a 'sliding scale,' requiring greater objective reasonableness and more substantial evidence in support of a decision depending on the degree of the administrator's [conflict of interest]."⁶⁹ The *Williams* court departed from its Fourth Circuit precedent in light of *Glenn*, which held that a structural conflict of interest is a "factor" to be taken into account like any other consideration relevant to a judge's review of ERISA claims, and not one worthy of courts "creat[ing] special burden-of-proof rules."⁷⁰

Similarly, the Tenth Circuit addressed *Glenn's* abrogation of its circuit precedent in *Holcomb v. Unum Life Insurance Company of America*, noting that the court had shifted the burden of proof to the administrator in prior benefit denial cases under abuse-of-discretion level review, but that *Glenn* "expressly reject[ed] and therefore abrogate[d] this approach."⁷¹ Cases from the Fifth and Eighth Circuits illustrate similar shifts and abandonment of circuit precedent regarding the weight of conflicts in abuse-of-discretion review post-*Glenn*.⁷² The idea that circuits interpret broad Supreme Court holdings into more specific mechanisms is not foreign, nor indicative of "ignoring" the holdings of the Supreme Court, as the *Barton* rehearing denial dissent would suggest.

BARTON'S FUTURE APPLICATIONS

Barton represents the beginning of another line of ERISA case law that may well end up reined in by a future Supreme Court holding if its doctrine becomes too problematic. While the dissent presents valid criticisms, *Barton* has already found a few sparse citations and tentative applications.⁷³

In the most in-depth application so far of *Barton*'s rule, the District of Nevada applied the holding in *Estate of Burgard v. Bank of America* in September 2016.⁷⁴ In *Burgard*, the court addressed a discovery dispute occurring within a case now governed by *Barton*.⁷⁵ In this case, the decedent, Ms. Burgard, was presented with a document from her employer, a bank, upon her retirement in 1986, promising life insurance and accidental death and dismemberment coverage going forward.⁷⁶ In 2012, Ms. Burgard was killed in a motor vehicle accident, triggering a payout of the accidental death benefit.⁷⁷ By this time, Bank of America had replaced Ms. Burgard's former employer through "a succession of bank acquisitions," and it alleged that it "[did] not have any information or documents indicating the fate of the life insurance policy provided to Ms. Bugard at the time of her retirement in 1986."⁷⁸ The court detailed *Barton*'s burden-shifting framework, and held that Bank of America's statement that it lacked information was "not necessarily a satisfactory answer under *Barton*."⁷⁹ The court went on to authorize further discovery, noting that the further discovery "might have been unnecessary if Defendants maintained and were able to produce documents regarding 'the fate of [the policy].'"⁸⁰ Notably, the holding in *Burgard* indicates an embrace of extrinsic evidence under the *Barton* burden shift.

On a practical level, by leaving the question of what constitutes a prima facie case open on remand rather than reversing the district court's opinion, the Ninth Circuit may have created more questions than answers for plaintiffs and judges, but the *Barton* holding does provide some clues for plan administrators situated similarly to those at ADT. If a plan administrator can root a denial of benefits decision in the records it does have rather than those it lacks, it may circumvent the issue entirely. For example, the plan administrator in *Barton* could have pointed to the thousands of covered employees it *does* have records on, acknowledged that Barton worked for various divisions of ADT over the years, and ultimately still denied him benefits based on the strong inference of ineligibility drawn from his absence in their comprehensive records. Although nothing about the underlying facts is changed, this explanation looks less like a denial based on insufficient evidence—including no evidence contradicting Barton's eligibility—and instead frames the denial as one rooted in robust record-keeping practices that wouldn't trigger the *Barton* burden shift.

CONCLUSION

In the words of Chief Justice Roberts, in the *Conkright* majority opinion: "People make mistakes. Even administrators of ERISA plans. That should come as no surprise, given that [ERISA] is 'an enormously

complex and detailed statute,' and the plans that administrators must construe can be lengthy and complicated."⁸¹ While Chief Justice Roberts did not explicitly extend this dictum to include circuit court judges, it is worth noting that they are entrusted with construing the same complicated, detailed plans and ERISA provisions as plan administrators. Additionally, judges take on this task while remaining cognizant of the delicate balance between the various entities that ERISA exists to protect, the varying lines of precedent within their circuit and in other circuits, and their own duty to administer justice.⁸²

It remains to be seen whether the Supreme Court will decide in time that the Ninth Circuit made a mistake with its holding in *Barton*. For the time being, it presents a mechanism that appears relatively simple on its face, takes a clear stand on a policy issue, and has the capacity to greatly assist plan beneficiaries who are wrongly denied benefits by employers or plan administrators who would seek to hide behind their own record-keeping failures to avoid paying out benefits. Whether done maliciously or inadvertently, careless record-keeping regarding an employer or employee's eligibility and participation in an ERISA plan can no longer shield a plan administrator once a claimant has made a prima facie case for benefits owed—at least in the Ninth Circuit. Ideally, a rule like this would influence plan administrators to take additional care in maintaining such records, although many cases likely to prevail under *Barton* may have similar fact patterns, where the time for maintaining the records is decades in the past.

Despite the chaos that *Barton* sparks behind the scenes regarding standards of review, its holding is good law—just as other circuits' "sliding scale" approach to conflicts of interest were—until the Supreme Court decides to take the wheel again, as it did in *Firestone*, *Conkright*, and *Glenn* to create clarity and additional guideposts for Circuit Judges' future decisions.

NOTES

1. *Estate of Barton v. ADT Sec. Servs. Pension Plan*, 820 F.3d 1060, 1070 (Ikuta, J., dissenting).
2. *Barton*, 820 F.3d at 1062.
3. *Id.*
4. *Id.* at 1063.
5. *Id.*
6. *Id.*
7. *Barton*, 820 F.3d at 1063.
8. *Id.* at 1065.

9. *Id.*
10. *Id.*
11. *Barton*, 820 F.3d at 1069.
12. *Id.* at 1070.
13. *Id.* at 1066.
14. *Id.*
15. *Brick Masons Pension Trust v. Industrial Fence & Supply, Inc.*, 839 F.2d 1333, 1338 (9th Cir. 1988).
16. *Id.* at 1335.
17. *Id.* at 1337–1338. *See also* 29 U.S.C. § 1059(a)(1) (“every employer shall . . . maintain records with respect to each of his employees sufficient to determine the benefits due or which may become due to such employees”).
18. *Brick Masons*, 839 F.2d at 1338 (citing *Combs v. King*, 764 F.2d 818, 822-27 (11th Cir. 1985)).
19. *Anderson v. Mt. Clemens Pottery Co.*, 328 U.S. 680, 66 S.Ct. 1187, 90 L.Ed. 1515 (1946); 29 U.S.C. § 201 *et seq.* Some holdings from *Anderson* were superseded by the Portal-to-Portal Act of 1947, but they are not relevant to the burden-shifting issue. 29 U.S.C. § 241 *et seq.* *See also Sandifer v. U. S. Steel Corp.*, 134 S.Ct. 870, 875, 187 L.Ed.2d 729, 82 USLW 4071 (2014) (interpreting the Portal-to-Portal Act and discussing its evolution out of the *Anderson* holding).
20. *Id.* at 687.
21. *Id.* at 687–688.
22. *Id.* at 686–687.
23. *Barton*, 820 F.3d at 1068.
24. *Brick Masons*, 839 F.2d at 1338 (citing *Combs*, 764 F.2d at 822–825); 29 U.S.C. § 1059(a)(1) (stating that “every employer shall . . . maintain records with respect to each of his employees sufficient to determine the benefits due or which may become due to such employees.”).
25. *Barton*, 820 F.3d at 1067 (citing 28 U.S.C. § 1024(b)(4)).
26. *Id.* (citing *Hughes Salaried Retirees Action Comm. V. Adm’r of Hughes Non-Bargaining Ret. Plan*, 72 F.3d 686, 690 (9th Cir. 1995) (en banc) (quoting S.Rep. No. 127, 93d Cong., 2d Sess. (1974), *reprinted in* 1974 U.S.C.C.A.N. 4838, 4863)).
27. *Id.* at 1067–1068 (citing *Cent. States, Se. & Sw. Areas Pension Fund v. Cent. Transp., Inc.*, 472 U.S. 559, 572, 105 S.Ct. 2833, 86 L.Ed.2d 447 (1985) (stating that ERISA’s reporting and disclosure standards place a duty on plans to determine “who is in fact a plan participant”)).
28. *Barton*, 820 F.3d at 1072–1073 (Ikuta, J., dissenting).
29. *Id.* at 1064.
30. *Brick Masons*, 839 F.2d at 1338–1339.
31. *Barton*, 820 F.3d at 1074 (Ikuta, J., dissenting) (summarizing the basic fact pattern of *Anderson v. Mt. Clemens Pottery Co.*).

32. *Id.* at 1069.
33. *Id.*
34. *Id.* (citing *Motion Picture Indus. Pension & Health Plans v. N.T. Audio Visual Supply, Inc.*, 259 F.3d 1063, 1066-67 (9th Cir. 2001).
35. *Motion Picture*, 259 F.3d at 1066.
36. *Id.*
37. *Id.* at 1068.
38. *Barton*, 820 F.3d at 1070 (Ikuta, J., dissenting) (citing *Conkright v. Frommert*, 559 U.S. 506, 513, 130 S.Ct. 1640, 176 L.Ed.2d 469 (2010)).
39. *Barton*, 820 F.3d at 1065.
40. *Id.* at 1071 (Ikuta, J., dissenting).
41. *Barton*, 820 F.3d at 1071 (Ikuta, J., dissenting) (citing *Walker v. American Home Shield Long Term Disability Plan*, 180 F.3d 1065, 1069–1070 (9th Cir. 1999).
42. *Firestone Tire & Rubber Co. v. Bruch*, 489 U.S. 101, 115, 109 S.Ct. 948, 103 L.Ed.2d 80 (1989).
43. *Id.*
44. *Jebian v. Hewlett-Packard Co. Employee Benefits Org. Income Prot. Plan*, 349 F.3d 1098, 1110 (9th Cir. 2003) (stating that a review for abuse of discretion is limited to the record before the plan administrator); *Abatie v. Alta Health & Life Ins. Co.*, 458 F.3d 955, 969–970 (9th Cir. 2006) (listing cases with similar holdings from several other circuits and holding the same itself).
45. *Abatie*, 458 F.3d at 970. *See also* *Jebian*, 349 F.3d at 1110 (stating that the evidentiary limitation of the administrative record “does not apply to *de novo* review”); *Mongeluzo v. Baxter Travenol Long Term Disability Benefit Plan*, 46 F.3d 938, 944 (9th Cir. 1995) (stating that district courts may allow evidence from outside the administrative record only when the evidence is “necessary to conduct an adequate *de novo* review”).
46. *Atwood v. Newmont Gold Co., Inc.*, 45 F.3d 1317, 1322–1323.
47. *Id.* at 1323.
48. *Abatie*, 458 F.3d 955 at 959, 966.
49. *Id.* at 966.
50. *Abatie*, 458 F.3d at 970.
51. *Id.*
52. *Barton*, 820 F.3d at 1073 (Ikuta, J., dissenting).
53. *Id.* at 1069.
54. *See* *Tremain v. Bell Industries, Inc.*, 196 F.3d 970, 976 (9th Cir. 1999) (stating that conflict of interest “must be weighed as a factor in determining whether there is an abuse of discretion” and that when a conflict exists, the court’s review “although still for abuse of discretion, is “less deferential”) (citing *Firestone*, 489 U.S. at 115, 109 S.Ct. 948).
55. *Barton*, 820 F.3d at 1070.

