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## Monthly Newsletter – Volume 2, No. 10 – October 5, 2006

### *Highlights of the Month*

- 1. Financial Accounting Standards Board (FASB) Issues Final Statement on Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans**
- 2. Class-Action Lawsuits Alleging Excessive 401(k) Plan Fees Filed Against Plan Sponsors**
- 3. Internal Revenue Service Issues Final Regulations Regarding Deductions for Payments to Redeem Employer Securities Held by an Employee Stock Ownership Plan (ESOP)**
- 4. Department of Labor Seeks Comments on Possible Changes to Rules for Independent Accountants Retained by Plans**
- 5. Eleventh Circuit Court of Appeals Decides ERISA Status of Disability Program**
- 6. Department of Labor Proposes Rules to Implement the Pension Protection Act Provision Allowing Default Investment Alternatives in Participant Directed Plans**
- 7. U. S. Court of Appeals Rejects Halliburton's Attempt to Reduce Retiree Benefits for Employees of an Acquired Company**

### **Financial Accounting Standards Board (FASB) Issues Final Statement on Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans**

On September 29, 2006, the FASB issued a standard that requires employers to fully recognize the obligations associated with single-employer defined benefit pension, retiree healthcare and other postretirement plans in their financial statements. Under past accounting standards, the funded status of an employer's postretirement benefit plan (i.e., the difference between the plan assets and obligations) was not always completely reported in the balance sheet. Employers reported an asset or liability that usually differed from the plan's funded status because prior accounting standards allowed employers to delay recognition of certain changes in plan assets and obligations that affected the costs of providing such benefits. Prior standards only required an employer disclose the complete funded status of its plans in the notes to the financial statements.

The newly issued Statement of Financial Accounting Standards No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans (SFAS No. 158)*,

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requires an employer to recognize, in its statement of financial position, an asset for a plan's overfunded status or a liability for a plan's underfunded status. The requirement to recognize the funded status of a benefit plan and the disclosure requirements are effective as of the end of the fiscal year ending after December 15, 2006, for entities with publicly traded equity securities; and at the end of the fiscal year ending after June 15, 2007, for all other entities. Early application is encouraged but must be for all of the employer's benefit plans. SFAS No. 158 also requires that an employer measure a plan's assets and its obligations that determine its funded status as of the end of the employer's fiscal year (with limited exceptions) and recognize changes in the funded status of a defined benefit postretirement plan in the year in which the changes occur. The requirement to measure plan assets and benefit obligations as of the date of the employer's fiscal year-end statement of financial position is effective for fiscal years ending after December 15, 2008, and may not be applied retrospectively.

Statement No. 158 applies to plan sponsors that are public and private companies and nongovernmental not-for-profit organizations.

### **Class-Action Lawsuits Alleging Excessive 401(k) Plan Fees Filed Against Plan Sponsors**

Nine class-action lawsuits were recently filed in Illinois, Missouri, Connecticut and California, by Schlichter, Bogard & Denton challenging investment-related fees paid by the companies' respective 401(k) plans to service providers, including revenue sharing arrangements between plans, mutual funds, and record keepers. The defendants include Lockheed Martin Corp., Boeing Company, International Paper Co., Bechtel Corp., Exelon Corp., Caterpillar, Inc., United Technologies Corp., Northrop Grumman Corp., and General Dynamics Corp., their boards of directors, the investment and administrative committees of the affected plans, and the persons who serve on those committees. The complaints in the cases allege similar causes of action. All of the plaintiffs are participants in their respective 401(k) plans. All of these plans allow participants to direct the investment of their accounts among various investment options. The plaintiffs allege that the defendants breached their fiduciary obligations under ERISA by causing the plans, and thereby the participants in the plans, to pay excessive fees and expenses which directly impact the participants' account value and retirement benefits.

