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Monthly Newsletter – Volume 2, No. 12 – December 6, 2006

Highlights of the Month

- 1. Seventh Circuit Court of Appeals Upholds Right of ERISA Plans to Recover Overpaid Benefits Through Reduction of Future Benefit Payments**
- 2. Provisions of the Pension Protection Act of 2006 Become Effective January 1, 2007**
- 3. Internal Revenue Service Issues Final Regulations on Use of Electronic Media to Satisfy Notice Requirements and Transmit Elections and Consents**
- 4. District Court Concludes Individual Disability Insurance Policy with Employer-Paid Premiums is an ERISA Plan**

Seventh Circuit Court of Appeals Upholds Right of ERISA Plans to Recover Overpaid Benefits Through Reduction of Future Benefit Payments

The Seventh Circuit Court of Appeals has upheld the right of employee benefit plans covered under the Employee Retirement Income Security Act (ERISA) to recover overpaid benefits by means of reductions in future benefit payments. [*Northcutt and Smith v. General Motors Hourly-Rate Employees Pension Plan, General Motors Corp., and General Motors Life and Disability Benefit Program 2006 U.S. App. (7th Cir. 2006)*]

The case involved two participants, one who was receiving benefits under an employer-sponsored long-term disability plan and one who was receiving supplemental disability benefits under the employer's pension plan. The terms of the plans provided that a participant's benefits would be reduced for any period in which a participant was also entitled to Social Security benefits and that participants who received retroactive Social Security awards were required to repay benefit amounts that became overpayments as a result. Both participants signed acknowledgements of this repayment obligation. In the event that repayments were not made, each plan provided for reduction or suspension of future benefit payments to recover any overpayments. After both participants received lump-sum Social Security awards and did not make the required repayments to the plans, the plans suspended their benefit payments to recoup the overpayments. The participants sued, but the lower court entered judgment in favor of the plans. The Seventh Circuit



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rejected the participants' characterization of the Supreme Court's decision in the Knudson case [*Great-West Life & Annuity Insurance Co. v. Knudson*, 534 US 204 (2002)] as having deprived ERISA plans of all ability to enforce reimbursement rights, including reimbursement through benefit reductions. Instead, the Court found Knudson inapplicable in this case because Knudson addressed the judicial remedies available in a civil action under ERISA, whereas this case did not involve any civil action by the plans. The Seventh Circuit also agreed with the lower court's finding that recovery of overpayments in accordance with plan provisions clearly authorizing benefit reductions did not violate any aspect of ERISA that the participants could identify, and did not violate any articulated policy of ERISA.

Provisions of the Pension Protection Act of 2006 Become Effective January 1, 2007

Key provisions of the Pension Protection Act of 2006 (PPA) which will become effective on or after January 1, 2007 include the following:

- ❖ **Divestiture of Employer Stock in non-ESOP plans** (PPA §901; §507) - Effective for plan years beginning after December 31, 2006, certain plans holding publicly traded employer stock must permit participants to divest any employer securities purchased with their elective deferrals, or other employee contributions, and to reinvest the proceeds into other plan investments. Divestment of employer securities bought with employer contributions must be allowed at anytime after the participant has completed three years of service. [These requirements do not apply to Employee Stock Ownership Plans (ESOPs) that do not hold elective deferrals, other employee contributions, employer matching or certain non-elective contributions.] Notification of the ability to divest employer stock must be provided to participants no later than 30 days prior to the first date at which participants are first eligible to divest. A three-year phase-in period applies to employer contributions in existing plans with exceptions for those participants over age 55. The Treasury Department and IRS issued Notice 2006-107, on November 30, 2006, providing transition guidance on the provision of the PPA relating to the diversification rights of plan participants and beneficiaries. The notice points out that some participants will be eligible for diversification rights under the PPA as early as January 1, 2007. However, plans with plan years beginning on or after January 1, 2007 and before February 1, 2007 are not required to provide participants with notification before January 1, 2007. The



