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A quarterly newsletter about employee benefits and current issues

Third Quarter 2009

▶ **REMINDER: 2010 WELFARE PLAN CHANGES COMING SOON**

With annual enrollment season fast approaching, now is the time to consider 2010 welfare plan changes.

[Continued on page 2](#)

▶ **A FIDUCIARY DUTY TO SET REASONABLE EXECUTIVE COMPENSATION?**

When corporate executives also serve as ERISA fiduciaries for employee stock ownership plans (“ESOPs”), their business decisions may become subject to heightened legal scrutiny.

[Continued on page 3](#)

▶ **AMENDMENT DEADLINE LOOMING FOR PPA CHANGES**

The Pension Protection Act of 2006 (“PPA”) became law on August 17, 2006. The PPA is one of the most sweeping retirement reform bills in recent history, mandating a host of changes for tax-qualified retirement plans.

[Continued on page 5](#)

▶ **PARTICIPANT LOAN EXTENSION CAN CARRY UNEXPECTED CONSEQUENCES**

Many 401(k) and other employer retirement plans allow participants to borrow from their accounts.

[Continued on page 6](#)

▶ **DOL PROVIDES REPORTING RELIEF FOR 403(B) PLANS SUBJECT TO ERISA**

The 2009 calendar year is a time of great change for employers sponsoring Section 403(b) tax-sheltered annuity plans.

[Continued on page 8](#)

▶ **EMPLOYER’S AGGRESSIVE ANTI-SMOKING POLICY SURVIVES COURT CHALLENGE – FOR NOW**

In a closely watched case pending in a Massachusetts federal court, Scotts LawnService has successfully defended its policy of refusing to hire anyone who smokes, even if they do so on their own time.

[Continued on page 10](#)

Benefits and Employment Briefing

REMINDER: 2010 WELFARE PLAN CHANGES COMING SOON

With annual enrollment season fast approaching, now is the time to consider 2010 welfare plan changes. We have discussed each of these changes in detail in past issues of *Benefits in Brief*, a newsletter produced by Spencer Fane Britt & Browne LLP. Thus, the following is just a brief reminder of the new requirements, with the relevant effective date for each:

- ▶ **Mental Health Parity** – Effective for plan years beginning on and after October 2, 2009 (January 1, 2010, for a calendar-year plan), group health plans must provide mental health and substance abuse benefits on substantially the same terms as medical/surgical benefits. The new requirements will likely require sponsors to amend their plans to remove any separate frequency limits that had applied to mental health and substance abuse benefits (e.g., outpatient visit limits or hospital stay limits), as well as to equalize the deductibles and coinsurance levels that apply to mental health and substance abuse benefits. (Please see the [November 2008 article](#) for additional details on the new Mental Health Parity requirements.)
- ▶ **Michelle's Law** – Effective for plan years beginning on or after October 9, 2009

(January 1, 2010, for a calendar-year plan), group health plans must permit dependent children who lose their eligibility as a “student” due to a “medically necessary” leave of absence to continue their coverage for up to 12 months. This may require plan sponsors to update their plan documents, summary plan descriptions, enrollment materials, and other employee communications. (Please refer to the [November 2008 article](#) for additional details on Michelle's Law.)

- ▶ **Genetic Information Nondiscrimination Act (GINA)** – Effective for plan years beginning after May 21, 2009 (January 1, 2010, for a calendar-year plan), group health plans and insurers are prohibited from restricting enrollment or adjusting premiums for the *group* on the basis of genetic information. They will also be limited in the extent to which they may request information concerning an employee's genetic information – including family medical history – before enrolling the employee in a health plan. (Please refer to the [July 2008 article](#) for additional details on GINA.)
- ▶ **HIPAA Privacy and Security** – Effective February 17, 2010, the HIPAA Security Rule will be directly applicable to business associates. Additionally, the

Benefits and Employment Briefing

HIPAA Privacy Rule contains an expanded right to request restrictions on the use or disclosure of protected health information. Health plan sponsors may need to review and update their notices of privacy practices, review and update their privacy and security policies and procedures, review their plan documents, amend their business associate agreements, and provide updated training to their workforce. (Please refer to the [March 2009 article](#) for additional details on these HIPAA changes.)