As an example, in the lawsuit filed against International Paper Co., the plaintiffs allege that the defendants: "charged fees and expenses to the Plans that were, or are, unreasonable and/or not incurred solely for the benefit of the Plans' participants; failed to monitor the fees and expenses paid by the Plans...; failed to inform themselves of, and understand, the various methods by which vendors in the 401(k), financial and retirement



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industry collect payments and other revenues from 401(k) plans; failed to establish, implement, and follow procedures to properly and prudently determine whether the fees and expenses paid by the Plans were reasonable and incurred solely for the benefit of the Plans' participants; failed to properly inform, and/or disclose to, the Plans' participants the fees and expenses that are, or have been, paid by the Plans..." The assets of the plans referenced in the International Paper Co. lawsuit are held in a master trust established by the company which in turn invests in a series of additional master trusts which actually hold the investment assets including stocks, bonds, mutual funds, common collective trusts and other pooled investments, and International Paper Co. common stock. According to the lawsuit, this method of investment management causes the participants to pay "Plan-level 'Hard-Dollar' fees; Master Trust 'Hard Dollar' fees assessed against each participant's account by each separate master trust; investment management and administrative fees charged by the various mutual funds, common collective trusts and/or similar investment vehicles included in each separate master trust; and 'Revenue Sharing' fees hidden within the expense ratio of each such mutual fund, common collective trust, and/or other pooled investment vehicle."

### **Internal Revenue Service Issues Final Regulations Regarding Deductions for Payments to Redeem Employer Securities Held by an Employee Stock Ownership Plan (ESOP)**

On August 25, 2005 (70 FR 49897), the IRS issued a notice of proposed rulemaking containing proposed regulations under sections 162(k) and 404(k) to address two issues:

1. which corporation is entitled to the deduction for applicable dividends under section 404(k) where the payor and employer are different entities; and
2. whether a payment in redemption of employer securities held by an ESOP is deductible.

On August 30, 2006, the IRS issued final regulations on the second issue addressed in the proposed regulations. Specifically, the final regulations provide that amounts paid to reacquire stock held by an ESOP is not tax deductible. See Treas. Regs. §§ 1.162(k)-1(c) and 1.404(k) 3, Q&A-2.

#### **Background**

The proposed regulations reiterated the IRS' disagreement with the 9<sup>th</sup> Circuit's *Boise Cascade* decision. In the *Boise Cascade Corporation v. United States*, 329 F. 3d 751 (9<sup>th</sup> Cir. 2003), the employer was entitled to a tax deduction for amounts it paid to reacquire



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stock from terminated participants. The 9<sup>th</sup> Circuit reasoned that distribution by the ESOP of the redemption proceeds to the participants was a transaction separate from the redemption transaction. Therefore, the 9<sup>th</sup> Circuit concluded that the distribution did not constitute a payment in connection with the corporation's reacquisition of its stock, and that Code section 162(k) did not bar the deduction of such payments.

In 2001, the IRS issued Revenue Ruling 2001-6 (2001-1 C.B. 491), which held that Code section 162(k) barred a deduction for payments made in redemption of stock from an ESOP. In this Revenue Ruling the IRS also concluded that such payments were not applicable dividends under Code section 404(k)(1). In reaching the conclusions in the Revenue Ruling the IRS stated that allowing a dividend deduction for redemption of the ESOP stock would prevent the ESOP participants from availing themselves of certain tax benefits including the right to reduce taxes by utilizing the return of basis provisions under Code section 72, the right to make rollovers of ESOP distributions received upon separation from service, and the protection against involuntary cash-outs.

This provision of the proposed regulations aroused little opposition and only two comments were received by the IRS. Therefore, the final regulations issued on August 30, 2006, adopt without material change the provisions of the proposed regulations concerning payments in redemption of employer securities held by an ESOP.

### ***Effective Date***

The final regulations are effective for any payments to reacquire stock that are made on or after and amounts paid on or after August 30, 2006. The final regulations codify the IRS position that the deduction for such payments constitutes in substance avoidance or evasion of taxation.

### **Department of Labor Seeks Comments on Possible Changes to Rules for Independent Accountants Retained by Plans**

In the Federal Register dated September 11, 2006, the Department of Labor (DOL) published a request for public comments concerning the advisability of amending Interpretive Bulletin 75-9 (29 CFR 2509.75-9). Interpretive Bulletin 75-9 (IB 75-9) deals with the independence of accountants who are engaged to audit employee benefit plans under section 103(a)(3)(A) of the Employee Retirement Income Security Act of 1974 (ERISA). Under ERISA, a plan administrator is required to retain an "independent qualified public accountant" to examine the financial statements of the plan and render an opinion as to whether the financial statements and schedules required to be included in the plan's annual report are presented fairly in conformity with generally accepted



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accounting principles (GAAP). The DOL is seeking information that will assist it in evaluating whether and to what extent IB 75–9 provides adequate guidance to meet the needs of plan administrators, other plan fiduciaries, participants and beneficiaries, accountants, and other affected parties on when a qualified public accountant is independent. Written comments must be received by the DOL no later than December 11, 2006.