56. *Muniz v. Amec Const. Management, Inc.* 623 F.3d 1290, 1294 (9th Cir. 2010) (stating that the burden of proof falls on the claimant in a de novo review an ERISA plan administrator's decision).
57. *Id.* at 1295.
58. *Id.*
59. *Id.*
60. *Muniz*, 623 F.3d at 1295–1296.
61. *Barton*, 820 F.3d at 1074.
62. *Id.* (citing 29 U.S.C. § 1001(a)); see also *Boyd v. Bert Bell/Pete Rozelle NFL Players Ret. Plan*, 410 F.3d 1173, 1178 (9th Cir. 2005) (holding that fiduciaries of benefit plans are “obligated to guard the assets of the Plan from improper claims”).
63. *Conkright v. Frommert*, 559 U.S. 506, 516–517, 130 S.Ct. 1640, 1648, 176 L.Ed.2d 469 (2010) (stating that ERISA represents a “careful balancing between ensuring fair and prompt enforcement of rights under a plan and the encouragement of the creation of such plans.”) (citing *Aetna Health Inc. v. Davila*, 542 U.S. 200, 215, 124 S.Ct. 2488, 159 L.Ed.2d 312 (2004)).
64. *Estate of Barton v. ADT Sec. Servs. Pension Plan*, 837 F.3d 1014, 1015 (9th Cir. 2016) (N.R. Smith, J., dissenting).
65. *Conkright*, 559 U.S. at 513, 130 S.Ct. at 1646.
66. *Barton*, 837 F.3d at 1016.
67. See *Abatie*, 458 F.3d at 962 (stating that “Congress expected federal courts to develop a body of common law to govern [ERISA] claims and to determine the appropriate standards of review,” and that “since ERISA’s inception in 1974, Congress has not altered the statute to provide for a standard of review.”). See also *Franchise Tax Bd. v. Constr. Laborers Vacation Trust*, 463 U.S. 1, 24 n. 26, 103 S.Ct. 2841, 77 L. Ed. 2d 420 (1983) (noting that ERISA’s legislative history suggests that “a body of Federal substantive law will be developed by the courts to deal with issues involving rights and obligations under private welfare and pension plans.” (quoting 120 Cong.Rec. 19,942 (1974) (remarks of Sen. Javits))).
68. *Abatie*, 458 F.3d at 967.
69. *Williams v. Metro. Life Ins. Co.*, 609 F.3d 622, 630 (4th Cir. 2010). See also, e.g. *Stup v. UNUM Life Ins. Co. of Am.*, 390 F.3d 301, 307–311 (4th Cir. 2004) (applying the “sliding scale” analysis to an abuse of discretion review).
70. *Metro. Life Ins. Co. v. Glenn*, 544 U.S. 105, 116, 128 S. Ct. 2343, 2351, 171 L. Ed. 2d 299 (2008).
71. *Holcomb v. Unum Life Ins. Co. of Am.*, 578 F.3d 1187, 1192 (10th Cir. 2009) (citing *Glenn*, 544 U.S. at 116). See also, e.g. *Fought v. Unum Life Ins. Co. of Am.*, 379 F.3d 997 (10th Cir. 2004) (applying the Tenth Circuit’s prior burden shifting framework).
72. See, e.g., *Ariana M. v. Humana Health Plan of Texas, Inc.*, 884 F.3d 246 (5th Cir. 2018); *Boyd v. ConAgra Foods, Inc.*, 879 F.3d 314 (8th Cir. 2018).
73. See, e.g. *Soich v. Aetna Life Ins. Co.*, No. 3:16-CV-88-SI, 2017 WL 449171, at *4 (D. Or. Feb. 2, 2017) (citing the *Barton* rule and ultimately holding that the plaintiff failed to make a prima facie case sufficient to trigger the *Barton* burden shift); *Popovich v. Metro. Life Ins. Co.*, 281 F. Supp. 3d 993, 997 (C.D. Cal. 2017) (citing

Barton and stating its rule that the “plaintiff bears the burden of proof . . . except with regards to matters within the defendant’s control.”); *Thomas v. Aetna Life Ins. Co.*, No. 215CV01112JAMKJN, 2016 WL 4368110, at *7 (E.D. Cal. Aug. 15, 2016) (stating that under *Barton*, “a claimant may bear the burden of proving entitlement to ERISA benefits when the claimant has better—or at least equal—access to the evidence needed to prove entitlement.”). See also *Motes v. Time Warner Cable Pension Plan*, No. 6:15-CV-00373-RWS, 2017 WL 3034675 at *1 (E.D. Tex. July 18, 2017) (stating the *Barton* burden shift as the applicable legal standard despite being out of Circuit, and ultimately holding that the plaintiff’s evidence was too unreliable to establish a prima facie case).

74. *Estate of Burgard by & through Horan v. Bank of Am., N.A.*, No. 215CV00833RFBGWF, 2016 WL 10839796, at *6 (D. Nev. Sept. 9, 2016).

75. *Id.*

76. *Id.* at *1.

77. *Id.*

78. *Burgard*, 2016 WL 10839796 at *2.

79. *Id.* at *7.

80. *Id.*

81. *Conkright*, 559 U.S. at 509, 130 S.Ct. at 1644. (quoting *Mertens v. Hewitt Associates*, 508 U.S. 248, 262, 113 S.Ct. 2063, 124 L.Ed.2d 161 (1993)).

82. 28 U.S.C. § 453 (Oath of justices and judges to “administer justice without respect to persons, and do equal right to the poor and to the rich.”)

Time to Review Executive Compensation Arrangements in Light of IRS Guidance on Section 162(m)

Janet Lowder, Jane Jeffries Jones, Jan Baldwin, and Vivian Coates

In August, the Internal Revenue Service (IRS) published limited initial guidance regarding key aspects of the changes brought about by the Tax Cuts and Jobs Act of 2017 to Section 162(m) of the Internal Revenue Code of 1986, as amended, which caps deductible executive compensation at \$1 million. This article summarizes IRS Notice 2018-68 and suggests action items for public companies in light of this guidance.

SUMMARY OF THE ACT

The Tax Cuts and Jobs Act of 2017 made sweeping changes to Code Section 162(m), including:

- Removing the exemption for performance-based compensation from the \$1 million compensation deduction limitation.
- Expanding the list of executives (or “covered employees”) subject to the \$1 million deduction cap to include a company’s CFO, in addition to its CEO and three other most highly compensated executive officers. Anyone serving as CEO or CFO at any point during a company’s fiscal year (vs. being in service at year-end only) also became a “covered employee.”

Janet Lowder is an associate with Womble Bond Dickinson LLP, based in its Charlotte, N.C., office. She advises clients on compensation plans and arrangements and executive compensation matters. Jane Jefferies Jones is a partner with Womble Bond Dickinson, also based in Charlotte. She specializes in executive compensation and corporate matters, and represents many of the firm’s public securities team public company clients. She leads the firm’s Corporate and Securities practice group. Vivian Coates is an associate with Womble Bond Dickinson. She counsels clients on compensation systems, and is based in the Winston-Salem, N.C. office. Jan Baldwin is a partner with Womble Bond Dickinson’s Corporate and Securities practice group. Her practice focuses on tax and ERISA rules governing employee benefit plans and executive compensation arrangements. She is based in the Winston-Salem office.

Further, once an executive becomes a covered employee under Code Section 162(m) (effective for years beginning January 1, 2017), he or she will now be subject to the Code Section 162(m) \$1 million deduction limitation in all future years—including after termination of employment or death.

- Grandfathering certain written compensation arrangements in effect on November 2, 2017, that were not previously subject to the \$1 million deduction limitation, so long as the arrangement is not materially modified. Under the grandfather rule, companies may be able to continue to deduct previously exempt compensation even if in excess of \$1 million notwithstanding the changes brought about by the Act. For example, arrangements with individuals who were not previously covered (*e.g.*, CFOs) and compensation arrangements previously exempt but not currently exempt (*e.g.*, stock options and other performance-based compensation) may be eligible for grandfather treatment.
- Expanding the companies covered by Code Section 162(m) to include all companies required to file Securities and Exchange Commission (SEC) reports under Section 15(d) of the Securities Exchange of 1934, as amended (*i.e.*, public debt issuers).

RECENT IRS GUIDANCE

The Notice addresses (1) the amended definition of “covered employee” and (2) the scope of the grandfather rule for certain outstanding arrangements. Key takeaways include:

“Covered Employees” and “NEOs” Are Not Synonymous

The IRS emphasizes that covered employees subject to the Code Section 162(m) \$1 million deduction cap may include persons who are not treated as named executive officers (NEOs) for proxy statement purposes. Of note, smaller reporting companies (SRCs) and emerging growth companies (EGCs) are not treated differently from larger companies for Code Section 162(m) purposes. Also, covered employees do not need to be employees at year-end. Consequently, covered employees for Code Section 162(m) purposes may be different than the individuals disclosed in a company’s SEC filings due to termination

or retirement of executive officers during the year or midyear merger and acquisitions transactions.

Grandfather Treatment Narrowly Interpreted

The Notice narrowly interprets a company's ability to seek grandfather protection for its compensation arrangements. To be eligible,

- The compensation must have been exempt from the Code Section 162(m) \$1 million deduction limitation prior the Act. Any compensation that was previously captured under Code Section 162(m) will not be eligible for relief.
- The compensation must be subject to a written binding contract in effect on November 2, 2017, pursuant to which the company is legally obligated (*e.g.*, under state contract law) to pay remuneration. The Act applies to any compensation in excess of what the company was legally required to pay on November 2, 2017. Companies will therefore need to analyze the enforceability of a compensation agreement in light of state and other laws as a component of the grandfather determination.
- The compensation arrangement must not have been materially modified on or after November 2, 2017. The IRS states that a material modification occurs when an agreement is amended to increase the amount of compensation payable. As described in greater detail below, compensation arrangements that provide for negative company discretion and/or supplemental compensation will generally result in the loss of grandfather treatment.

Grandfather Treatment Ends upon Agreement Renewal (Including Automatic Renewals)

A written binding contract that is terminable by a company without the employee's consent is treated as renewed after November 2, 2017, on the date of any such termination, if made, would be effective. For example, if a contract automatically extends unless 30 days' prior notice is given by the company or employee, the agreement is treated as renewed (and grandfather treatment terminated) on the date the termination would be effective if notice were given. An arrangement does not end if the contract is terminated or canceled only by terminating the employment relationship of the employee.

Grandfather Treatment Precluded to Extent Negative Discretion Retained

As discussed above, to receive grandfather treatment, the compensation must be payable pursuant to a written binding contract in effect on November 2, 2017, that constitutes a legally binding obligation of the company. To the extent that a company retains negative discretion to reduce payments, the IRS views this as lacking a legal obligation to pay, and the compensation is not eligible for grandfather treatment. The Notice suggests that the IRS will view a contract as not being legally binding if a company has the discretion to reduce an award to zero; however, if the company has agreed to compensate an employee with at least a certain base amount of compensation, despite having negative discretion to otherwise reduce the award to that “floor” level, the “floor” portion of the award may be eligible for grandfather treatment.

Certain Supplemental Agreements Terminate Grandfather Treatment

If a company enters into a side agreement to supplement grandfathered compensation, the grandfathered compensation may lose its special status. To determine whether the supplemental compensation is a material amendment of such grandfathered compensation, the IRS will consider whether the additional compensation is paid on substantially the same elements or conditions as the compensation in the grandfathered agreement. For example, entering into a new executive compensation agreement to annually pay an additional cash sum for service (that exceeds a cost of living adjustment) will be viewed as amending a prior grandfathered employment agreement, terminating grandfather treatment. However, entering into an agreement with an executive to issue a restricted stock award would not terminate treatment of the executive’s grandfathered compensation under his or her employment agreement because the restricted stock award is not based solely on service, as it is for base salary, but service and stock price.

Annual Cost of Living Adjustments Not Considered a Material Modification

Companies may increase the salaries of executives to reflect cost of living adjustments without losing grandfather treatment. Cost of living adjustments are not considered material contract amendments. But note that while the underlying salary as in effect on November 2, 2017, may be eligible for grandfather treatment (despite the cost of living

adjustment), the amount attributable to the cost of living adjustment will be subject to the \$1 million cap.

Grandfather Treatment Not Necessarily Lost if Compensation Accelerated or Deferred

The acceleration of compensation may be permitted without loss of grandfather treatment in certain instances where the compensation is discounted to reflect the time value of money. Likewise, so long as no more than a reasonable rate of interest (or an amount tied to a predetermined actual investment) is paid on deferred compensation under a written binding agreement, the compensation paid under that agreement will not lose its grandfather treatment.