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- publication includes a model notice that can be used to satisfy the participant notification requirement.
- ❖ **Participant Statements Provided Periodically** (PPA §508) – For defined contribution plans which provide participants the ability to direct the investment of their accounts, benefit statements must be provided, in either written or electronic form, to participants on at least a quarterly basis beginning with 2007 plan years. If self-direction is not available under the plan, benefit statements must be provided at least annually. Defined contribution benefit statements must provide an explanation of the importance of portfolio diversification, including a "plain English" discussion of the inherent risk of holding more than 20 percent of the portfolio in a single security, such as an employer security, and a notice indicating that further information on investing and diversification is available on the Department of Labor web site. Such statements apply to both daily-valued and balance-forward defined contribution plans. Statements must be provided at least every three years (or annually upon written request) to active participants in a defined benefit plan who have a non-forfeitable accrued benefit under the plan.
 - ❖ **Vesting Schedule Changed for Non-Matching Employer Contributions to Defined Contribution Plans** (PPA §904) – The vesting schedule for non-matching employer contributions must be either a three-year cliff or six-year graded schedule for plan years beginning after December 31, 2006..
 - ❖ **Rollover for Non-Spouse Beneficiaries** (PPA §601) – Effective for distributions made after December 31, 2006, a non-spouse beneficiary of a qualified plan is able to make a rollover to an inherited IRA; however, such distributions must begin immediately using the "minus one" method, while surviving spouses may continue to delay distribution until December 31 of the calendar year in which the deceased participant would have reached age 70 ½.

Internal Revenue Service Issues Final Regulations on Use of Electronic Media to Satisfy Notice Requirements and Transmit Elections and Consents

The Internal Revenue Service has issued final regulations (*T.D. 9294, 10/20/2006; Reg. §1.401(a)-21*) regarding the use of electronic media to satisfy notice requirements, and to transmit elections or consents relating to employee benefit arrangements. The final regulations apply to any notice, election, or similar communication provided to, or made by, a participant or beneficiary under the following:



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- ❖ Code §401(a) qualified plans, §403(a) or §403(b) annuity contracts, simplified employee pensions (SEPs), savings incentive match plans (SIMPLE plans), or §457(b) governmental plans;
- ❖ accident and health plans or arrangements under Code §104(a)(3) or Code §105, Code §125 cafeteria plans, Code §127 educational assistance plans, Code §132 qualified transportation fringes, Code §220 Archer medical savings accounts, and Code §223 health savings accounts; and
- ❖ individual retirement plans, including Roth IRAs and deemed IRAs under a qualified employer plan described Code §408(q). [Reg. § 1.401(a)-21(a)(2)]

The rules in the final regulations apply whenever there is a requirement that an applicable notice under one of the above Code sections be provided in written form, regardless of whether that Code requirement cross-references the final regulations. The rules provided in §1.401(a)-21 apply to applicable notices provided, and to participant elections made, on or after January 1, 2007. However, a retirement plan, an employee benefit arrangement, or an individual retirement plan that provides an applicable notice or makes a participant election that complies with the requirements set forth in these regulations on or after October 1, 2000, and before January 1, 2007, will not be treated as failing to provide an applicable notice or to make a participant election merely because the notice or election was not in writing or written form.

The regulations do not apply to:

- ❖ any notice, election, consent, or disclosure required under the provisions of Title I or IV of ERISA over which the Department of Labor or the Pension Benefit Guaranty Corporation has interpretative and regulatory authority. Thus, they do not apply to a plan's furnishing of a summary plan description or a summary annual report;
- ❖ a Code §411(a)(3)(B) suspension of benefits, Code §4980B(f)(6) COBRA notices, or any Code provisions over which DOL and PBGC have interpretive authority; and
- ❖ other Code requirements, such as those relating to tax reporting, tax records, or substantiation of expenses. [Reg. §1.401(a)-21(a)(3)]

The rules for the use of electronic media are in addition to all other general requirements for required notices and elections. Any communication that is provided using an electronic medium must satisfy all the otherwise applicable requirements, including timing and content rules, relating to that communication. [Reg. §1.401(a)-21(a)(4)] In addition, the content of the notice and the medium through which it is delivered must be reasonably designed to provide the information to a recipient in a manner no less understandable to him than if provided on a written paper document. When the applicable



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notice is provided, the electronic transmission must alert the recipient to the significance of the transmittal (including the identification of the subject matter of the notice), and provide any instructions needed to access the notice, in a manner that is readily understandable and accessible. [Reg. §1.401(a)-21(a)(5)]

The regulations provide two methods by which a retirement plan, employee benefit arrangement, or an individual retirement plan is permitted to provide an applicable notice to a recipient through the use of an electronic medium:

- ❖ **Consumer Consent Method** - an applicable notice is permitted to be provided to a recipient using an electronic medium after the recipient consents to the electronic delivery of the notice. (The rules under the consumer consent method reflect the consumer consent requirements at section 101(c) in E-SIGN.) Under the consumer consent method, before an applicable notice is provided to a recipient using an electronic medium, the participant must consent to receive the communication electronically. The consent generally must be made in a manner that reasonably demonstrates that the participant can access the notice in the electronic form that will be used to provide the notice. (Alternatively, the consent may be made using a written paper document, but only if the participant confirms the consent in a manner that reasonably demonstrates that the participant can access the notice in the electronic form to be provided.) Prior to consenting, the participant must receive a disclosure statement that outlines the scope of the consent, the participant's right to withdraw his or her consent to receive the communication electronically (including any conditions, consequences, or fees in the event of the withdrawal), and the right to receive the communication using paper and any fees imposed for receiving paper. The disclosure must also specify the hardware and software requirements for accessing the electronic media and the procedures for updating information to contact the participant electronically. In the event the hardware or software requirements change, new consent must be obtained from the participant, generally following the rules of section 101(c) of E-SIGN.
- ❖ **Alternative Method** - provides rules that are generally intended to replicate the requirements in the 2000 regulations that apply to notices required under Code sections 402(f), 411(a)(11), and 3405, and thereby allow plans to continue to provide these notices electronically using electronic systems that satisfy the standards in the 2000 regulations. Under the alternative method, at the time the applicable notice is provided, the recipient must be advised that he or she may request and receive the applicable notice in writing on paper at no charge. In addition, any recipient of the notice must be "effectively able" to access the electronic medium used to provide the notice.



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The participant election rules require that (1) the participant be effectively able to access the electronic medium in order to make the participant election, (2) the electronic system be reasonably designed to preclude any person other than the appropriate individual from making a participant election, (3) the electronic system provide the participant with a reasonable opportunity to review, confirm, modify, or rescind the terms of the election before it becomes effective, and (4) the individual making a participant election, within a reasonable time period, receive a confirmation of the election through either a written paper document or an electronic medium under a system that satisfies the applicable notice requirements of either the consumer consent delivery method or the alternative delivery method. [Section 101(c) of E-SIGN does not apply to participant elections.] These regulations do not apply with respect to a participant who is not effectively able to access the electronic medium or media in order to make a participant election. Accordingly, the plan must offer each such participant the right to make an election in another medium that is accessible to the participant (such as a paper election).

A plan subject to the QJSA requirements is permitted to provide the notice required by Code §417 to a participant through the use of electronic media as long as the plan complies with either of the two methods described above for providing electronic notices. Similarly, a participant's consent to a distribution is permitted to be provided through the use of electronic media if the plan complies with the standards described below, subject to obtaining a valid spousal consent. Section 417 requires any spousal consent to a waiver of a QJSA to be witnessed by a plan representative or a notary public. In accordance with section 101(g) of E-SIGN, these regulations authorize the use of an electronic acknowledgment or notarization if the standards of section 101(g) of E-SIGN and state law applicable to notary publics are satisfied. The signature of a spouse must be witnessed in the physical presence of the plan representative or notary public.

District Court Concludes Individual Disability Insurance Policy with Employer-Paid Premiums is an ERISA Plan

The plaintiff, James R. O'Leary, sought to recover benefits under a disability policy issued by Provident Life and Accident Insurance Company (Provident). In 1988, O'Leary was hired as the administrator for The New England Carpenters Training Fund (the "Fund"). The trustees of the Fund's trust consisted of representatives of both labor unions and employers. At the date of his hiring, O'Leary was not provided with disability insurance coverage; however, after several weeks, the Board of Trustees for the Fund decided to provide O'Leary with disability insurance coverage. Following the Board's



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decision to provide coverage, O’Leary applied for a disability policy with Provident. On his application, O’Leary stated that his employer would “pay for all disability coverage to be carried by [me] with no portion of the premium to be included in [my] taxable income.” The policy took effect in 1988 and the premiums were paid with checks from the Fund. Although the Board of Trustees had discretion to terminate O’Leary’s disability coverage at any time, it kept the policy in place during the entirety of his employment with the Fund. O’Leary never received a summary plan description or any other such documentation in connection with the disability policy. The Fund kept a physical copy of the disability policy. O’Leary alleged that he became disabled on December 23, 1998, and remained so. Provident paid disability benefits for about 18 months beginning in April 1998, but reserved the right to make a different formal determination regarding benefits after its investigation into his alleged disability. By letter dated October 11, 2000, Provident informed O’Leary of its determination that his inability to work was not due to an injury or sickness, that he therefore did not meet the policy’s definition of disabled, and that it owed him no further benefits. O’Leary appealed the decision, but was denied in May 2001.