The request for comments lists the following specific questions that the DOL would like responders to address.

- ❖ Should DOL adopt the guidelines regarding independence that are already utilized by such entities as the SEC, AICPA and the GAO?
- ❖ Specifically, is additional guidance needed to address the prohibition against an independent accountant, his firm, or a member of the firm having a “direct financial interest” or a “material indirect financial interest” in a plan or a plan sponsor?
- ❖ Should DOL issue guidance on whether, and under what circumstances, employment of an accountant’s family members by a plan or a plan sponsor that is a client of the accountant or his firm impairs the firm’s independence?
- ❖ Is further guidance necessary with respect to the definition of “maintaining financial records” as it is used in the prohibition of using an accountant if the accountant or his firm maintains the financial records for the benefit plan, as well as the definitions for “promoter”, “underwriter”, “investment advisor”, “voting trustee”, “director”, “officer”, and “employee of the plan or plan sponsor” as used in identifying disqualifying positions?
- ❖ Further questions ask for feedback on the following:
  - level of non-audit services provided by accountants and accounting firms and their impact on independence,
  - period of time that the independence standard should cover,
  - effect of audit committees on the process,
  - types and levels of fees charged by accountants and their firms for audit and non-audit services, and
  - need for accountants and their firms to have written policies and procedures that describe their process for determining independence with respect to benefit plans.



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## **Eleventh Circuit Court Decides ERISA Status of Disability Program**

In *Moorman v. UnumProvident Corp.*, (2006 WL 2660931, [C.A. 11 05-15383]), the Eleventh Circuit of the Court of Appeals was asked to review a ruling by the district court regarding ERISA's preemption of an employee's state law claims regarding disability benefits.

### ***Facts***

The employer's office manager was contacted by an insurance agent who asked permission to approach and enroll the company's employees in a disability plan. The insurance agent met with the office manager who selected various group coverages to be made available and worked with the agent in establishing eligibility requirements. Through word of mouth, the company's employees were made aware that the agent would be visiting to discuss disability insurance and the agent came to the company and met with those employees who expressed interest. No representatives of the company attended those meetings and each employee could choose to apply for coverage or decline to do so. The company revised its employee handbook to include a reference to the disability insurance option; this was the only disability arrangement offered. At the time of their enrollment in disability coverage, the employees only received a copy of their enrollment form. The agent later sent plan booklets and coverage certificates to the office manager, but not all of these materials were distributed to the enrollees. The certificates clearly stated that the plan was governed by ERISA. On occasion the office manager would refer employees to the UnumProvident 1-800 number for claim forms and information. However, the office manager would also provide claim forms to employees and assist them with completion of the forms upon request. One such employee, Moorman, enrolled in the plan and later filed for disability when he was diagnosed with cancer. UnumProvident initially determined that he qualified for benefits but subsequent review denied his claim. Moorman unsuccessfully disputed the denial and filed a state law claim alleging wrongful denial of benefits. The district court issued a summary judgment ruling that the disability plan was governed by ERISA and therefore not subject to state claims due to ERISA preemption. Moorman appealed this ruling to the Court of Appeals.

### ***Court's Analysis***

In its ruling, the Court first discussed the requirements for a safe harbor exemption from ERISA status under 29 CFR 2510.3-1(j). (The DOL explicitly exempts from ERISA



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governance certain “group or group-type insurance programs offered by an insurer to employees.”) There are four elements needed to satisfy the safe harbor exemption:

1. no contributions are made by an employer or employee organization;
2. participation in the program is entirely voluntary for the employee;
3. the sole functions of the employer with respect to the program are, without endorsing the program, to permit the insurer to publicize the program to employees, to collect premiums through payroll deductions and to remit them to the insurer; and
4. the employer receives no consideration in the form of cash, or otherwise, in connection with the program.