1993 Transition Guidance

In the Notice, the IRS follows and expands upon its transition rules released in 1993 in connection with the adoption of the Code Section 162(m) \$1 million deduction limitation with regards to what constitutes a written binding agreement and a material modification. It, however, is unclear whether the IRS will interpret specific questions more narrowly going forward, given the fact that the Notice includes additional limitations not found in the 1993 guidance.

PRACTICAL CONSIDERATIONS

In light of the Notice's guidance, public companies should:

- **Identify and track covered employees.** Companies should consider which employees may be considered a covered employee for Code Section 162(m) purposes, remembering that the analysis is different from determining NEOs. M&A transactions, interim executive positions and smaller public company status may complicate the analysis. Companies will also need to remember that under the new rules, once an executive becomes a covered employee under Code Section 162(m), he or she will always be a covered employee, and his or her compensation will be subject to the \$1 million deduction limitation. For this reason, companies will face additional burdens to maintain accurate records of their covered employees.

- **Discern if a single compensation agreement includes compensation elements that are eligible for grandfather treatment and others that are not.** Companies should analyze individual elements of executive compensation arrangements as some agreements may include eligible and ineligible elements for grandfather treatment. For instance, a CEO's 2016 employment agreement may provide for the payment of a base salary (which would not be eligible for grandfather treatment) as well as payment of a performance-based bonus that qualified for the Code Section 162(m) performance-based compensation exemption prior to the Act.
- **Analyze whether pre-existing arrangements constitute written binding contracts.** Companies should take stock of which of their compensation agreements may be eligible for grandfather treatment. This analysis begins with assessing which, if any, arrangements were exempt from the Code Section 162(m) deduction limitation prior to the Act. For those exempt arrangements, the company must determine whether a written binding agreement exists that legally obligates the company to pay compensation. This analysis will involve a review of state and any other applicable law. Where written, legally binding compensation arrangements exist, the company must finally assess whether there have been any material amendments to the agreement that preclude seeking grandfather treatment.
- **Analyze CFO compensation-related agreements.** Previously, CFOs were excluded from covered employee status. Now that CFOs are captured by Code Section 162(m), companies should take special care to review CFO compensation arrangements and any proposed amendments to such arrangements to determine if grandfather treatment is available.
- **Pause before amending executive compensation agreements.** Even if an executive is not currently a covered employee, companies should consider whether the individual is likely to become a covered employee before amending his or her compensation arrangements. This is especially true for companies undergoing corporate restructures or management transitions where top-level positions may be eliminated or roles divided, pushing previously fourth- or fifth-highest compensated employees (other than CEO/CFO)

(*i.e.*, individuals previously outside of Code Section 162(m)'s reach) into a top three compensated position and therefore into covered employee status.

- **Watch for additional IRS guidance.** The Notice indicates that additional regulations are forthcoming and requests comment on various applications of Code Section 162(m), including in the context of foreign private issuers, initial public offerings, and M&A transactions.

Notwithstanding the changes in compensation deductibility made effective under the Act (and further detailed in the Notice), boards should continue to exercise their fiduciary duties in making executive compensation decisions by considering what is in the best interests of their company and its shareholders.

Phased Retirement Programs as Part of an Age-Friendly Business Strategy

Barry Kozak

Phased retirement programs are one method available for employers to allow older employees to gradually transition into retirement. The benefit for employers is two-fold: it can control the costs for some of its more seasoned workforce and can provide mentorship and appropriate transfer of institutional knowledge to the remaining workforce. For the individuals, it allows them to remain in the workforce for a few additional years to shore up their retirement readiness and concentrate on creating a plan for life after retiring.

Unfortunately, too few employers have a formal phased retirement program in place. This article advocates for employers to adopt formal-phased retirement programs. It explores whether phased retirees could continue to receive current employee benefits, such as health and welfare, fringe, and other currently available employee benefits and perks. Additionally, the article provides insight on how phased retirees can continue to accrue additional benefits and supplement lower current compensation with systematic or ad hoc distributions from the employer's qualified and nonqualified retirement plans. As phased retirement becomes more of an issue for both employers and employees, this article sets out the issues that an employer should explore with its advisors to deal with the reality of aging workforces and to become an age-friendly work environment.¹

MMeet Barry, a fictitious Baby Boomer, who is 65. He has determined that he wants to retire at age 66 and wants to move to a continuing care retirement community (CCRC) in a sun-belt state, into the perfect house touching the 14th hole of a private golf course. Barry's personal financial services professional has helped him determine that he would need a monthly income stream of \$10,000 to support that lifestyle but, as of now, his Social Security benefits (if he elects to start

Barry Kozak, an attorney and an enrolled actuary, is a consultant at October Three Consulting based in its Chicago office. He holds faculty appointments at The John Marshall Law School, where he teaches estate planning classes, and at Loyola University Chicago School of Law, where he teaches elder law classes, and where he served as a Distinguished Scholar in Residence during 2017.

benefits at 66) plus other fixed income streams (such as pensions, purchased annuities, rental income, and bond-ladder portfolios) are expected to provide a total revenue of \$7,000 per month. So, Barry will be short \$3,000 each month. What can he do? The normal array of choices² for Barry are:

1. Liquidating, selling, converting, or borrowing against other accumulated wealth to generate an additional income stream of \$3,000 per month;
2. Moving to a different house within the CCRC that is a mile away from the golf course that only requires \$7,000 per month (or any other variation on downsizing his expected lifestyle and happiness in retirement);
3. Throwing all caution into the wind, enjoying his fantasized lifestyle, and hoping for an early death before running out of money or becoming a burden on his family or society; or,
4. Continuing to work beyond age 66 to increase his wealth and to decrease the total period he is actually in retirement.

There are pros and cons of any of Barry's choices, but let's assume he chooses to delay the start of retirement by working longer than originally imagined. Although finding a new job or starting his own business are possibilities, continued full-time employment with his current employer seems to be the easiest path—assuming Barry can continue performing the normal physical and cognitive functions of his job at the level expected by his employer, or if his aging mind and/or body have diminished somewhat, then he can hopefully work with his employer to find a mutually acceptable accommodation under the auspices of the Americans with Disabilities Act. There is also a new and developing alternative called phased retirement. From Barry's point of view, since he would prefer to retire but instead will continue working out of necessity, he must negotiate with his employer to accomplish one or more of his goals, which can include: being allowed some days of telecommuting so he does not need to physically be in the office every day of the workweek; being allowed to take extra vacation time; being moved into a different position that reduces his stress or performance goals; or being allowed to simply work fewer hours.

Let's assume that his employer does not have a formal phased retirement program. If, after openly exposing his financial insecurities with his boss, manager, or human resources department, his request is ultimately denied, then Barry will try to continue working in his full-time position as if nothing happened, but might now be tethered

with heightened stress and anxiety as his opinion of his employer, and his own motivation to be a productive employee, have diminished. On the other hand, if Barry was too afraid to even approach his employer with his proposal in the first place, then he will just continue working and acting as if he doesn't have the stress of retirement readiness in his consciousness (which can lead to the normal nonproductive activities associated with financial stress, such as absenteeism or presenteeism).³

Again, assuming his employer does not have a formal phased retirement program, if, and only if, his employer sees Barry as an important employee, then the employer will agree to Barry's phased retirement proposal. Although seemingly a win-win situation for both parties, two major concerns must be addressed:

1. Can Barry continue to participate in the health, welfare, retirement, and fringe benefit plans and programs during his period of phased retirement? and
2. If Barry begins receiving reduced compensation, can he supplement the lost salary through planned or ad hoc distributions from any of the employer-provided retirement plans in which Barry is a participant and has an accrued benefit or individual account balance?

In addition, but strictly from the employer's point of view, this individual negotiation to allow Barry to phase into his retirement might conflict with other individual agreements negotiated with other favored employees who are granted their unique phased retirement demands, which can lead to an administrative, logistical, and communication nightmare. Further, if Barry's employer starts implementing some informal phased retirement programs for different employees, then they might need to pay attention to the morale, expectations, and likelihood for discrimination litigation from the remainder of the workforce if any of them have been or will be denied a similar opportunity should they desire a phased retirement.

This article advocates for employers to adopt formal phased retirement programs. First, the article frames the current environment regarding phased retirement programs, and then juxtaposes the benefits of formal phased retirement programs against problems that can arise from ad hoc informal phased retirement agreements. Then, the article explores whether phased retirees could continue to receive current employee benefits, such as health and welfare, fringe, and other currently available employee benefits and perks, and retirement benefits. Specifically with retirement plans, the article provides the parameters and issues that must be considered if the employer wants

a phased retiree to be allowed to receive current in-service distributions from the plan to supplement a diminished salary. As phased retirement becomes more of an issue for both employers and employees, this article hopefully sets out the issues that an employer should explore with its advisors to deal with the reality of aging workforces, and to become an age-friendly work environment.

PHASED RETIREMENT PROGRAMS: FORMAL VS. INFORMAL

Few businesses have adopted formal phased retirement programs (other than government employers, institutions of higher education, and firefighter municipalities). Phased retirement programs can be structured to actually benefit three concerns within an organization. First, the employees who are eligible for and who voluntarily enroll in the program will generally have reduced stress (and can possibly even be more productive) as they dip their toes into retirement rather than diving into it. Second, the employer can properly budget for any promises made through the program, and can properly plan for succession as the date of departure of a phased retiree is actually fixed and is not simply a random day known only in the mind of the employee. Third, the younger employees of the organization can see a clearer path for their own upward movement within the organization and their ultimate career phase-out.

There are not any requirements for employers to adopt formal phased retirement programs, but this article will highlight some of the advantages of doing so and assuage some of the fears. In this section, statistics are provided, benefits to an employer that adopts a plan are discussed, and issues to be considered when an employer simply enters into disparate ad hoc phased retirement agreements will be explored.

Current Statistics on Phased Retirement Programs

According to employer responses to a recent survey, “[i]nformal phased retirement programs, which provide a reduced schedule and/or reduced responsibilities prior to full retirement, have increased from 9 to 14 percent since 2014.”⁴ On the other hand, surveyed employers that provide formal phased retirement programs have only increased from 4 to 5 percent over the same five-year period.⁵ The survey also found that “77 percent of employers believe many of their employees plan to continue working after they retire, and 47 percent say many of their employees envision a phased transition to retirement. Yet far

fewer actually let them keep working for the firms in retirement and have a phased retirement.”⁶

A report from the US Government Accountability Office (GAO) found that “[o]lder workers are [likely] more concentrated in white-collar and service occupations. . . . because their jobs tend to be less physically demanding than blue-collar jobs.”⁷ Interestingly, the GAO report estimates that only about 35 percent of older workers who *believe* that they have the opportunity to reduce work hours will *actually* have the opportunity to do so with their current employer.⁸ Employers with technical and professional workforces—such as those in the consulting, education, governmental, and high-tech sectors—are most likely to offer phased retirement programs.⁹

Here is the problem: more than 70 percent of large employers suggested that they fear uncertainty about “regulatory complexities and ambiguities involving federal tax and age discrimination laws [will] impact their organization’s ability to offer a phased retirement program.”¹⁰ “Evidence seems to show most employers don’t offer phased retirement because they haven’t been forced to do it yet.”¹¹ So, there is a double edge sword: nothing is compelling an employer to provide a formal phased retirement program, and, with no regulatory parameters, there are unknown risks and liability for those employers that experiment.

Most formal phased retirement program designs mandate a short period of phased retirement, such as two to three years. One point of comfort for employers might be that new labor and employment laws and regulations are almost always prospective only, so it is likely that those employers that experiment with phased retirement programs tailored to their unique workforce demographics and dynamics will not suffer from any parameters that might or might not ever be promulgated by federal, state, or local authorities. If an existing phased retirement program does actually violate a future requirement, there will almost certainly be a grandfathering or transitional relief offered in the new law or regulation. Unfortunately, this actual or perceived barrier of lack of guidance is the initial hurdle that needs to be discussed as any employer contemplates a formal phased retirement program.