Following Provident’s denial of disability benefits, O’Leary filed suit in Worcester Superior Court. The complaint, filed on October 10, 2003, alleges breach of contract (Count I), that Provident acted “arbitrarily and capriciously” (Count II) and “unreasonably” (Count III) in failing to continue his disability benefits and asserting that his condition did not meet the terms of the policy. In Count IV, he alleges that “available evidence clearly indicates that [he] was and is disabled under the terms of the policy . . . and he is entitled to recover benefits for that disability under the terms and provisions of the policy.” Provident removed the case to District Court. Following a hearing on July 30, 2004, the Court ordered limited discovery as to the issue of whether ERISA governed this case and requested briefing by the parties.

There were two questions presented in this case: (1) whether the disability policy provided to O’Leary by the Fund qualified as an employee welfare benefit plan for purposes of ERISA; and (2) if so, whether ERISA preempted O’Leary’s state law claims. In its ruling, the District Court noted that the First Circuit has adopted the so-called *Donovan* test for determining whether an ERISA employee welfare benefit plan exists. Under the *Donovan* test, an employee welfare benefit plan has five elements: (1) a plan, fund, or program (2) established or maintained (3) by an employer or by an employee organization, or by both, (4) for the purpose of providing . . . disability . . . benefits (5) to participants or their beneficiaries. The District Court stated that there did not appear to be a dispute that elements three, four, and five were met: the Fund is an employer that provided disability benefits to O’Leary, who was a participant. The issues in this case were whether the policy is a “plan” that the Fund “established or maintained.” The *Donovan* court formulated the standard for determining whether a plan has been



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established: a “plan, fund, or program” under ERISA is established if, from the surrounding circumstances, a reasonable person can ascertain the intended benefits, a class of beneficiaries, the source of financing, and procedures for receiving benefits.” The District Court determined that under the circumstances in this case, a “plan” had clearly been established for purposes of ERISA.

The complaint filed by O’Leary argued that the disability policy did not constitute an employee welfare benefit plan with the meaning under ERISA. In support of this argument, he asserted: (1) that the mere purchase of insurance is insufficient to establish an ERISA plan; (2) there was no ongoing administrative scheme; (3) the disability policy was not permanent and was subject to termination by the Board of Trustees at any time; (4) there was no written plan; (5) the disability coverage was only provided to O’Leary and not to any other Fund employee; (6) the policy was an individual, rather than group, policy; (7) O’Leary, rather than the Fund, applied for the benefits; and (8) the disability coverage was not part of his original hiring package. The District Court’s ruling notes that while an ERISA plan can be established through the purchase of insurance, not every insurance purchase qualifies as a plan. Further, the District Court noted the First Circuit has indicated that “[t]he crucial factor in determining if a ‘plan’ has been established is whether the purchase of the insurance policy constituted an expressed intention by the employer to provide benefits on a regular and long term basis.” The District Court concluded that there was considerable evidence that the Fund intended to provide O’Leary with long term benefits including that the Fund entered into a contractual agreement with Provident to pay the policy premiums, that the Board of Trustees approved an increase in benefits on a number of occasions; and that the Board of Trustees kept the coverage in place for the entirety of O’Leary’s employment, which spanned ten years. In addition, the District Court concluded that the Board of Trustees’ ability to terminate O’Leary’s policy at any time does not remove the plan from the scope of ERISA as ERISA exempts welfare plans from vesting requirements. In dismissing the claim regarding the lack of a written plan, the District Court relied on *Donovan* again; in *Donovan*, the Eleventh Circuit stated that “[t]here is no requirement of a formal, written plan in either ERISA’s coverage section... or its definitions section.” The District Court dismissed the contention that coverage of only a single employee would preclude the disability policy from being an ERISA plan, as well as the claim that an individual policy, in place of a group policy, would prevent this from being an ERISA plan. The District Court stated that even if O’Leary had established the plan by applying for the benefits, the Fund had maintained the policy through premium payments and thus met the ERISA definition for an employee welfare benefit plan by either establishing or maintaining the plan. The District Court dismissed the complaint’s final point by stating that there is no ERISA requirement that a plan be established at the outset of hiring. After determining that the disability policy did constitute a plan covered by ERISA, and



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thus any state claims were preempted, the District Court granted summary judgment for the defendant.