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Monthly Newsletter – Volume 3, No. 9 – October 10, 2007

Highlights of the Month

1. **Department of Labor Issues Proposed Regulations Establishing a Safe Harbor for Fiduciaries for the Selection of Annuity Providers for Individual Account Plans**
2. **Internal Revenue Service Closes Determination Letter Program for Pre-Approved Defined Contribution Plans**
3. **Internal Revenue Service Extends Deadline for Plan Document Requirements for Nonqualified Deferred Compensation Plans**
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Department of Labor Issues Proposed Regulations Establishing a Safe Harbor for Fiduciaries for the Selection of Annuity Providers for Individual Account Plans

In 1995, the Department of Labor (DOL) issued Interpretive Bulletin 95-1 (IB 95-1), which provided guidance on Employee Retirement Income Security Act (ERISA) fiduciary standards applicable to the selection of annuity providers for pension plan benefit distributions. Among other things, IB 95-1 required plan fiduciaries to take steps to obtain the safest annuity available unless it would be in the interest of the participants and beneficiaries to do otherwise. In Advisory Opinion 2002-14A, the DOL indicated that the general fiduciary principles contained in IB 95-1 applied equally to the selection of annuity providers for defined benefit plans and for defined contribution plans.

The Pension Protection Act of 2006 (PPA) § 625 directed the DOL to clarify that the selection of an annuity contract as an optional form of distribution from an individual account plan is not subject to the safest available annuity standard under IB 95-1, but would still be subject to otherwise applicable fiduciary standards. The DOL has now issued an interim final rule limiting the application of IB 95-1 to defined benefit plans (effective November 13, 2007) and proposed regulations [*Prop. Labor Reg. 2550.404a-4(b); 72 Fed. Reg. 52021, 9/12/2007*] that provide, in the form of a safe harbor, guidance for the selection of annuity providers and contracts for individual account plan distributions.

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The proposed regulations provide that for a defined contribution plan, the selection of an annuity provider in connection with a benefit distribution (benefit distribution options available to plan participants) is a fiduciary act and is governed by the fiduciary standards of ERISA § 404(a)(1). Under § 401(a)(1), fiduciaries must discharge their duties solely in the interest of participants and beneficiaries. The proposed regulations provide a safe harbor under which a fiduciary would be considered to have acted prudently in the selection of an annuity provider for purposes of benefit distribution if certain conditions are satisfied.

The specific conditions of the safe harbor require a fiduciary to:

- Engage in an objective, thorough, and analytical search for providers;
- Determine whether the fiduciary has the expertise or knowledge to evaluate the annuity provider, and if so, the fiduciary is not required to engage an independent expert to perform such an evaluation;
- Consider information sufficient to assess the ability of the annuity provider to make all future payments under the contract; such information would generally require consideration of the annuity provider's experience and financial expertise, its level of capital, surplus, and reserves available to make payments under the contract, the provider's rating from insurance ratings services, the structure of the annuity contract and the use of separate accounts to underwrite the provider's obligations, the availability of additional protections available through state guaranty associations, and any other information that the fiduciary considers to be relevant;
- Consider the cost of the contract in relation to the benefits and administrative services to be provided under the contract;
- Conclude that, at the time of the selection, the annuity provider is financially able to make all future payments under the annuity contract and the cost of the contract is reasonable in relation to the benefits and services provided;
- Periodically review the conclusion made above for those annuity providers selected to provide multiple annuities over time, but not after the annuity has been purchased for an individual participant or beneficiary.

Internal Revenue Service Closes Determination Letter Program for Pre-Approved Defined Contribution Plans

On December 18, 2007, the Internal Revenue Service (IRS) will temporarily stop accepting determination letter applications for defined contribution plans that are filed on Form 5307, *Application for Determination for Adopters of Master or Prototype or Volume Submitter Plans*. The IRS will continue to process applications made before December 18, 2007, provided that the plan has a favorable GUST opinion or advisory letter. Any applications received after December 18, 2007, will be returned to the

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applicant. The IRS stated that this action is being taken because all pre-approved (i.e., master and prototype and volume submitter) defined contribution plans are required to be restated to comply with the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), and to be submitted to the IRS for a determination letter using Form 5307 during the two-year period which the IRS plans to announce in early 2008.