Formal vs. Informal Phased Retirement Programs

Employees who do not work under a contract or union agreement are free to leave when they want to leave (whether for health problems, better opportunities elsewhere, or a poor relationship with coworkers or management). Of course, an employer can terminate an at-will employee for cause, or even no-cause, subject to governing state labor and employment rules. Either way, if the employer provides a formal

option for phased retirement, then it can provide the business with predictable, budgetable, and mutually rewarding paths for many of their individual employees who end their careers with them.

Phased retirement is similar, in some ways, to early retirement windows, but they accomplish different goals. Early retirement benefits programs, whether a permanent option or only available for a short period of time during a window, are just meant to have some older workers retire. If the employer sponsors a defined benefit pension plan, then instead of providing a large severance bonus as an inducement to voluntarily retire, the benefits promised through the defined benefit plan are sweetened and artificially amplified. There are tax advantages to both the employer and intended early retiree for such a program. If the program was set up properly and the right number of eligible employees voluntarily retire, the employer benefits from avoiding bad publicity as an employer that fired or laid off a sizable portion of their labor force; and if the target group is older, then there is no fear of age discrimination claims since there is a waiver of litigation rights provided through the Age Discrimination in Employment Act (ADEA).¹²

Early retirement strategies help reduce ongoing costs by offering a targeted group of employees a deal that seems too good to pass up (even if it costs the employer some money to fund the additional benefits promised through the qualified pension plan). On the other hand, phased retirement programs actually embrace the emerging trends and demographics of workers who want to remain in the workforce longer, and also allows the employer to better control how and when they will phase out into retirement. According to a joint AARP and Society of Human Resources Management publication (albeit a bit dated), if an organization faces a labor shortage and/or a skills shortage, then a properly designed, communicated, and administered phased retirement program might solve the problem.¹³

Finally, for an employer that is concerned for the emotional well-being of its employees (whether because of paternalism or simply productivity metrics), many individuals continue working or return to work after retiring for nonfinancial reasons.¹⁴

Since there is a complete lack of regulation around either formal or informal phased retirement programs, employers could possibly get into trouble by offering either. It, however, seems likely that a formal program—broad in scope, written, and communicated to at least a sizable portion of the workforce—can be seen as less discriminatory than a few informal phased retirement programs negotiated with obviously key and important employees. Again, regardless of any existing laws, when only a few employees can phase into retirement, then the internal Human Resources department might have communication and administrative difficulties, as each phased retirement program will

likely have its own unique terms, triggers, and thresholds. In addition, such an informal practice can lead to a series of disgruntled workers who might allege age or sex discrimination should they ask for a similar consideration yet get denied.

SHOULD PHASED RETIREES CONTINUE TO RECEIVE CURRENT EMPLOYEE BENEFITS AND TO ACCRUE ADDITIONAL EMPLOYEE BENEFITS?

Since almost all phased retirement programs result in reduced working hours, there might be some situations where the reduced hours of some employees reclassify them as part-time employees under the normal classifications of that organization. On the other hand, for very large organizations with a spectrum of disparate employee benefits for different classifications of workers, an employee who moves to a less strenuous position during phased retirement might fall under a different classification of worker, and therefore be eligible for a different set of benefits. These are not necessarily barriers to a formal phased retirement program (or even ad hoc agreements), but rather is part of the planning stages to ensure that the result is intended and can be easily communicated to the employee before making the voluntary decision to enter into the phased retirement program.

Issues with Basic Health and Welfare Benefit Plans

There is really no boilerplate advice that can be applied to all employers. Most of the employee-benefit programs are pursuant to a contract, formal plan document, or at least some summary provided in an employee handbook or on the company Web site (such as vacation days, use of a concierge service, pet sitting service, or on-premises gym). The issue here is whether an employee who is considered a phased retiree internally at the organization will be considered as a legitimate participant in any of the various employee benefit plans.

As to any of the purely internal programs, the employer has full discretion in amending the legal definitions and parameters of which employees can participate and what costs are transferred to those employees. On the other hand, any program offered through a third-party vendor (such as health, life, long-term care, or disability insurance group policies, or access to an employee assistance program) might need to be renegotiated to specifically include phased retirees in an existing group of eligible participants, or to renegotiate the terms of the contract. Unfortunately, insurance companies especially might take an individual's decision to accept a phased retirement as

a signal of diminished health, whether or not true, so there might be an additional underwriting cost to keep phased retirees covered by health insurance. Again, when it comes to existing employee benefit programs, each organization must just determine how phased retirees would be treated under the existing legal definitions, and make strategic decisions as to whether the outcomes are acceptable or need to be amended.

Issues with Basic Qualified Retirement Plans

Unlike health and welfare benefits, which are available purely on a current basis, retirement benefits promised, funded, and delivered through a plan have more moving parts and, therefore, more specific rules under the Employee Retirement Income Security Act (ERISA) and the Internal Revenue Code, as amended from time to time by other laws, including the ADEA. If an employee is currently participating in a retirement plan, accruing additional retirement benefits as he or she continues working and as his or her salary increases, then any phased retirement program must almost assuredly allow for continued accruals during periods of phased retirement. A second issue with retirement plans is whether the employer can provide in-service distributions from the retirement plan to the employee that will supplement a reduced salary during periods of phased retirement.

All qualified retirement plans¹⁵ must fall into one of two mutually exclusive categories: a defined contribution plan¹⁶ or a defined benefit plan.¹⁷ Before delving into the separate issues with phased retirement, especially when the phased retiree participates in a qualified retirement plan, the employer must consider the nondiscrimination rules as they relate to benefits, rights, and features.¹⁸ At the very least, participation in the formal phased retirement program should be voluntary; all similarly situated employees should be eligible (especially if there are non-highly compensated employees (HCEs) who can be objectively considered to be similarly situated to HCEs); and the program should be communicated properly to all employees who can take advantage of the phased retirement program (and, perhaps, with even more effort and resources to make sure all non-HCEs who are eligible for phased retirement receive timely and relevant information).

The issues with continued participation and in-service distributions in qualified defined contribution plans and defined benefit plans are introduced in the next section. First is a summary of the historical regulation of phased retirement as it affects qualified retirement plans. Then specific attention is paid to defined contribution plans and then defined benefit plans, with a quick discussion of plans maintained specifically by governmental employers and institutions of higher

education. Closing out this section is a summary of some of the issues an employer must address with accruals and in-service distributions with any executive compensation and other plans of deferred compensation within which the employee moving to phased retiree status participates.

Legal Issues under the Internal Revenue Code and ERISA, as Amended by the ADEA: a Chronology

There has never been an actual definition of “retirement” in the Internal Revenue Code. Even before ERISA was enacted, Treasury Regulations previously provided that defined benefit plans “... must be established and maintained by an employer primarily to provide systematically for the payment of definitely determinable benefits to its employees over a period of years, usually for life, *after retirement*.”¹⁹ As a result, the IRS’s position was that defined benefit pension plans generally could not pay benefits to a participant before he or she retired.

After ERISA, the IRS started providing guidance on the relevance of actual retirement as a possible trigger point for distributions from a qualified plan, ruling that the concept of retirement is basically irrelevant in a profit-sharing plan—yet that concept is crucial in a pension plan.²⁰ Neither context nor definition was assigned to the term retirement in either of the relevant revenue rulings, so either the IRS assumed that the term retirement was universally understood, or tacitly acknowledged that providing a definition was a whole other project unto itself. Interestingly, the first underpinnings of phased retirement programs in either type of plan were laid out:

For profit-sharing plans—A provision for continued participation under a profit-sharing or stock bonus plan, and for contributions to provide additional benefits for employees who remain in employment beyond the stated age, does not adversely affect the qualification of the plan, if the provision is uniformly applied to all employees under similar circumstances and does not result in prohibited discrimination. Arrangements made between an employer and an employee regarding the compensation to be paid for services rendered have no bearing on the qualification of a profit-sharing plan under section 401(a) of the Code unless, of course, the total deferred and nondeferred compensation is unreasonable.²¹

For pension plans—Arrangements, however, may be mutually made for continued employment beyond normal retirement age. In such event, provision may be made with respect to the treatment of the pension benefits such as, for example, payment as though the employee had actually retired, deferment to actual

retirement without increment for the interval between the normal retirement date and actual retirement, or actuarial equivalent on actual retirement of the benefit at normal retirement age.²²

The first time we start to see the term phased retirement program is in 2002, when the IRS requested public comments on issues relating to phased retirement arrangements under qualified defined benefit plans.²³ After receiving numerous public comments, Treasury then promulgated proposed regulations,²⁴ and then received additional public comments, and held a public hearing on March 14, 2005. So, all else being equal, Treasury would have issued final regulations and, sometime in 2003 or 2004, we would have a legal framework within which pension plans could be used to provide supplemental income to employees who continue working, but with reduced hours and a reduced salary, thus providing a key component to a comprehensive phased retirement program.

Then, in 2006, a Congressional election year in which the Republican Congress arguably had “done so little that can conceivably be bragged about”²⁵ during the first half of the year, the House versions and Senate versions of the Pension Protection Act were taken off the shelf, dusted off, and very quickly reconciled and passed into law.²⁶ Code Section 401(a)(36) was added to the laundry list of qualification requirements and, effective in 2007, “[a] trust forming part of a pension plan shall not be treated as failing to constitute a qualified trust under this section solely because the plan provides that a distribution may be made from such trust to an employee who has attained age 62 and who is not separated from employment at the time of such distribution.” Double negatives aside, the provision allows qualified pension plans to allow distributions to employees after attaining their 62nd birthday, regardless of the plan’s defined normal retirement age, and regardless of whether the employee has completely and wholly retired.

In the following year, the IRS wanted to revisit the earlier phased retirement regulations, and asked for public comments on:²⁷

- Whether in-service distributions of a benefit to a participant who has attained age 62 but who has not attained normal retirement age should be limited to no greater than the benefit to which the participant would be entitled at normal retirement age, reduced in accordance with reasonable actuarial assumptions (*e.g.*, should only unsubsidized benefits be permitted pursuant to Code Section 401(a)(36))?
- If subsidized benefits are permitted to be distributed to a participant who has attained age 62 but is still in-service and has not yet attained normal retirement age, how should the subsidized benefits be characterized for purposes of Code Section

411? For example, should the subsidized benefits be treated as a subsidized early retirement benefit despite the fact that the participant has not yet separated from employment?

- If the subsidized benefits are not treated as a subsidized early retirement benefit, should the subsidized benefits be treated as a part of the participant's accrued benefit, or is there some other characterization of the subsidized benefits for purposes of Code Section 411?
- Whether final regulations permitting in-service distributions under a bona fide phased retirement program should be issued, in light of the ability of plans to permit in-service distributions after age 62 pursuant to Code Section 401(a)(36)?

Although public comments were due by April 16, 2007, there seems to be no public record of any action taken to summarize these comments or to take any action after that date. The fact that these specific questions were unresolved at the IRS indicates at least some of the struggle points an employer might encounter if they establish a phased retirement program while maintaining a qualified defined benefit pension plan.

On May 22, 2007, Treasury published final regulations²⁸ with instructions on how a pension plan document can be amended to allow for in-service distributions after a participant attains age 62. Generally, the normal retirement age under the plan "must be an age that is not earlier than the earliest age that is reasonably representative of the typical retirement age for the industry in which the covered workforce is employed"²⁹ and "[a] Normal Retirement Age of 62 or later is a safe harbor, and is deemed to meet the general rule."³⁰

The regulations, while still not providing any affirmative definition of "retirement," adds a new provision, which consists entirely of two short sentences using one of the potential aspects of a bona fide phased retirement program to define what is *not* retirement: "For purposes of [this definition of Normal Retirement Age set forth in these Regulations], retirement *does not* include a mere reduction in the number of hours that an employee works. Accordingly, benefits *may not* be distributed prior to retirement age *solely* due to a reduction in the number of hours that an employee works."³¹ This isolated provision is not discussed in the preamble to the regulations and does not seem to have any tangential dependence on any other provision in the regulations; therefore, it can be argued that a reduction in the number of hours worked can be one of several triggers that allow benefits to be distributed prior to retirement age, since "solely" is a much higher standard than other adverbs, such as primarily, materially, or substantially. On the other hand, an argument can be made that other aspects

of a phased retirement program, such as a reduction in salary or a reduction in responsibilities and/or seniority can be the sole trigger for benefits to be paid.