- ▶ **Children's Health Insurance Program Reauthorization Act (CHIPRA)** – By February of 2010, the DOL and HHS are expected to issue model notices by which employers may notify employees of the potential availability of premium assistance under the Children's Health Insurance Program (CHIP). Employers will have to provide these notices by the first day of the plan year after the model notices are issued. (Please refer to the [February 2009 article](#) for additional details on these CHIP changes.)

Julia M. Vander Weele, Partner
Spencer Fane Britt & Browne LLP



A FIDUCIARY DUTY TO SET REASONABLE EXECUTIVE COMPENSATION?

When corporate executives also serve as ERISA fiduciaries for employee stock ownership plans ("ESOPs"), their business decisions may become subject to heightened legal scrutiny. That was the holding of the Ninth U.S. Court of Appeals in a recent case in which ESOP participants raised ERISA challenges to a CEO's compensation package. The decision also upheld a California federal trial court's ruling that barred the executives from using corporate assets to pay their defense costs. (*Johnson v. Couturier*, 7/27/09). Although this decision is at odds with holdings from at least one other court of appeals, it may nonetheless give ESOP fiduciaries pause when making certain business decisions.

The *Couturier* case arose out of complaints by ESOP participants that three executives of Noll Manufacturing, who also served as fiduciaries for the ESOP, breached their obligation under ERISA to act solely in the interest of participants when they approved an allegedly excessive compensation package for one of the executives. The executives contested that allegation, claiming that this was a business decision, not an act that was subject to ERISA's fiduciary duties. They also sought to have their defense costs reimbursed from corporate assets, pursuant to indemnification agreements they had with the company.

Benefits and Employment Briefing

The participants filed a motion asking the court to bar the company from paying the executives' litigation expenses, arguing that to do so would further dilute the value of the company – and thus their interests in the ESOP – and that it would violate Section 410(a) of ERISA. That provision of ERISA makes it illegal for a plan to indemnify its fiduciaries for their wrongful conduct. The lower court granted the participants' request, and the Ninth Circuit affirmed that decision.

On appeal, the fiduciaries argued that decisions they made when acting as corporate executives – such as approving executive compensation packages – should not be subject to review under ERISA. The Ninth Circuit acknowledged that in most cases business decisions are not governed by ERISA's fiduciary standards, but said that in this case those standards were implicated because the decisions affected the ESOP's value. The court also focused on the fact that the business decisions at issue involved the compensation of one of the fiduciary decision-makers. "Where, as here, an ESOP fiduciary also serves as a corporate director or officer, imposing ERISA duties on business decisions from which that individual could directly profit does not to us seem an unworkable rule."

Does this ruling mean that corporate executives cannot also serve as ESOP fiduciaries without subjecting their business decisions to fiduciary scrutiny under ERISA?

Most likely the answer is "no." The Ninth Circuit emphasized that the defendants' business decisions, and their request to have their legal fees reimbursed, affected the company's equity, and thus the value of the participants' stake in the ESOP. That analysis admittedly is troubling, because nearly all business decisions affect corporate value. Nevertheless, three distinguishing factors about this case may help other ESOP fiduciaries sleep better at night:

- ▶ First, the ESOP in the *Couturier* case was sponsored by a relatively small, closely held company, and the compensation package at issue constituted nearly 65% of the company's total assets. The effect of the challenged business decision on the ESOP's value was therefore much more significant than would ordinarily be the case.
- ▶ Second, the business decisions at issue here also involved self-dealing on the part of one of the fiduciaries, as it was 'his compensation that was excessive.
- ▶ Third, the court's analysis will not necessarily be embraced by courts in other parts of the country. The Ninth Circuit acknowledged that its reasoning had essentially been rejected by the Eighth Circuit, which has held in the past that corporate officers and directors do not act as ERISA fiduciaries when making decisions such as these.