Various revenue procedures issued by the IRS in 2005 address a staggered remedial amendment system for plans that are qualified under Internal Revenue Code § 401(a), with five-year amendment/approval cycles for individually designed plans and six-year cycles for pre-approved plans. The submission period for the six-year cycle for pre-approved defined contribution plans ended on January 31, 2006. Sponsors and practitioners were required to restate their pre-approved defined contribution plans for EGTRRA and other changes in qualification requirements and apply for new opinion or advisory letters during the submission period. When the review of the pre-approved defined contribution plans is nearing completion, the IRS plans to announce the date by which adopting employers must adopt the newly approved plans. This date will also be the deadline for such employers to file Form 5307 applications for their plans.

Submissions for determination letters on Form 5307 will continue to be accepted for plan amendments related to a voluntary correction program submission or as required under the correction on audit.

Internal Revenue Service Extends Deadline for Plan Document Requirements for Nonqualified Deferred Compensation Plans

The IRS has extended transition relief for complying with the plan document requirements for nonqualified deferred compensation plans (NQDC Plans) under IRC § 409A until December 31, 2008. In addition, the IRS provided guidance and limited relief on the requirements for time and form of payment, and stated that it will soon approve a voluntary compliance program under § 409A.

IRS Notice 2007-78 provides a December 31, 2008, deadline to adopt documents that comply with § 409A, subject to limited requirements on the timely written designation of a time and form of payment. The Notice also provides that a NQDC plan will not violate § 409A on or before the December 31, 2008, deadline simply because the plan's written provisions do not meet the requirements of § 409A, its final regulations or other guidance if: 1) the plan is operated in accordance with the requirements of § 409A, the final regulations and other guidance; and 2) the plan is amended on or before December 31, 2008, to comply retroactively to January 1, 2008. The amended written plan must contain all of the written provisions required by § 409A final regulations and accurately

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reflect the operation of the plan on or after January 1, 2008, including the terms and conditions under which any initial or subsequent deferral elections were allowed.

Nonqualified deferred compensation plans or arrangements must contain provisions in writing that comply with the time and form of distribution requirements under § 409A by December 31, 2007. Compliant times and forms of distribution can be specified in a separate written document and then incorporated into the plan document by amendment after January 1, 2008. A plan or arrangement that specifies permissible payment events allowed under § 409A by the end of 2007 is considered to be in compliance with the time and form of distribution requirements even if the plan or document does not include §409A-compliant definitions of those permissible payment events. The designation of a specified payment date or a fixed schedule of payments must meet the requirements of §409A-3(i)(1) by December 31, 2007.

3rd Circuit Appeals Court Rules That Bad Company News Does Not Constitute Breach of Fiduciary Duty for Plan with Company Stock

The U.S. 3rd Circuit Court of Appeals has ruled that a communications company did not breach its fiduciary duties under ERISA by failing to remove a company stock investment option in its retirement plans after company developments led to a stock price drop. In its opinion, the Circuit Court stated that the corporate bad news did not constitute a "dire situation" that would require the company to stop offering the company stock as an investment option or divestiture of the company stock from the plans holding it.

Avaya, Inc. (Avaya) sponsors three pension benefit plans covered by ERISA, including the Avaya Inc. Savings Plan (Savings Plan). Jane Edgar was an employee of Avaya and participated in the Savings Plan. The Savings Plan provided various investment options, selected by Avaya, for participants to choose among for investment of their elective contributions. One of the investment options was the Avaya Stock Fund, which was invested primarily in shares of Avaya common stock. The Summary Plan Description for the Savings Plan stated that "the value of your investment [in the Avaya Stock Fund] will vary depending on Avaya's performance, the overall stock market, the performance and amount of short-term investments held by the fund and the amount of fund expenses." It also stated that "investing in a non-diversified single stock fund carries more risk than investing in a diversified fund." In April 2005, Avaya released its quarterly earnings report and announced that it was unlikely to make its earnings forecast for fiscal year 2005, primarily due to sales disruptions caused by the implementation of new delivery methods by the company; costs associated with integrating recent acquisitions; and "potential softness in the U.S. technology market."   Following this announcement, the