UnumProvident conceded that the plan met three of the four elements for the exemption, with the only element in question being that of the “sole functions” of the employer. According to the Department of Labor, *“an employee organization will be considered to have endorsed a group or group-type insurance program if the employee organization expresses to its members any positive, normative judgment regarding the program. An employee organization may, in the course of permitting an insurer, insurance agent, or insurance broker to market the group or group-type insurance program to its employees or members, facilitate the publicizing and marketing of the program, but only to an extent short of endorsing the program. An endorsement within the meaning of [§] 2510.3-1(j) occurs if the employee organization urges or encourages member participation in the program or engages in activities that would lead a member reasonably to conclude that the program is part of a benefit arrangement established or maintained by the employee organization.”* In the view of the Court, any functions by the employer apart from the two listed exceptions disqualify a plan from the safe harbor exception. The Court concluded that actions by the employer constituted “endorsement” for the purposes of this ERISA section, including the determination of a waiting period for benefits, and the identification of the plan in the employee handbook as a part of the company’s employee benefits. In addition, the enrollment forms described the plan as the employer’s comprehensive disability program and the employer maintained a supply of claim forms and assisted with at least one or two claim forms on behalf of employees.

The Court went on to state that though the safe harbor exception did not apply in this case, “that does not necessarily mean that the insurance policy is a part of an ERISA plan.” The Court then analyzed the arrangement pursuant to the requirements for an ERISA welfare benefit plan: “the defendants must show five things to establish that an ERISA plan governs its relationship with the plaintiff: (1) a plan, fund or program, (2) [that has been] established or maintained (3) by an employer... (4) for the purpose of providing disability benefits (5) to participants or their beneficiaries.” The Court focused



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on whether the employer “established or maintained” the plan since this was the only contested factor. Seven equally important factors were identified by the Court to determine whether the employer established a welfare benefits program:

1. the employer’s representations in internally distributed documents;
2. the employer’s oral representations;
3. the employer’s establishment of a fund to pay benefits;
4. actual payment of benefits;
5. the employer’s deliberate failure to correct known perceptions of a plan’s existence;
6. the reasonable understanding of employees; and
7. the employer’s intent.

The Court concluded that almost all of these factors indicated that the employer in this case did establish and maintain an employee welfare benefit plan governed by ERISA even though the employer may not have intended to do so.

### **Department of Labor Proposes Rules to Implement the Pension Protection Act Provision Allowing Default Investment Alternatives in Participant Directed Plans**

DOL’s Employee Benefit Security Administration (EBSA) has published proposed regulations detailing how individual account plans can implement the changes allowed by the Pension Protection Act of 2006 (PPA) with respect to investing participants’ assets in the absence of direction from the participants. For plan years beginning after December 31, 2006, the PPA provides that a participant in an individual account plan will be treated as exercising control over the assets in the account with respect to the contributions and earnings which, in the absence of an investment election by the participant, are invested by the plan in accordance with regulations set forth by the DOL.

The proposed regulations list six conditions that must be met to relieve a fiduciary of liability for any loss that is the “direct and necessary” result of investing a participant’s account in the absence of direction from the participant. The six conditions are:

1. Assets must be invested in a “qualified default investment alternative” (QDIA). A QDIA may not invest directly in employer securities and may not impose financial penalties or otherwise restrict the ability of the participant to transfer the investment. In addition, the manager of a QDIA must either be an investment manager (within ERISA §3(38)) or a registered investment



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- company (Investment Company Act of 1940). A QDIA must be diversified so as to minimize the risk of large losses and may be a life-cycle or targeted-retirement-date fund, a balanced fund, or a professionally managed fund.
2. The participant must have had the opportunity to direct the investment of the assets but did not elect to do so.
  3. An appropriate notice must be furnished to the participant within a reasonable period of time-- at least 30 days in advance of the first such investment, and at least 30 days in advance of each subsequent plan year. The required notice can be furnished in the plan's summary plan description, summary of material modifications, or as a separate notification. The notice must include a description of the circumstances under which assets may be invested on behalf of the participant in a QDIA, a description of the QDIA (investment objectives, risk and return characteristics, and fees and expenses), a description of the right of the participant to direct the investment to any other available investment alternative without financial penalty, and an explanation of where to obtain investment information concerning those investment alternatives.
  4. The plan must provide that any material provided to the plan regarding the investment, such as account statements and prospectuses, must be provided to the participant.
  5. A participant must have the opportunity to direct the investment of the account out of the QDIA with the same frequency as available for other plan investments, but not less than quarterly, without financial penalty.
  6. The plan must offer the opportunity to invest in a “broad range of investment alternatives” within the meaning of 29 CFR 2550.404c-1(b)(3).