Benefits and Employment Briefing

ESOPs often present special challenges for corporate officers and directors who also have responsibilities to the plan. The Ninth Circuit's *Couturier* decision gives those individuals one more thing to think about when balancing their roles.

Gregory L. Ash, Partner
Spencer Fane Britt & Browne LLP

AMENDMENT DEADLINE LOOMING FOR PPA CHANGES

The Pension Protection Act of 2006 (“PPA”) became law on August 17, 2006. The PPA is one of the most sweeping retirement reform bills in recent history, mandating a host of changes for tax-qualified retirement plans. Most of these changes are already in effect – some have been for years.

Accordingly, most sponsors have long since wrestled with the necessary changes to plan administration and are operating their plans in compliance with PPA’s requirements. Others have implemented some of the PPA’s optional provisions. But most PPA changes will require plan *amendments*, as well, and the deadline for adopting those amendments is fast approaching.

The PPA gives plan sponsors until the end of the 2009 plan year to amend their documents (2011 for governmental plans). This lag between the effective date and the

amendment deadline creates a trap for the unwary. Sponsors who implemented PPA changes in the “real world” years ago must not overlook the necessary plan amendments. Even those who are aware of the deadline might forget necessary document changes because of the sheer number of new requirements.

Here is a *partial* list of the PPA changes that may require amendments to tax-qualified retirement plans:

- ▶ Faster vesting rules for employer contributions;
- ▶ New funding rules for defined benefit plans;
- ▶ New automatic enrollment rules for 401(k) plans;
- ▶ Modified actuarial assumptions and mortality tables for lump sums and other payments subject to the Tax Code’s present value requirements;
- ▶ A 75% “qualified optional survivor annuity” requirement for plans that offer annuity forms of payment;
- ▶ Greater diversification rights for plans holding publicly traded employer securities;
- ▶ Expanded direct rollover rules;
- ▶ An extended notice and consent period for distributions; and

Benefits and Employment Briefing

- ▶ Benefit limitations for underfunded defined benefit plans.

Now is the time for sponsors to review their plan documents for compliance with the PPA. Sponsors of calendar-year plans have until only December 31 to adopt the necessary amendments. For some, this will mean revisiting complex retirement plan issues that they have already addressed with participants and administrative staff. But timely amendments will avoid the necessity of a costly corrective filing with the IRS.

Larry Jenab, Associate
Spencer Fane Britt & Browne LLP

PARTICIPANT LOAN EXTENSION CAN CARRY UNEXPECTED CONSEQUENCES

Many 401(k) and other employer retirement plans allow participants to borrow from their accounts. These loans can carry a number of advantages, including ready availability and a reasonable rate of interest. Moreover, if properly structured, a participant loan can be obtained (and repaid) on a tax-free basis.

On the other hand, the failure to comply with the Tax Code's constraints on participant loans can subject a borrowing participant to

immediate income taxation and, if the participant is not yet age 59½, a 10% penalty tax. Two recent Tax Court decisions highlight one aspect of these participant loan rules that can be easily overlooked, thereby subjecting participants to these adverse tax consequences.

Both of these cases arose under the same plan, the New York City Employees' Retirement System ("NYCERS"), and both involved participants who chose to refinance existing loans by increasing the loan amount *and* extending the original repayment term. As explained below, this extension was what triggered the dispute with the IRS.

Under Section 72(p) of the Tax Code, any participant loan will be treated as a taxable distribution unless the following three conditions are satisfied:

1. The principal amount of the loan (when added to the outstanding balance of all other loans from plans sponsored by the same employer) does not exceed a specified limit;
2. The loan, by its terms, must be repaid within five years (with an exception for home acquisition loans); and
3. The loan must be repaid through substantially level amortization, with payments no less frequently than quarterly.