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share price of Avaya common stock fell from $10.69 per share to $8.01 per share. In July 2005, Edgar filed a class action lawsuit under ERISA § 502, 29 U.S.C. § 1132(a)(2). The defendants in the case moved to dismiss the case for lack of standing and for failure to state a claim for breach of fiduciary duty. The District Court of New Jersey granted the motion with respect to the latter claim [*Edgar v. Avaya*, No. 05-3598, 2006 WL 1084087 (D.N.J., Apr. 25, 2006)]. Edgar then appealed the District Court's ruling.

In its finding in favor of Avaya, the Circuit Court reviewed the decision of Avaya to offer its common stock as an investment option in the Savings Plan for abuse of discretion. The District Court relied on *Moench v. Robertson* [62 F. 3d 553 (3d Cir. 1995)] in determining that although the Savings Plan is not an Employee Stock Ownership Plan (ESOP), it is entitled to the same judicial deference when deciding to invest plan assets in the sponsoring company's stock. In *Moench v. Robertson*, the Circuit Court stated that ESOP fiduciaries are still required to act in accordance with the duties of "loyalty and care" that apply to fiduciaries of ERISA plans. In that decision, the Circuit Court presented a rebuttable presumption that would apply to individual account plans: "an ESOP fiduciary who invests plan assets in employer stock is entitled to a presumption that it acted consistently with ERISA by virtue of that decision" and further that such a presumption could be overcome "by establishing that the fiduciary abused his discretion by investing in employer securities." To accomplish such a rebuttable, the plaintiff must show that the fiduciary could not have reasonably believed that its actions were in keeping with how a prudent trustee would operate. Edgar alleged that Avaya "recklessly" disregarded facts about the effect that the acquisitions and changes in delivery methods would have on their earnings and business. The Circuit Court disagreed that these developments or the drop in stock price "created the type of dire situation which would require the defendants to disobey the terms" of the Savings Plan by not offering Avaya common stock as an investment option. The Circuit Court further concluded that the "defendants fulfilled their duty of disclosure under ERISA by informing participants about the potential risks associated with investing" in the company's stock and that the failure of Avaya to inform participants about the adverse company development prior to the earnings release does not constitute a breach of their disclosure obligation.

Discount Rates Used in Conversion of Cash Balance Plans Contested in Two Lawsuits

The U.S. District Court for the Eastern District of Missouri (Missouri Court) recently found [*Sunder v. U.S. Bank Pension Plan* (2007 WL 2811078, E.D. Mo.,479] that a company's use of a higher discount rate than the 30-year Treasury rate, for converting participants' accrued benefits in a defined benefit pension plan to an opening balance in a cash balance plan was incorrect.

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Mercantile Bank (predecessor to U.S. Bank) sponsored a defined benefit pension plan for its employees. In 1998, the plan was converted to a cash balance plan under which participants received pay credits and interest credits. When converting the benefits, the company used a calculation where it projected the accrued benefit forward to age 65 using the Treasury rate, 6.07% at the time of the conversion, and discounted back to present value using an 8% discount rate for participants older than age 45, and 7% for those younger than age 45. Edward Sunder and Louis Jarodsky, both former employees of Mercantile Bank, resigned from the bank in August 2000. Upon retiring, they elected to receive their benefits in a lump-sum distribution, and later filed a lawsuit against Mercantile Bank alleging that their payments were improperly calculated and that the cash balance plan was age discriminatory. On motions for summary judgment, the Missouri Court determined that cash balance plans are not age discriminatory and dismissed that part of the claim. After a bench trial, the Missouri Court determined that there was no factual dispute over the interest rates used in calculating the lump-sum distributions but were requested by Sunder and Jarodsky to reconsider the calculation of their opening account balances in the cash balance plan.