This Treasury Decision also amended the final Regulations under Code Section 411(d)(6) to require that “[a] plan provision that permits a participant to receive an in-service distribution is an optional form of benefit that is protected under section 411(d)(6), but is not an early retirement benefit.”³²

So, the whole concept of Treasury using the current Internal Revenue Code to allow phased retirement programs where partial benefits are paid from a defined benefit plan to supplement the employee’s corresponding diminution in compensation seemed to fade into the background. Some IRS and Treasury personnel might have opined at public conferences that phased retirement remains as an open project, but there was not any formal mention of phased retirement for qualified 401(a), 403(b), or 457(b) plans on any of the publicly released IRS Priority Guidance Plans since 2007.³³

Then, in 2012, Congress specifically allowed for phased retirement plans supported by governmental 457(b) pension plans to be allowed. The Moving Ahead for Progress in the 21st Century Act (MAP-21 of 2012)³⁴ allows a new phased retirement program for federal employees under which a federal agency may allow a full-time retirement-eligible employee to elect to enter phased retirement status in accordance with regulations to be issued by the Office of Personnel Management (OPM). OPM published final regulations on phased retirement programs from the Civil Service Retirement System (CSRS) and the Federal Employees’ Retirement System (FERS), indicating that are “a human resources tool that will allow full-time employees to work a part-time schedule and draw partial retirement benefits during employment.”³⁵

As an aside, since the Department of Labor, through its Employee Benefits Security Administration, has statutory authority over Title I aspects of ERISA, it is worthwhile exploring whether they have provided any guidance on what a phased retirement plan can look like and, regardless of any in-service distributions from any of the ERISA retirement plans, whether it has even opined if a phased retirement program would be considered, in and of itself, an ERISA plan. As of the date of this article, nothing official (or even unofficial) has been published. The ERISA Advisory Council, however, submitted reports on phased retirement with suggestions to the Secretary of Labor in 2000 and again in 2008.³⁶ Nothing appears to have moved forward due to these suggestions.

If the Plan Is a Qualified Defined Contribution Plan

As to continued contributions during the period of phased retirement, the type of plan will dictate what options are available to the

sponsoring employer. Unlike a defined benefit plan, which can be used in an early retirement program or phased retirement program by promising additional benefits (as long as the employer funds the promises), defined contribution plans can only provide a contribution in the current year based on the employee's current year compensation. So, for employer contributions (such as in a money purchase plan, a profit-sharing plan, or matching contributions in a 401(k) plan), the best a plan can provide is that a diminished salary paid to an employee during phased retirement can be annualized (so, if an employee is receiving 70 percent of salary for a reduction of 30 percent of hours during phased retirement, for purposes of the plan, the annualized salary can be listed as the 100 percent).³⁷ Similarly, for elective contributions, the plan document for a 401(k) plan can provide for annualized salary.³⁸ So, an employee can still accrue a benefit under a defined contribution plan during a period of phased retirement, but other than annualizing the salary for purposes of the maximum limitations, the employer cannot artificially increase a participant's account balance in any way.

As to distributions, the very basic rule is that employer contributions are generally available to be paid out as in-service distributions as long as the plan document specifically provides for such distributions,³⁹ but employee contributions can only be paid as an in-service distribution upon incurring an unforeseen hardship⁴⁰ or as a normal benefit upon retirement.⁴¹ Therefore, a defined contribution plan that includes employer contributions can be easily amended to allow in-service distributions.

If the Plan Is a Qualified Defined Benefit Plan

Since the proposed regulations of 2004 were never finalized, they can only serve as a starting point.⁴² For any employer looking to incorporate distributions from a defined benefit plan to supplement the lower salaries that will be paid to their phased retirees, the plan's attorneys and actuaries must ensure continued compliance of the plan. Some of the discussions being led by the author at his current firm for some clients include, but are not limited to, the following.

First, is an employee in phased retirement actually retired? Benefits may not be distributed prior to normal retirement age *solely* due to a reduction in the number of hours that an employee works.⁴³ So, distributions are generally only allowed at normal retirement.⁴⁴ The plan, however, can provide any other normal retirement age,⁴⁵ and, further, the plan document may allow in-service distributions at any age after 62 if the plan's stated normal retirement age is later than 62.⁴⁶ Therefore, employers contemplating a formal phased retirement program who want phased retirees to have the option of taking

distributions from the pension plan to supplement a reduced salary should consider amending the plan document to allow partial distributions to any participant attaining age 62 and who has a diminished salary due to being a phased retiree.

A second issue is whether an employee can postpone required minimum distributions (RMDs) during periods of phased retirement. Generally, “non-5-percent owners can postpone [taking RMDs] until April 1 of the year following the calendar year in which the employee attains age 70 *or the calendar year in which the employee retires.*”⁴⁷ Therefore, without further guidance from Treasury or a statutory change by Congress, someone in phased retirement has assumedly not retired, and is, assumedly, not required to take an RMD, but there is no justification for this other than logic. This can be the trigger for a private letter ruling request.

Another potential issue with defined benefit plans that provide for continued participation and accruals for employees while in phased retirement are the general nondiscrimination and minimum coverage rules. It seems more conservative and in accordance with the spirit of the rules to define in the plan document that any participant who was considered an HCE before “phased retirement” will continue to be considered an HCE.⁴⁸

Benefit limitations must also be taken into account. Generally, the annual benefit being promised, funded, and ultimately paid to any participant is the lesser of \$160,000, as amended for inflation each year, or 100 percent of the participant’s average compensation for his or highest three years.⁴⁹ The guidance for multiple annuity starting dates, however, seem to allow separate “phased retirement annuities” to be added together.⁵⁰

Continued participation must also be considered, so in addition to the normal definition of an eligible employee, the plan document should be amended to allow employees classified as phased retirees to continue participation in the plan.

As to continued accruals during the period of phased retirement,⁵¹ the provisional granting of a “year of service”⁵² for any participant receiving a “phased-retirement annuity” must be crafted to accomplish the desired goal. Perhaps all phased retirees receive a full year of service under the plan simply for working the number of hours pursuant to the phased retirement program. On the other hand, the plan document can provide a fractional year of service for the percentage of time working (for example, if one employee chooses to work 70 percent of normal hours during phased retirement, then the plan document can reflect that she will accrue a benefit based on seven-tenths years of service, and a different employee who works 60 percent will receive an accrual based on six-tenths years of service).

If the Employer Is a Governmental Entity or an Institution of Higher Education

Governmental Employers

Since the only truly sanctioned phased retirement plan is for certain employees of certain governmental pension plans offered by certain federal agencies, we might be able to glean some insight and logic as to how to craft a phased retirement plan that touches qualified pension plans maintained by for-profit employers.⁵³

During the period of phased retirement: the “phased retirement benefit” equals the participant’s accrued benefit (calculated at the phased retirement age, and payable as a life annuity) multiplied by a “phased retirement percentage,” which is the percentage of hours working during phased retirement.

Then, at full retirement, the now retired plan participant is entitled to a “total benefit,” which equals the sum of the “phased retirement benefit” and an “additional amount.” This “additional amount” equals the sum of (a) all cost of living adjustments applied to the “phased retirement benefit” and (b) a newly calculated vested accrued benefit (calculated at the full retirement age, and payable as a life annuity) multiplied by [1 – the “phased retirement percentage.”]

Although the notice is primarily a discussion of how the governmental employee receiving a phased retirement annuity will be taxed (most governmental plans allow for after-tax contributions to purchase additional pensions, and phased retirement benefits complicate the determination of return of basis rules under Code Section 72(e)), it does provide an instructive example.

Some observations by the author:

- This hypothetical plan is a governmental plan, which does not require prorated accruals during the period of phased retirement, as a qualified defined benefit pension plan likely would require, as discussed above.
- The IRS notice was primarily about how a government employee, who elects a period of phased retirement under a governmental plan, will calculate the includable portion of income for each distribution, both during the phased retirement period and then after full retirement, since there will be a basis for after-tax contributions made to the plan during full employment and during phased retirement. As most qualified defined benefit pension plans do not allow for after-tax contributions, the final part of the notice is irrelevant.⁵⁴

Institutions of Higher Education

When Congress passed the 1986 amendments to the ADEA of 1967, prohibiting mandatory retirement on the basis of age for most workers, it included several temporary exemptions, notably one for tenured faculty in higher education. So, after this exemption was made permanent,⁵⁵ many institutions of higher education have embraced phased retirement programs, especially in cases where pure early retirement windows have failed to encourage enough older faculty members to voluntarily retire. With tenured faculty, there are some inducements that are not necessarily found in other industries: perhaps the title of Emeritus professor, extra sabbatical leave, permission to limit serving on internal governance committees, consideration given to the classes they want to teach and when they want to teach them, permission to start a consulting business during the phased retirement period, and other issues. Although university human resources policies, such as phased retirement, don't always influence HR issues in corporate America, since most public universities and colleges (and many private) phased retirement programs are simply available on-line with a quick search, for-profit employers and organizations can at least glean structure and form on their own phased retirement programs.

Nonqualified Deferred Compensation Plans

If certain executives and favored employees are hired pursuant to an employment contract that is individually negotiated, then participation in a phased retirement program might require re-negotiation. If and when an employer implements a formal phased retirement program, then future negotiations and employment contracts should at least include a provision contemplating what will happen if that executive chooses to phase into retirement. More attention must be paid by an employer that maintains a nonqualified deferred compensation plan. Basically, in order to avoid deferred compensation being included in gross income for any particular year, the arrangement must meet the following requirements in form and in operation:⁵⁶

- **Distributions.** Amounts deferred must be payable only upon one of the following events: separation from service, a specific date or time, death, disability, change of control, or unforeseeable emergency;
- **Acceleration.** The plan must not permit the acceleration of the time or schedule of any payment under the plan (except as provided in regulations); and

- **Elections.** Any election to defer compensation for services performed in a given tax year must be made prior to the beginning of that tax year, and elections regarding the time and form of payment must generally be made by that date.

So, continued accruals and participation during periods of phased retirement do not seem problematic, because the rules do not generally require any limitations of benefits promised. Accelerating or changing the terms of distributions, however, might not be allowed for participants in phased retirement, especially if the partial distribution would be for one or several of the executives being promised deferred compensation as opposed to all participants of the plan. A solution might be for future nonqualified deferred compensation plan documents to be drafted contemplating an executive to voluntarily decide to participate in a phased retirement program.

CONCLUSION

As indicated, surveys clearly indicate that employees want an option to phase into retirement, and employers need to address an aging workforce. Individually negotiated phased retirement programs for certain favored employees can satisfy both desires, but informal programs can create an internal communication and administration problem, and affect morale with the rest of the workforce who are not favored enough to negotiate their own phased retirement agreements. Therefore, a phased retirement program can be designed to assuage both concerns; internally, the HR department has one set of rules for all phased retirees, and the younger workers see a path for their ultimate departure.

Most employees would like to continue receiving current employee benefits during the phased retirement period (such as health, welfare and fringe benefits). If the plan or program is self-administered by the employer, then it might be a simple exercise to amend the terms and definitions to extend the availability of the benefits to employees during phased retirement. It might take a little more effort, and possibly some additional underwriting costs, if the plans (such as health insurance) are administered by third parties.

The more time-consuming effort might be figuring out how a qualified retirement plan, or even a nonqualified deferred compensation plan, can be amended to allow continued and nondiscriminatory benefit accruals during periods of phased retirement and, if desired, the ability of phased retirees to start taking scheduled or ad hoc distributions from the plan to supplement a lower salary. Treasury had issued proposed regulations in 2004 that have never been finalized, so they

cannot be relied upon, but the logic discussed within can be insightful. However, those proposed regulations do not include amendments to the Code made by the PPA, or any other subsequent regulations. Therefore, it is up to the plan's attorney, actuary, or other professional consultant, to determine how a qualified plan document can be amended (and, as this author proposes, these professionals can start the discussion about phased retirement programs with their current employer clients).