Benefits and Employment Briefing

The loan limit is generally equal to the lesser of \$50,000 (reduced to reflect any loans outstanding during the one-year period before the new loan is made) or one-half of the participant's vested account balance.

The IRS regulations issued under Section 72(p) discourage the use of refinancing as a way of extending the term of an existing loan. They do so by providing that, where an existing loan is replaced by a loan having a later repayment date, *both* loans must be treated as outstanding on the date of the new loan. If the sum of these loans (along with all other outstanding loans to the same participant) exceeds the limit described above, the replacement loan will result in a deemed distribution equal to the amount in excess of that limit.

In both of these recent cases, the participant opted for a new loan that not only increased the amount of an existing loan, but also extended the repayment term of that loan. NYCERS cautioned both participants that this would likely result in a portion of the new loan being treated as taxable income. It also reported that taxable portion on a Form 1099-R. When the participants failed to report this amount as taxable income on their personal tax returns, the IRS issued income tax assessments. Moreover, because both participants were under age 59½, the IRS assessed the 10% penalty tax.

In both cases, the Tax Court agreed with the IRS that the extended term of the new loan triggered the regulatory requirement that both the existing and new loans be treated as outstanding on the date of the new loan. This caused the Section 72(p) loan limit to be exceeded. The Court therefore upheld the IRS's determinations as to both the income and penalty taxes.

Both of these participants could have obtained an additional loan on a nontaxable basis – had they been willing to continue making payments on the existing loan in accordance with the original payment schedule. Plan administrators should be prepared to advise participants of the potentially adverse tax consequences of extending an existing loan, as well as alternative approaches that might achieve a participant's goals without triggering these taxes.

Kenneth A. Mason, Partner
Spencer Fane Britt & Browne LLP

Benefits and Employment Briefing

DOL PROVIDES REPORTING RELIEF FOR 403(B) PLANS SUBJECT TO ERISA

The 2009 calendar year is a time of great change for employers sponsoring Section 403(b) tax-sheltered annuity plans. The first new IRS regulations in over 40 years, which became effective on January 1, 2009, have redefined a sponsoring employer's roles and responsibilities with respect to these programs. Under those regulations, 403(b) plans must be maintained pursuant to a "written plan" (although, in separate guidance, the IRS has given plan sponsors until the last day of 2009 to have this "written plan" in place).

Perhaps just as significantly, 2009 marks the first year that *ERISA-covered* 403(b) plans are subject to expanded Form 5500 reporting requirements. ERISA-covered plans include those (other than church plans) that are maintained by Code Section 501(c)(3) organizations, and not by public schools. For plans with more than 100 participants, ERISA requires the engagement of an independent accountant to audit the plan's financial statements. As icing on the cake, the 2009 annual reports will now be required, for the first time, to be filed electronically under the Department of Labor's new "EFAST 2" filing system.

For plan years beginning before January 1, 2009, ERISA-covered 403(b) plans were

subject to very limited Form 5500 reporting. Plan administrators were required to complete a few specific lines on the Form 5500, but they were not required to provide any financial information or to attach any schedules. And even *large* 403(b) plans were not required to obtain an audit. For plan years beginning on or after January 1, 2009, however, ERISA-covered 403(b) plans are subject to the same Form 5500 reporting requirements as qualified plans, including the audit requirement for large plans.

These new reporting (and audit) requirements present a significant challenge for 403(b) plans, because many such plans are merely a "collection" of individual annuity contracts or custodial accounts. Moreover, many of these plans have more than one investment provider, or they have historically allowed participants to make "contract exchanges" to investment providers that no longer have (or perhaps never had) any connection to the plan sponsor. As a result, employers sponsoring such plans have been wondering how they will be able to gather the information needed to complete the annual report for the 2009 plan year. Likewise, auditors engaged to audit such plans have been wondering what assets they will be expected to audit.