The Missouri Court cited *Esden v. Bank of Boston* [(2000, CA2, (299 F. 3d 154)] in noting that the Treasury regulations outlined under ERISA lay out the assumptions and methods to be used in determining the accrued benefit under a defined benefit pension plan. In converting to a cash balance plan, the Missouri Court stated that the employer was required to protect participants' accrued benefits when calculating their opening balance. The Missouri Court when on to say that the opening balance for Sunder and Jarodsky represented their accrued benefits under the defined benefit pension plan and by using a higher discount rate (8% compared with 6.07%) to calculate their opening balance, Sunder and Jarodsky's benefits were not protected. The Missouri Court concluded that the statutory requirement for a plan to use the 30-year Treasury rate in calculating lump-sum distributions is also applicable to the determination of participants' opening balances in converting to the cash balance plan.

In a related action, a lawsuit has been filed against U.S. Bank (*Pellett and Williams v. U.S. Bank Pension Plan*, Case 4:07-cv-01683-CDP), alleging improper use of a discount rate in converting participants' accrued benefits in a defined benefit pension plan to a cash balance plan. This suit was filed by former employees of Mercantile Bank (the predecessor to U.S. Bank) and seeks class action status. The suit seeks to have U.S. Bank recalculate the opening balances under the cash balance plan using the statutory discount rate pursuant to 26 U.S.C. § 417(d)(3), and adjust participants' retirement accounts accordingly, and to pay or credit interest to participants from the date of conversion, January 1, 1999, onward.

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Disability Benefit Not an ERISA Plan Despite Labeling by Employer

The Sixth Circuit Court recently ruled that a short-term disability plan offered by an employer was not an ERISA plan, in spite of statements made in the Summary Plan Description (SPD) which might have led employees to believe otherwise. [*Langley v. DaimlerChrysler Corp*., 2007 WL 2701091 (6th Cir., 2007)]

Brenda Langley worked for DaimlerChrysler in production. In 2004, Langley took a leave of absence from the company and after a period of time returned to work. During her leave of absence, Langley filed for short-term disability benefits through DaimlerChrysler's Disability Absence Plan (Plan) which provides payments to employees who are unable to perform all of the duties of the job. DaimlerChrysler denied the request for benefits after which, Langley filed suit in Ohio state court alleging various offenses, including violation of ERISA. (Daimler Chrysler had the suit moved to federal court.) The U.S. District Court for the Northern District of Ohio granted summary judgment to DaimlerChrysler and found that the Plan was not an ERISA plan, but a payroll practice. Langley then appealed and the case was heard by the Circuit Court.

The Circuit Court reviewed the case and found in favor of DaimlerChrysler. Under DOL regulations, normal compensation paid to an employee as a result of disability and from the employer's general assets does not constitute an employee welfare benefit plan, but is considered a payroll practice [29 CFR §2510.3-1(b)(2)] not subject to ERISA. In this case, DaimlerChrysler makes short-term disability payments solely from its general assets thus meeting the requirements for a payroll practice. The Circuit Court also considered whether statements made in the SPD for the Plan, which could lead employees to believe that the Plan was subject to ERISA, were enough to cause the Plan to be subject to ERISA. The Circuit Court relied both on *McMahon v. Digital Equipment Corporatio*n, [162 F. 3d 28 (1st Cir., 1998)] where the First Circuit Court stated that "we do not hold that an employer's mere labeling of a plan determines whether a plan is an ERISA plan", and on *Stern v. IBM* where the Eleventh Circuit Court stated that "its mere labeling of the plan should not determine whether ERISA applies…where, as here, an employer pays an employee's normal compensation for periods of mental or physical disability entirely from general assets, the program constitutes an exempted payroll practice under 29 CFR §2510.3-1(b) and not an ERISA plan." The Circuit Court also determined that the District Court had subject-matter jurisdiction over the complaint because it involved claims sufficiently related to ERISA to invoke federal-question jurisdiction under 28 U.S.C. § 1331 and 29 U.S.C. § 1132(e).

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