When thinking about formal phased retirement plans, in the absence of any true regulatory parameters, employers and their advisors can look to a few places at least for inspiration and the questions that need to be asked (but not for the answers): the proposed regulations for bona fide phased retirement programs that touch on qualified defined benefit plans⁵⁷ and the relevant listing of required modifications (LRMs);⁵⁸ the regulations⁵⁹ and guidance⁶⁰ on phased retirement programs within a governmental employer and how that touches a governmental pension plan; any phased retirement program offered by a university or college that is available through the internet,⁶¹ and a review of the GAO report⁶² that summarizes the formal phased benefit programs offered by nine unnamed large employers.

NOTES

1. In the author's practice, an age-friendly business has a combination of any or all of the following formal and communicated initiatives: phased retirement programs; flexible work arrangements; mentorship and institutional knowledge transfer programs; education to different groups based on career stages (such as distribution and estate planning for late-career employees, retirement planning for midcareer employees, and debt management and wealth accumulation planning for early-career employees); various forms of support for employees with family caregiver duties; and, other proactive activities that strive to eliminate age discrimination and ageism at all levels of the organization and at all touch points of an employment relationship.

2. This scenario fits in with how many financial service professionals currently think about retirement readiness planning. The author is a member of the board of directors of the Greater Chicago chapter of the Society of Financial Service Professionals and, through the American College of Financial Services, holds Chartered Financial Consultant (ChFC) and Retirement Income Certified Professional (RICP) designations.

3. See, *i.e.*, Beth Pinsker, "Money Stress is a Productivity Killer at Work," Reuters (March 7, 2016) (citing a Willis Tower Watson study that concludes that workers who have money concerns keep them from doing their jobs, resulting in lost 12.4 days due to presenteeism in 2015, and just 3.5 days to absence), available at <https://www.reuters.com/article/us-usa-employment-productivity-idUSKCN0W91WP>; and Sandy Smith, "Presenteeism Costs Business 10 Times More than Absenteeism," EHS Today (March 16, 2016) (citing a report by Global Corporate Challenge, that found that employees take an average of four days off per year for sick time, but admitted to being unproductive an average of 57.5 days a year, because workers are facing increasing personal,

health, financial, and family pressures, but the stigma of any indication of mental illness or affectations, such as depression or stress, signal that taking days off from work is worse than going into work, even if not productive.), available at <https://www.ebstoday.com/safety-leadership/presenteeism-costs-business-10-times-more-absenteeism>.

4. *2018 Employee Benefits: The Evolution of Benefits, A Research Report* by the Society for Human Resource Management (2018), available to SHRM members at <https://www.shrm.org/hr-today/trends-and-forecasting/research-and-surveys/Documents/2018%20Employee%20Benefits%20Report.pdf>.

5. *Id.*

6. Kerry Hannon, “Hoping for a Phased Retirement? Don’t Count on It,” *Forbes.com* (August 4, 2017) (citing “All About Retirement: An Employer Survey, 17th Annual Transamerica Retirement Survey,” Transamerica Center for Retirement Studies (August 2017)).

7. *Phased Retirement Programs, Although Uncommon, Provide Flexibility for Workers and Employers*, U.S. Government Accountability Office Report to the Special Committee on Aging, U.S. Senate, GAO-17-536 (June 2017) at page 11.

8. *Id.*, at p.12.

9. *Id.*, at p.22.

10. *Id.*, at p.26.

11. “The Case for Phased Retirement,” Knowledge@Wharton (November 1, 2016), available at <http://knowledge.wharton.upenn.edu/article/the-case-for-phased-retirement/>.

12. “To minimize the risk of potential litigation, many employers offer departing employees money or benefits in exchange for a release (or “waiver”) of liability for all claims connected with the employment relationship, including discrimination claims under the civil rights laws enforced by the Equal Employment Opportunity Commission (EEOC)—the Age Discrimination in Employment Act (ADEA), Title VII, the Americans with Disabilities Act (ADA), and the Equal Pay Act (EPA).” From “Understanding Waivers of Discrimination Claims in Employee Severance Agreements,” The US Equal Employment Opportunity Commission, available at https://www.eeoc.gov/policy/docs/qanda_severance-agreements.html.

13. “Phased Retirement and Flexible Retirement Arrangements: Strategies for Retaining Skilled Workers” (2006), available at https://assets.aarp.org/www.aarp.org/_articles/money/employers/phased_retirement.pdf.

14. *See, e.g.*, Chris Farrell, “A Benefit of Working Longer: Keeping Your Brain Sharp,” *www.Forbes.com* (June 26, 2017): “Work may even help stave off dementia. A large study of nearly half a million self-employed workers in France suggests that delaying retirement means people may be at less risk of developing dementia, including Alzheimer’s disease.”

15. Retirement plans that comply with all of the requirements, limitations, and prohibitions listed at IRC § 401(a).

16. IRC § 14(i) defines a defined contribution plan as “a plan which provides for an individual account for each participant and for benefits based solely on the amount contributed to the participant’s account, and any income, expenses, gains and losses, and any forfeitures of accounts of other participants which may be allocated to such participant’s account.” Note that ERISA § 3(34) uses the term “individual account plan” to represent basically the same set of plans that are considered defined contribution plans under the IRC.

17. IRC § 414(j) generally defines a defined benefit plan as “any plan that is not a defined contribution plan.”
18. Treas. Reg. § 1.401(a)(4)-4.
19. Treas. Reg. § 1.401(a)-1 (emphasis added).
20. *Compare* Rev. Rul. 69-414, regarding profit-sharing plans, with Rev. Rul. 71-24, regarding pension plans. The focus on in-service distributions was repeated in Rev. Rul. 71-147.
21. Rev. Rul. 69-414.
22. Rev. Rul. 71-24.
23. IRS Notice 2002-43.
24. “Distributions from Pension Plan under Phased Retirement Program,” REG-114726-04 (November 10, 2004), providing a summary of existing law and seeking to amend existing Reg. § 1.401(a)-1 and to add a new provision at Reg. § 1.401(a)-3.
25. Editorial, “The Pension Piñata,” *N.Y. Times*, Aug. 13, 2006, at 9.
26. P.L. 109-280, signed into law by President George W. Bush on Aug. 17, 2006.
27. IRS Notice 2007-8.
28. T.D. 9325, amending existing Treas. Regs. § 1.401(a)-1 (May 22, 2007).
29. Treas. Reg. § 1.401(a)-1(b)(2)(i), “General Rule.”
30. Treas. Reg. § 1.401(a)-1(b)(2)(ii), “Age 62 Safe Harbor.”
31. Treas. Reg. § 1.401(a)-1(b)(3), “Benefit Distribution Prior to Retirement” (emphasis added).
32. *See* Treas. Regs. §§ 1.411(d)-3(g)(6) and 1.411(d)-4, Q&A-1(a)(3), Q&A-1(b)(1), and Q&A-2(a)(1).
33. All current and prior IRS Priority Guidance Plans can be accessed through <https://www.irs.gov/privacy-disclosure/priority-guidance-plan>.
34. P.L. 112-141.
35. 79 FR 46607, Aug. 8, 2014.
36. *See* <https://www.dol.gov/agencies/ebsa/about-ebsa/about-us/erisa-advisory-council/reports>.
37. Under IRC § 415(c), an annual addition is limited for any participant to \$40,000, as adjusted for inflation on an annual basis, or 100% of his compensation.
38. Under IRC § 402(g)(1)(B), the maximum deferral is \$15,000, as adjusted for inflation on an annual basis, and assuming all employees who voluntarily phase into retirement will be at least 50 years old, under IRC §§ 414(v) and 402(g)(1)(C) is \$5,000, as adjusted for inflation on an annual basis. Note there are different limits for SIMPLE 401(k) plans. Since 401(k) plans that accept elective deferrals are technically called “cash or deferred arrangements,” the true limit can be seen as with the annual addition limitation, the lesser of total compensation for the year or the statutory dollar limit.
39. *See, e.g.*, two pre-ERISA promulgations, Rev. Rul. 68-24 and Rev. Rul. 71-295 (confirming that profit-sharing and stock bonus plan documents can allow for in-service distributions after an employee had participated for at least five years or after the amounts had accumulated in the trust for at least two years).

40. IRC § 401(k)(2)(b).

41. For distributions of elective deferrals, the employee must have a severance of employment, which occurs when an employee ceases to be an employee of the employer maintaining the plan. Treas. Reg. §1.401(k)(1)(d)(2). The true meaning of severance is still a bit controversial under the “same desk rule,” which can become an issue for employees who basically do the same job after a change in control of the sponsoring employer or if the individual’s classification changes from a leased employee to a regular employee.

42. There are many examples in the proposed regulations, but since they cannot be relied upon, there is no need to summarize them in this article. However, going through them might be a good exercise to highlight all of the issues with qualified defined benefit plans that are triggered with a phased retirement program. Note that these proposed regulations do not include any of the additional requirements for accruals and distributions that were added to the IRC or that were clarified through guidance or litigation, since published in 2004.

43. Under Treas. Regs. § 1.401(a)-1(b)(3) Benefit Distribution Prior To Retirement, “for purposes of paragraph (b)(1)(i) of this section, retirement does not include a mere reduction in the number of hours that an employee works.”

44. IRC § 411(a)(8)(B) defines “normal retirement age” as the later of age 65 or the fifth anniversary of the time a plan participant commenced participation in the plan. However, under IRC § 411(a)(8)(A), the plan can provide any other normal retirement age, and under IRC § 401(a)(36) and Treas. Reg. § 1.401(a)-1(b)(2)(ii), the plan document may allow in-service distributions at any age after 62.

45. IRC § 411(a)(8)(A).

46. IRC § 401(a)(36) and Treas. Reg. § 1.401(a)-1(b)(2)(ii).

47. IRC § 401(a)(9)(C) (emphasis added).

48. In addition to the normal rules for classifying HCEs under IRC § 414(q).

49. IRC § 415(b)(1).

50. Treas. Reg. 1.415(b)-1(b)(1)(iii). Note that T.D. 9319, 72 FR 16878-16931 (Apr. 5, 2007), “§ 1.415(b)-2 Multiple Annuity Starting Dates. [Reserved.]” was added to the table of contents of the Code of Federal Regulations, so that might be the appropriate place for future guidance, especially on multiple annuity starting dates during periods of phased retirement, to be published.

51. Continued accruals beyond normal retirement age are required under IRC § 411(b)(1)(H), and the accrued benefit may not decrease on account of increasing age or service under IRC § 411(b)(1)(G).

52. IRC §411(a)(5).

53. IRS Notice 2016-39.

54. IRS Notice 2016-39 actually was published to clarify the basis recovery fraction under IRC § 72(e)(8)(b) with respect to a phased retirement payment from a governmental plan.

55. ADEA, 29 U.S.C. § 623(m), “Voluntary retirement incentive plans.”

56. IRC § 409A.

57. *Supra*, n.24.

58. The LRMs are a collection of information packages designed to assist sponsors who are drafting or re-drafting plans to conform with applicable law and regulations. The various LRMs are available at <https://www.irs.gov/retirement-plans/listing-of-required-modifications-lrms>.

59. *Supra*, n.35

60. *Supra*, n.53.

61. *Supra*, n.55 (and associated text).

62. *Supra*, n.7, at Appendix II: Profiles of Phased Retirement Programs for Selected Employers.

The ACA Seesaw

Karen R. McLeese

By the time you are reading this article, the 2018 midterm elections have passed. In some, if not most of the elections, the Affordable Care Act (ACA) played a role, and in some instances, a leading role. Litigation challenging and rescinding various aspects of the ACA continues to reign. In this column, we will look at the issues that are being considered and contemplate where we might be going.

THE INDIVIDUAL SHARED RESPONSIBILITY MATTER

Under the ACA, beginning in 2014, virtually all Americans are required to maintain a minimum level of coverage, called minimum essential coverage (MEC), or be liable for a shared responsibility tax.¹ The Tax Cuts and Jobs Act, however, reduced the penalty tax to zero for tax years beginning on January 1, 2019, but left in place the requirement to maintain MEC.²

In February 2018, a coalition of 20 state attorneys general from primarily Republican states, led by Texas Attorney General Ken Paxton and Wisconsin Attorney General Brad Schimel, filed a lawsuit with the US District Court for the Northern District of Texas³ arguing that repeal of the individual tax should cause the entire ACA to fall.