In response to concerns expressed by 403(b) plan sponsors (as well as investment providers, consultants, advisors, and auditors), the DOL has issued Field

Benefits and Employment Briefing

Assistance Bulletin ("FAB") 2009-2. This FAB provides transition relief for administrators of 403(b) plans who are otherwise required to comply with the expanded Form 5500 reporting requirements for the first time in 2009.

Taking direction from prior IRS guidance as to which 403(b) contracts or accounts are subject to the "written plan" requirement, FAB 2009-2 provides that, for purposes of the Form 5500 reporting requirements, the DOL will not consider an annuity contract or a custodial account to be part of the Section 403(b) plan if the investment contract satisfies the following requirements:

1. the contract or account was issued to a current or former employee before January 1, 2009;
2. the employer ceased to have any obligation to make contributions (including employee salary deferral contributions), and in fact ceased making all such contributions to the contract or account, before January 1, 2009;
3. all of the rights and benefits under the contract or account are legally enforceable against the insurer or custodian by the individual participant, without any involvement by the employer; and
4. the participant is fully vested in the contract or account.

Under this FAB, most 403(b) investments with "discontinued" investment providers (i.e., providers who, as of January 1, 2009, no longer had a "payroll slot" that allowed them to receive ongoing contributions) will be exempt from the Form 5500 reporting requirements. The same is true of 403(b) investments that were transferred -- prior to January 1, 2009 -- to an investment provider that never had a payroll slot. This means that 403(b) plan administrators will not be required to include these assets on the financial schedules (Schedules I or H) that are attached to the annual report, and that auditors of large 403(b) plans will not be required to take these assets into account when auditing those financial schedules.

The FAB also provides that current or former employees whose only accounts or contracts under a 403(b) plan are excludable under the transition relief described above need not be counted as participants for Form 5500 annual reporting purposes. This will allow some plans that might otherwise have been "large" plans (i.e., plans with 100 or more participants as of the beginning of the plan year) to file as "small" plans (generally, plans with fewer than 100 participants as of the beginning of the plan year). This, too, could be significant, since most "small" plans will be able to use the Form 5500-SF (Short Form 5500), and *all* "small" plans are exempt from the independent audit requirement.

Benefits and Employment Briefing

Finally, the FAB clarifies that the DOL will not reject a Form 5500 with a "qualified," "disclaimed," or "adverse" audit opinion if the accountant expressly indicates that the sole reason for such an opinion was because certain pre-2009 contracts were not covered by the audit or included in the plan's financial statements. Other than this very narrow relief, accountants engaged to perform audits of Section 403(b) plans are expected to perform audit procedures and report in accordance with generally accepted auditing standards, as required by ERISA and relevant DOL regulations.

No doubt, this DOL guidance will come as welcome relief for sponsors of Section 403(b) plans, as well as the accountants who must audit those plans.

Robert A. Browning, Partner
Spencer Fane Britt & Browne LLP



EMPLOYER'S AGGRESSIVE ANTI-SMOKING POLICY SURVIVES COURT CHALLENGE – FOR NOW

In a closely watched case pending in a Massachusetts federal court, Scotts LawnService has successfully defended its policy of refusing to hire anyone who smokes, even if they do so on their own

time. The employer's anti-smoking policy was just one component of a comprehensive wellness initiative. Employers across the country who are seeking judicial guidelines on the extent to which they can stretch wellness programs may find some comfort in this ruling, but they would be well advised not to place *too* much emphasis on it.