The proposed regulation does not provide relief from the general fiduciary rules regarding the selection and monitoring of a default investment alternative or from any liability that results from a failure to satisfy these duties, including liability for any resulting losses. Like other investment alternatives made available under a plan, a plan fiduciary would be required to carefully consider investment fees and expenses in choosing a qualified default investment alternative for purposes of the proposed regulation. To the extent that a plan offers more than one investment alternative that could constitute a QDIA, fees and expenses should be an important consideration in selecting among the alternatives.

Comments on this proposal should be submitted to the DOL on or before November 13, 2006. These regulations will be effective 60 days after publication of the final rule in the Federal Register.



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## **U. S. Court of Appeals Rejects Halliburton’s Attempt to Reduce Retiree Benefits for Employees of an Acquired Company**

The 5<sup>th</sup> U.S. Circuit Court of Appeals has ruled that Halliburton can not alter retiree health benefits for a company it bought in 1998, unless it does the same for active employees. [C.A. 5, 06-20632]

### ***Facts***

In 1998, Dresser Industries, Inc. (“Dresser”), a Delaware corporation, merged with Halliburton N.C., Inc. (“Halliburton N.C.”), a newly formed Delaware corporation and wholly owned subsidiary of Halliburton Company (“Halliburton”), also a Delaware corporation. Prior to the merger, Halliburton and Dresser each sponsored their own welfare benefit programs for employees and retirees. Halliburton provided very limited retiree medical benefits, while the Dresser Retiree Medical Program provided significantly greater retiree medical benefits. In the merger agreement, Halliburton agreed to maintain the Dresser Retiree Medical Program for eligible participants, “except to the extent that any modifications to the program are consistent with changes in the medical plans provided by Halliburton for similarly situated active employees.” In November 2003, Halliburton amended three subplans of the Dresser Retiree Medical Program “to align the benefits provided to the participants in the three subplans more closely with the benefits provided to other Halliburton retirees.” Halliburton did not make similar modifications to the plans for its own similarly situated active employees. After receiving written complaints from affected Dresser retirees challenging the validity of the November 2003 amendments, Halliburton filed an action against the Dresser retirees in district court that sought class certification of all participants in the Dresser Retiree Medical Program. Additionally, Halliburton requested a ruling that the November 2003 amendments were valid and that the merger agreement did not limit Halliburton’s right to amend or terminate the Dresser Retiree Medical Program. The parties filed cross-motions for summary judgment, and the district court granted partial summary judgment in favor of the Dresser retirees. The district court held that the merger agreement modified the Dresser Retiree Medical Program and that Halliburton must maintain the program for eligible participants and could only amend or terminate the program if it makes the same changes to the programs for its similarly situated active employees.

In its decision upholding the district court ruling, the 5<sup>th</sup> Circuit stated that “a provision in a merger agreement could amend a welfare plan, even if it is not labeled as a plan amendment.” In order to amend a welfare benefit plan governed by ERISA, the employer must “provide a procedure for amending such plan, and for identifying the persons who have authority to amend the plan.” ERISA imposes no additional formalities on plan



amendments. Specifically, the 5<sup>th</sup> Circuit opined that there is no requirement that a document must have the title “plan amendment” in order to amend a welfare plan. Therefore, a provision in a merger agreement could amend a welfare plan, even if it was not labeled as such. The 5<sup>th</sup> Circuit further held that the merger agreement amended the Dresser Retiree Medical Program. Halliburton argued that the merger agreement section in question violated the prohibition in the merger agreement that dealt with vested benefits and that, in any event, there was no clear intention to vest benefits under section 7.09(g)(i) of the merger agreement. The 5<sup>th</sup> Circuit stated that this is a misinterpretation of the meaning of what it means to “vest” a right under ERISA. In its opinion, the 5<sup>th</sup> Circuit opined that an employer vests a benefit when it intends to confer “unalterable and irrevocable benefits on its employees and it does so by using clear and express language.” The 5<sup>th</sup> Circuit concluded that nothing in the merger agreement prevented Halliburton from modifying the Dresser retiree benefits as long as it made similar changes to its retiree medical programs for similarly situated active employees. Therefore, the benefits are not vested. In its final comments in the opinion, the 5<sup>th</sup> Circuit concluded “that it will not allow Halliburton to unilaterally take away the ‘bargained-for rights’ that Dresser and Halliburton negotiated and made on the Retiree Medical Program as part of their merger agreement. The parties were free to impose contractual obligations on the right to amend or terminate the Dresser Retiree Medical Program, and they did. Because of these limitations, Halliburton cannot alter the Retiree Medical Program, except as consistent with the plan as amended...”