In April, a coalition of 16 attorneys general from primarily Democratic states, led by California Attorney General Xavier Becerra, filed an action to intervene in the lawsuit. A month later, the judge of the Texas Court granted intervention in the matter. The 20-coalition group that initiated the action sought a preliminary injunction to suspend the law while the case winds its way through the court. In response, the Democratic coalition of state attorneys general filed a motion in opposition to a preliminary injunction seeking to ensure all aspects of ACA remain in force while court proceedings are carried out. Oral arguments in the matter of *Texas v. US* were heard on September 5.

Separately, in a relatively unusual move, the US Justice Department (DOJ) filed a response with the Texas Court on June

Karen R. McLeese 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 CBIZ Kansas City office.

Please check the edit made to the sentence "Oral arguments in the matter ..." and amend if necessary.

7, stating that the DOJ would no longer defend the individual mandate, including the guaranteed issue and preexisting condition limitation prohibition and rate restriction provisions of the law. On the same day, US Attorney General Jeff Sessions sent a letter to Congress⁴ defending the DOJ's position, which questions the constitutionality of the individual mandate in light of the repeal of the related tax penalty.

On September 13, Maryland Attorney General Brian E. Frosh filed a lawsuit in the US District Court for the District of Maryland⁵ against the Departments of Health and Human Services, Treasury, and Justice, seeking a declaratory judgment affirming the constitutionality of the ACA. AG Frosh argues that the benefits derived from the ACA have improved access to health care for all Marylanders by way of guaranteed access and allowing expansion of Medicaid, as well as reducing overall costs, including uncompensated care costs, due to community rating and cost-sharing restrictions.

COST-SHARING CHALLENGES

Section 1402 of the ACA provides that certain low-income individuals are entitled to cost-share payments for certain out-of-pocket expenses. The cost-sharing reductions are monies paid to insurers to help offset copayments and other out-of-pocket costs for certain lower-income individuals whose income falls below 250 percent of the federal poverty level and who obtain their coverage through the marketplace.

On October 12, 2017, the Departments of Health and Human Services and Treasury, by way of a Department of Justice opinion, announced that the cost-sharing reductions authorized under the ACA will cease immediately.⁶ Insurers will continue to be obligated to provide these cost-sharing reductions to eligible individuals but will not receive reimbursement from the federal government.

To this end, insurers have, and will, continue to incorporate this additional cost into premium. In effect, this ultimately increases the premium for coverage. For those obtaining coverage through the marketplace and receiving a premium subsidy, the increased premium will affect the amount of the federal subsidies requirement. The premium subsidy is not affected with the roll-back of the cost-sharing requirements. Those not entitled to a premium subsidy will feel the primary burden of the premium increase.

In the meantime, because insurers are still required by law to offer cost-share reductions and absorb the costs even without government reimbursement, they were allowed to cover the loss by increasing the premium on silver plans (silver-loading) offered through the

marketplaces beginning in 2018. Several states continue to bring forth challenges based on the termination of cost-sharing subsidies. In particular, a coalition of 19 states, led by California's attorney general, filed a lawsuit in October 2017.⁷ A US district judge of the Northern District of California dismissed the lawsuit on July 18, finding that insurers were being adequately compensated through silver loading methodology.⁸

A ruling by Judge Elaine D. Kaplan of the Court of Federal Claims in Montana⁹ on September 4 determined that the law does clearly and unambiguously require cost-sharing payments be made pursuant to Section 1402 of the ACA, notwithstanding Congress's failure to appropriate them; therefore, insurers are entitled to payment of cost-sharing amounts.

Several actions brought by insurers, including a class action lawsuit led by Common Ground Healthcare Cooperative,¹⁰ are seeking reimbursements from the government over the termination of cost-sharing reduction payments.

ASSOCIATION HEALTH PLAN CHALLENGES

An Executive Order issued on October 12, 2017, directed the ACA's tri-governing agencies (Departments of Health and Human Services, Labor, and Treasury) to develop ways to expand opportunity, primarily for small employers and individuals, to join together to purchase health coverage without many of the regulatory requirements otherwise imposed on small employers by the ACA.¹¹ In response to this directive, the tri-governing agencies released proposed rules and standards for establishing association health plans (AHPs) on January 5,¹² followed by final regulations on June 21.¹³ These rules expand the types of associations that can sponsor a group health plan on behalf of participating employers.

There are a number of legal challenges being raised to these rules. Specifically, on July 26, a dozen state attorneys generals filed a lawsuit in the US District Court for the District of Columbia against the Department of Labor challenging the formation of AHPs based on the premise that regulations circumvent requirements of ERISA that require a commonality of interest standard.¹⁴

Further, on September 22, California enacted a law¹⁵ that prohibits employer group health benefit plans from being issued, marketed, or sold to a sole proprietorship or partnership without employees, as well as prohibits individual health benefit plans to be sold to any entity without employees. Several states are considering similar proposals limiting the formation of AHPs, while others are setting up the regulatory framework to establish them.

There are also concerns that have plagued AHPs historically, *e.g.*, misdeeds by the plan or its sponsor or administrator could cause a rise in fraudulent entities, leaving people with unpaid claims.

Further, the advent of these rules could push the healthier groups out of the small employer market into AHPs. Another concern is whether the plan designs offered by AHPs would be less comprehensive than plans offered through the small employer insurance market, thus leaving people with minimalist coverage, albeit perhaps at a lower cost.

SHORT-TERM LIMITED DURATION POLICIES

An Executive Order issued on October 12, 2017,¹⁶ directed the ACA's tri-governing agencies to issue regulations expanding the availability of short-term limited duration insurance policies. Under the ACA, short-term limited duration insurance policies are limited to a period of no more than three months.¹⁷ To achieve the goal set forth in the Executive Order, regulations were issued on August 3¹⁸ expanding the duration of these policies from three months to up to 364 days, with the ability to renew, not to exceed 36 months from the origination date.

Notably, these short-term limited duration policies do not qualify as minimum essential coverage. Further, these policies are not required to comply with the market provisions, such as limitations on preexisting condition exclusions, providing maternity and mental health benefits, and the guaranteed issue and guaranteed renewal requirements, among others.

Proponents of these regulations believe that this change would allow a cost-effective option for individuals. Opponents to this type of plan design believe they will diminish the risk pool, leaving only high-risk claims individuals in the ACA marketplace.

States can regulate the availability and scope of these policies; for example, a state could provide that a short-term policy is limited to 90 days. Several states have recently enacted laws to limit the duration of these policies to three months, as well as to prohibit renewals or extensions. California passed a law prohibiting short-term limited duration policies altogether, requiring that, beginning January 1, 2019, these types of policies must be issued for a minimum period of at least one year.¹⁹

In addition, litigation relating to these types of policies has begun. On September 14, a coalition of consumer advocates and safety net health plans sued the tri-governing agencies based on the fact that these types of plans do not have to comply with the ACA's market reforms—*i.e.*, individuals could be subject to preexisting condition exclusions, premiums based on health status, limited benefit coverage, as well as the risk of rescission of coverage.²⁰

PENDING LEGISLATION AFFECTING THE ACA

Litigation notwithstanding, Congress continues to consider measures to amend or modify provisions of the ACA. On a seemingly perennial basis, bills are introduced that would delay the effective date of the Code Section 4980I excise tax on employer-sponsored plans, known as the Cadillac tax; revise the definition of “full-time employee” as it relates to the employer-shared responsibility mandate by increasing the amount of weekly working hours for applicable employees from 30 to 40, as well as suspending the ACA’s employer mandate penalty tax retroactively.

Following are some bills making further progress in Capitol Hill:

- **Protecting Patients from Surprise Medical Bills Act**, a draft bill released by a bipartisan Senate health care working group on September 29.²¹ This bill would provide consumer protections from surprise medical bills by limiting cost sharing to amounts owed to in-network providers, establishing a payment standard to be used by insurers when reimbursing providers, and prohibit balanced billing by providers.
- **Ensuring Coverage for Patients with Pre-Existing Conditions Act**²² would amend the Health Insurance Portability and Accountability Act (HIPAA) to guarantee the availability of health insurance coverage in the individual or group market. The bill would prohibit discrimination against individuals based on health status, including the prohibition against increased premiums due to preexisting conditions. This legislation is intended to restore the preexisting condition exclusions and other protections afforded by the ACA should litigation or legislation affect or otherwise remove these existing protections from the law.
- **The Patient Right to Know Prices Act**²³ and the Know the Lowest Price Act²⁴ call an end to so-called “gag clauses” that prevent pharmacists from advising individuals about differences between the price, copayment, or coinsurance of a drug under a health plan and a lower price of the drug without health insurance coverage.

In closing, the ACA seesaw (or maybe more aptly, teeter-totter) ride carries on. The fulcrum, of course, is the health needs of individuals. How these needs will be serviced or funded continues to go up and down through litigation and legislation. Time will tell how, or if, that perfect balance will be found.

NOTES

1. IRC § 5000A effective for months beginning after Dec. 31, 2013, was created by the Patient Protection and Affordable Care Act, Pub. L. No. 111-148 (2010) (PPACA) and amended by the Health Care and Education Reconciliation Act, Pub. L. No. 111-152 (2010) (HCERA).
2. An Act to Provide for Reconciliation Pursuant to Titles II and V of the Concurrent Resolution on the Budget for Fiscal Year 2018, Pub. L. No. 115-97, § 11081 (2017) (Tax Cuts and Jobs Act).
3. *Texas v. US*, 4:18-cv-001 67, US District Court, Northern District of Texas (Fort Worth).
4. Letter addressed to Hon. Paul Ryan, Speaker of the House of Representatives, from Attorney General Jeff Sessions, dated June 7, 2018 (available at <http://www.justice.gov/file/1069806/download>).
5. *State of Maryland v. United States of America et al.*, No. 1:18-cv-02849, US District Court for District of Maryland (Greenbelt).
6. Cover letter dated October 12, 2017, addressed to Seema Verma, administrator, Centers for Medicare & Medicaid Services, from Eric Hargan, acting secretary of US Dept. of Health & Human Services, regarding “Payments to Issers for Cost-Sharing Reductions,” followed by letter dated Oct. 11, 2017, addressed to the Hon. Steven Mnuchin, secretary of the Treasury, and Don Wright, acting secretary of US Dept. of Health & Human Services, from Jefferson Sessions, US attorney general (available at: <http://www.hhs.gov/sites/default/files/csr-payment-memo.pdf>).
7. *California v. Trump* (Case No. 3:17-cv-05895) District Court, Northern District of Calif.
8. Order Dismissing Case without Prejudice (Case No. 3:17-cv-05895-VC) signed by US District Judge Vince Chhabria of the Northern District of Calif. on July 18, 2018.
9. *Montana Health Co-Op v. US*, 2018 WL 4203938 (Fed. Cl. 2018).
10. *Common Ground Healthcare Cooperative v. United States*, 17-877 (Fed. Cl. 2018).
11. Presidential Executive Order 13813: Promoting Healthcare Choice and Competition Across the United States (Oct. 12, 2017).
12. Definition of “Employer” Under § 3(5) of ERISA—Association Health Plans, 29 CFR Part 2510, 83 Fed. Reg. 614 (Jan. 5, 2018).
13. Definition of “Employer” Under § 3(5) of ERISA—Association Health Plans, 29 CFR Part 2510, 83 Fed. Reg. 28912 (Jun. 21, 2018). *Also see* “Association Health Plans, ERISA Compliance Assistance” guide published by Department of Labor’s Employee Benefits Security Administration (available at: <https://www.dol.gov/sites/default/files/ebsa/about-ebsa/our-activities/resource-center/publications/compliance-assistance-publication-ahp.pdf>).
14. *State of New York et al. v. United States Department of Labor et al.*, Civ. Action 18-1747 [Case1:18-cv-01747], D.C. D.C.
15. Senate Bill No. 1375, Chapter 700 of laws enacted in 2018 Regular Session of California Legislature.
16. *Id.* (see endnote 10).