The lawsuit (*Rodrigues v. EG Systems, Inc. d/b/a Scotts LawnService*, D. Mass. 7/23/09) was filed by a contingently hired worker who was terminated after his nicotine test came back positive. His employer, Scotts LawnService, had recently launched a huge wellness program in an attempt to improve the health of its workforce and reduce its health care costs. The program included a 24,000 square foot, \$5 million on-site clinic staffed with doctors and nurses, reimbursement of fitness club membership fees, premium discounts for those who participated in a health risk assessment, and other incentives. It also included a sweeping smoke-free-workplace policy, which prohibited smoking both while at work *and* on employees' personal time.

Mr. Rodrigues, who is a smoker, applied for a job and was given a contingent offer of employment. The offer letter, which he read and signed, expressly conditioned his employment on negative results of the pre-employment nicotine test to which he submitted. While the test results were pending, however, Scotts allowed Mr.

Benefits and Employment Briefing

Rodrigues to work. When the results came back positive, Rodrigues was terminated.

Mr. Rodrigues sued Scotts under various theories that challenged the anti-smoking component of its wellness program. Among his theories of recovery were claims that the anti-smoking policy violated the Employee Retirement Income Security Act (“ERISA”), because it interfered with his ability to obtain health benefits, and that it violated public policy and his rights to privacy under Massachusetts state law. Notably, he did *not* challenge the program under either the Americans with Disabilities Act (“ADA”) or the Massachusetts Fair Employment Practices Act.

The case first drew headlines when the court refused to dismiss some of Mr. Rodrigues’ claims without considering evidence to be adduced by the parties. Some commentators saw that as a sign that Mr. Rodrigues might prevail. Those thoughts were put to rest, however, when the court later granted summary judgment to Scotts on all of Mr. Rodrigues’ remaining claims.

The court rejected his ERISA claim because Mr. Rodrigues was not eligible to participate in the Scotts health plan when he was terminated. The plan had a 60-day waiting period for new enrollees, and that period had not yet expired. Accordingly, the court ruled that Mr. Rodrigues did not enjoy any rights under the plan that could have been protected under ERISA.

The court also held that the claims premised on Massachusetts law were meritless. In evaluating Mr. Rodrigues’ contention that the employer’s anti-smoking program violated state public policy, the court concluded that, although the question was close, the weightier public policy actually favored a smoke-free society, rather than an individual’s right to smoke on his or her own time. The court dismissed the state law privacy claim because, in this particular case, Mr. Rodrigues made no secret of the fact that he was a smoker. During the two-week period that he worked for Scotts, he openly displayed packs of cigarettes to his supervisors. The judge therefore concluded that Mr. Rodrigues did not have an expectation of privacy in this conduct.

Although it was a victory for Scotts (and for employers in general), perhaps the most important lesson from this case is that it teaches us very little about the laws governing wellness programs. The lawsuit involved only one aspect of the much more comprehensive program sponsored by Scotts. It does not address the program’s compliance with the final regulations governing wellness programs under the Health Insurance Portability and Accountability Act (“HIPAA”), nor does it speak to how the program would fare if challenged under the ADA.

Moreover, the *state* law analysis in the decision is relevant only for employers who have employees in Massachusetts. Mr.

Benefits and Employment Briefing

Rodrigues might have been successful on similar claims had he been employed in Washington, Missouri, or Vermont. Indeed, some state statutes expressly *prohibit* adverse employment action premised on an employee's off-duty use of lawful agricultural products, such as tobacco.

Even under *Massachusetts* law, Mr. Rodrigues might have prevailed had the facts of his case been slightly different. And he might yet prevail, as he has appealed the lower court's decision.

Employers should not attempt to duplicate the comprehensive program initiated by Scotts solely on the basis of the *Rodrigues* decision. Before announcing any wellness initiative, they should engage competent

legal counsel to review the program under both federal and state laws to ensure that it will not have an adverse impact on the employer's fiscal health.

Gregory L. Ash, Partner
Spencer Fane Britt & Browne LLP

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630 N. Rosemead Blvd., Suite 300, Pasadena, CA 91107
(626) 351-2300 / (626) 371-0447 Fax
www.garnerbenefits.com