17. 26 CFR 54.9801-2; 29 CFR 2590.701-2; 45 CFR 144.103.
18. Short-Term, Limited-Duration Insurance, 83 Fed. Reg. 38212 (Aug. 3, 2018).
19. Senate Bill No. 910, Chapter 687 of laws enacted in 2018 Regular Session of California Legislature.
20. *Association for Community Affiliated Plans, et. al. v. United States Department of Treasury, et. al.*, (Civil Action No. 18-2133), D.C. D.C.
21. Members of the bipartisan Senate health care price transparency working group include US Senators Bill Cassidy, M.D. (R-LA), Michael Bennet (D-CO), Chuck Grassley (R-IA), Tom Carper (D-DE), Todd Young (R-IN), and Claire McCaskill (D-MO). Text of the discussion draft bill titled, Protecting Patients from Surprise Medical Bills Act (available at: <http://www.cassidy.senate.gov/imo/media/doc/Discussion%20Draft-%20Protecting%20Patients%20from%20Surprise%20Medical%20Bills%20Act.pdf>).
22. Ensuring Coverage for Patients with Pre-Existing Conditions Act (S.3388), 115th Congress (2017-2018), introduced by Sen. Thom Tillis (R-NC) on Aug. 23, 2018.
23. Patient Right to Know Prices Act (S. 2554), 115th Congress (2017-2018), sponsored by Sen. Susan Collins (R-ME); presented to President on Oct. 1, 2018.
24. Know the Lowest Price Act (S. 2553), 115th Congress (2017-2018), introduced by Sen. Debbie Stabenow (D-MI) on Mar. 14, 2018.

School Is Out!

“Excessive Fee” Class Action Lawsuits against Universities

James P. Baker

The Employee Retirement Income Security Act (ERISA) class action litigation spigot has been turned back on. A recent study published by the Center for Retirement Research at Boston College¹ indicates 401(k) class action litigation is again on the upswing. As you may recall, the last big surge in 401(k) plan litigation followed the subprime mortgage crisis recession in 2008. Those 401(k) plans class action lawsuits alleged employers acted imprudently by allowing company stock to be a 401(k) plan investment option. The Boston College Report indicates 107 401(k) class action lawsuits were filed in 2008 and that for 2016 to 2017, there were 107 new 401(k) plan class action lawsuits.

The rise in excessive fee litigation was to be expected. On February 3, 2012, the US Department of Labor published final regulations requiring extensive fee disclosures for retirement plans.² Now that service provider fees are visible, it has become much easier to decide whether those fees are “excessive.” Another factor fueling an interest in 401(k) plan governance is the fact that there is now more than \$5.3 trillion in assets held by those plans.³

The “excessive” fee lawsuits primarily target two things: (1) inappropriate investment choices and (2) charging too much for those investment choices. A third common claim is that the 401(k) plan’s recordkeeping fees are too high. All three of these “excessive fee” claims have recently been visited upon our country’s leading colleges and universities.

James P. Baker is a partner at Baker & McKenzie LLP and heads the firm’s ERISA litigation practice group. Chambers USA reports Mr. Baker is “an ERISA legend on the West Coast whose expertise has resulted in national acclaim,” and has noted that he has been “handling very prominent cases and producing work of the highest quality.” The Legal 500 USA has labeled him as “exceptional” for ERISA litigation. He continues to be favorably rated in all of these publications. He has also been listed as a leading attorney for ERISA litigation in Northern California Super Lawyers from 2005 to the present. He is an American College of Employee Benefits Counsel Fellow. He is AV rated by Martindale-Hubbell. Mr. Baker was Chair of the American Bar Association’s ERISA and Pension Litigation Subcommittee of the Committee on Business and Corporate Litigation from 2006 to 2016. He acts as a court-appointed mediator for ERISA cases in the Northern and Eastern Districts of California. Mr. Baker thanks Ginny Aldajani, a paralegal in Baker’s San Francisco office, for her thoughtful assistance in preparing this article.

A little over two years ago, the St. Louis-based law firm of Schlichter Bogart & Denton, LLP filed class action lawsuits against a number of elite US universities. Among those named in the lawsuits were Columbia University, New York University (NYU), Northwestern University, Yale University, and Massachusetts Institute of Technology (MIT). Copycat lawsuits filed by other firms named Brown University, Georgetown University, George Washington University, and the University of Chicago.

THE NORTHWESTERN UNIVERSITY EXCESS FEE LAWSUIT

Schlichter Bogart filed a class action ERISA lawsuit on behalf of participants in two Northwestern University defined contribution plans.⁴ On May 25, United States District Judge Jorge Alonso dismissed plaintiff Laura Divane’s complaint against Northwestern University with prejudice.⁵ Divane’s complaint against Northwestern University was massive—287 paragraphs and more than 144 pages. Divane made three broad claims:

1. The plan’s fiduciaries failed to monitor investment options, provided too many investment options, and the options included poorly performing funds with excessive fees;
2. The fees charged to participants for recordkeeping were excessive; and
3. The Northwestern University fiduciaries failed to negotiate more favorable investment fund expense ratios, including making institutional class funds available, rather than the available higher-cost retail funds.

In dismissing Divane’s first fiduciary breach claim, the court explained, “any plan participant could have avoided what plaintiffs considered to be the problems with those products ... simply by choosing other options.” Judge Alonso observed that the fact that the fund contained underperforming or more expensive investment options “does not a fiduciary breach make.” He found plaintiffs’ theory that participants were incapable of choosing between multiple investment funds was “paternalistic,” and that the plan simply did not violate ERISA by allowing participants to make their own investment choices, citing *Loomis v. Exelon Corp.*⁶

The Court also notes that the mere fact that plaintiffs believe index funds are a better long-term investment than the CREF Stock Account

does not a fiduciary breach make. Low-cost index funds were available to plan participants (Am. Compl. ¶¶ 161, 176), and one can understand why they might prefer those funds to the CREF Stock Account. Anyone who has paid attention to stock-market or investment-strategy news over the last decade would be hard-pressed to disagree with the notion that the average investor will do better investing in low-cost index funds rather than in attempting either to select individual stocks or to select actively managed mutual funds. What is good for the average investor, though, is not necessarily what is good for any particular individual. Warren Buffett, who has (famously) planned for his wife's money to be invested in low-cost index funds after his death, has (also famously) become one of the world's most successful investors by choosing individual stocks that are undervalued in the grand tradition of Benjamin Graham's *The Intelligent Investor*. A professor of economics or finance might prefer investment options different from what a professor of music might choose. Ultimately, plaintiff's theory is paternalistic, but ERISA is not.

Divane's argument that Northwestern paid too much for record-keeping fees was also rejected. She had alleged that the plan's practice of paying recordkeeping fees through revenue sharing was a breach of fiduciary duty. Judge Alonso stated that this claim "runs smack into *Hecker* and *Loomis* where the Seventh Circuit affirmed dismissal of similar claims. In *Hecker*, the Seventh Circuit said defendants did not violate ERISA by using revenue sharing to pay for plan expenses."^{7,8}

Divane next alleged it was a breach of fiduciary duty to offer 240 investment options in the employer match retirement plan and 180 investments in the employee-funded voluntary plan. Judge Alonso could not conclude that offering such a broad array of investment options was a breach of fiduciary duty. In fact, he observed that the two retirement plans both offered low-cost index funds. He concluded, "Plaintiffs have alleged that the plans offered them the very types of funds they want. That is not a breach of fiduciary duty."⁹ Nor does ERISA's fiduciary standard require the plan fiduciaries to "scour the market" to find the cheapest possible funds. Among the funds the participants could select, there were expense ratios of .05, .06, and .01 percent, which Judge Alonso found were "as a matter of law, low."¹⁰

THE NEW YORK UNIVERSITY CASE

Dr. Alan S. Sacerdote's initial complaint was filed on August 9, 2016. He asserted seven claims against NYU.¹¹ All but two of his claims were later dismissed in a court decision dated August 25, 2017. The two claims remaining for trial alleged a breach of the duty of prudence.

On July 31, 2018, Judge Katherine Forrest, after conducting an eight-day trial, ruled in favor of NYU on both claims. Although she found deficiencies in how the university's retirement plan committee operated, she decided there was no breach of fiduciary duty. Sacerdote, the lead plaintiff, made almost identical allegations to those made in the Northwestern University case.

The first prudence claim remaining for trial asserted the committee imprudently managed the selection and monitoring of recordkeeping vendors. This resulted in NYU paying excessively high service provider fees. The second breach of the duty of prudence claim remaining for trial was that the committee failed to remove two specific investment options. Following the trial, the court issued a detailed 36-page opinion. Although the court found that some of the committee members showed a lack of diligence, it concluded that the committee's conduct was not imprudent. The court paid particular attention to the "procedural prudence" of the committee in requesting proposals and in reviewing the performance of record keepers. The court further observed that the committee closely monitored the performance of the plan's investment options. Among other things, the committee received and reviewed a detailed investment performance report before each quarterly meeting. The minutes of the meetings showed the committee asked the investment advisor for advice and even questioned that advice. Certain funds were placed on a watch list at the quarterly committee meetings to determine whether the fund should be added or removed from the investment menu. The court ruled in NYU's favor on all claims. It concluded the evidence simply did not support plaintiffs' claim of a fiduciary breach concerning recordkeeper fees or with regard to monitoring or selecting the plan's investment options.

UNIVERSITY OF PENNSYLVANIA

The Schlichter lawsuit against the University of Pennsylvania was a mirror image of the NYU and Northwestern complaints.¹² Judge Pratter's Opinion followed the same pattern as the opinions in *Northwestern* and *NYU*.

UNIVERSITY OF CHICAGO

In May, the University of Chicago broke ranks with the other universities and reached a \$6.5 million settlement.¹³ It is the only university to do so. The cases against Brown University, Georgetown, George Washington, Duke University, Vanderbilt University, and MIT remain pending at the trial court level.

CONCLUSION

The Court decisions in NYU and Northwestern lay out an important road map. Plan fiduciaries must periodically investigate different investment and fee options offered by their 401(k) or 403(b) plans to ensure the investment options are “prudent.” The key to defending imprudence claims is process—what ERISA lawyers call “procedural prudence.” Plan fiduciaries must keep records showing what they have done to monitor investment fund fees and recordkeeping fees. Simply put, the process used by the fiduciaries in selecting investments and recordkeepers must be documented and must be explained in the documents. An ounce of procedural prudence now may prevent future class action excess fee claims.

NOTES

1. George S. Mellman and Geoffrey T. Sanzenbacher, “401(k) Lawsuits: What Are the Causes and Consequences?” Center for Retirement Research at Boston College; available at http://crr.bc.edu/wp-content/uploads/2018/04/IB_18-8.pdf.
2. See 29 C.F.R. 2550.408b-2.
3. BrightScope and Investment Company Institute, *The BrightScope/ICI Defined Contribution Plan Profile: A Close Look at 401(k) Plans 2015*, Mar. 2018; available at https://www.ici.org/pdf/ppr_18_dcplan_profile_401k.pdf.
4. The defined contribution plans in the university cases were IRC § 403(b) plans (the not-for-profit version of a 401(k) plan).
5. *Laura Divane v. Northwestern University, et al.*, Case No. 16-C-8157 (E.D. Ill. May 25, 2018).
6. *Loomis v. Exelon Corp.*, 658 F.3d 667, 673–674 (7th Cir. 2011).
7. *Hecker v. Deere & Co.*, 556 F.3d 575, 586 (7th Cir. 2009).
8. *Divane v. Northwestern University*, *supra* n.5 at p.15.
9. *Divane v. Northwestern University*, slip op. at p.17.
10. *Divane v. Northwestern University*, *supra* n.5 at p.17.
11. *Sacerdote, et al. v. New York University*, Case No. 16-cv-6284 (KBF).
12. *Sweda, et al. v. University of Pennsylvania*, Case No. 16-4329 (E.D. PA Sept. 21, 2017).
13. *Daugherty, et al. v. The University of Chicago*, Case No. 17-C-3736 (N.D. Ill.).

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