IVINS, PHILLIPS & BARKER
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EMPLOYEE BENEFITS UPDATE

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Agenda

1. DC Plans
   - 401(k) Fee Litigation
   - Company Stock
2. DB Plans
   - Pension De-Risking
3. Executive Comp
   - 409A
   - 162(m)
   - 3121(v)

#1 – 401(K) PLANS FEE LITIGATION

401(k) Fee Litigation – Overview

- Claims against plan sponsors for fiduciary breach
  - 1st generation cases: Challenges to revenue sharing payments made to service providers, which caused participants to pay excessive fees
  - 2nd generation cases: Challenges to –
    - Actively managed funds (versus index funds)
    - Retail share classes (versus institutional share classes)
    - Investment and transaction draft associated with unitized stock funds
    - Bundled service providers
  - 3rd generation cases: Challenges to –
    - Misleading disclosures
    - Superfluous advisers
    - Stable value funds (versus money market funds)
    - Target date funds overly invested in hedge funds and private equity
- Claims against service providers as functional fiduciaries due to authority over fund selection
  - Claims dismissed in 3rd, 7th, and 8th Circuits

401(k) Fee Litigation – Recent Settlements

- Settled lawsuits against plan sponsors:

Plan Sponsor	Settlement Amount	Filing Date
Lockheed Martin	$62 million	Feb. 20, 2015
Boeing	$57 million	Nov. 5, 2015
Novant Health	$32 million	Nov. 9, 2015
Ameriprise	$27.5 million	Mar. 26, 2015

- Settled lawsuits against service providers:

Service Provider	Settlement Amount	Filing Date
Nationwide	$140 million	Dec. 12, 2014
MassMutual	$9.5 million	Oct. 31, 2014

401(k) Fee Litigation – Recent Settlement Details

- *Boeing* case settles for $57 million
  - Excessive investment fees and imprudent investment offerings alleged
  - Non-monetary settlement provisions (pending final court approval):
    - Replace mutual funds with lower-cost separate accounts
    - Independent review of any technology sector fund to be offered

- *Novant Health* case settles for $32 million
  - Excessive recordkeeping and management fees and kickbacks alleged
  - Non-monetary settlement provisions (pending final court approval):
    - RFP required for recordkeeping and investment consulting
    - Recordkeeping fees must be flat, per-participant basis
    - Independent consultant review of investment offerings
    - Prior brokerage firm must be removed from future involvement in plans and real estate relationships

401(k) Fee Litigation – Recent Settlement Details

- *Lockheed* case settles for $62 million
  - Excessive investment fees and concealment alleged
  - Non-monetary settlement provisions (approved by Court):
    - Limit and monitor cash equivalents in the funds
    - Independent review of performance of funds
    - RFP for recordkeeping with at least 3 bids
    - Offer share class of investments with lowest expense ratio

- *Ameriprise* case settles for $27.5 million
  - Excessive recordkeeping and management fees alleged
  - Non-monetary settlement provisions (approved by Court):
    - RFP required for recordkeeping and investment consulting
    - Recordkeeping fees must be flat, per-participant basis
    - Limitations on expenses charged to (or reimbursed from) plan
    - Must consider use of collective trusts or separately-managed accounts

401(k) Fee Litigation – Non-Monetary Settlement Terms

- Summary of allegations and settlement terms:

Allegations	Settlement Terms
Excessive Fees	• RFP for recordkeeping and investment consulting services • Limitation on expenses • Flat, per-participant recordkeeping fees • Share classes with lowest expense ratios • Independent review of fund performance • Limit and monitor cash equivalents in funds

- Lessons learned on paying reasonable fees to vendors:
  - Use RFP to select record-keepers and investment managers
  - Pay record-keeping fees on per-participant basis
  - Consider passively managed index funds

401(k) Fee Litigation – Non-Monetary Settlement Terms

- Summary of allegations and settlement terms:

Allegations	Settlement Terms
Imprudent Investments	• Collective trusts and separate accounts to be considered • Independent review of less traditional offerings (such as technology sector fund)

- Lessons learned on employing prudent investment selection and monitoring process:
  - Judicious use of collective trusts and separate accounts instead of mutual funds
  - Regularly monitor investments for performance, especially less traditional sector funds

401(k) Fee Litigation – Non-Monetary Settlement Terms

- Summary of allegations and settlement terms:

Allegations	Settlement Terms
Conflict of Interest	• Removal of brokerage firm that received kickbacks from future involvement in plans

- Lessons learned on avoiding conflict of interest:
  - Unbundle record-keeping and investment consulting service providers

401(k) Fee Litigation – New Lawsuits

- Selected companies from most recent litigation wave:

Defendant	Complaint Filed
Aegon	Feb. 6, 2015
Allianz	Oct. 7, 2015
Intel	Oct. 29, 2015
Fidelity	Dec. 11, 2015
Insperity	Dec. 22, 2015
Anthem	Dec. 29, 2015

Defendant	Complaint Filed
Great-West*	Jan. 14, 2016
Oracle	Jan. 22, 2016
MassMutual*	Jan. 29, 2016
Intel (2nd suit)	Jan. 31, 2016
Verizon	Feb. 11, 2016
CVS	Feb. 11, 2016
Chevron	Feb. 17, 2016

* Sued as a service provider

401(k) Fee Litigation – New Lawsuits

- Highlighted summary from recent cases:

Category	Specific Allegations
Excessive Fees	• Excessive recordkeeping, administrative, and investment consulting fees relative to plans of similar size • Improper or misleading disclosure of recordkeeping, administrative, and investment consulting fees • Superfluous advisers receiving fees to select subadvisers

- Lessons learned: Need a prudent process for monitoring and disclosure of fees
  - Leverage size to obtain lower-cost institutional class shares of investments
  - Coordinate with recordkeeping and investment consulting service providers to comply with fee disclosure rules

401(k) Fee Litigation – New Lawsuits

- Highlighted summary from recent cases:

Category	Specific Allegations
Imprudent Investments	• Excessive allocation of target date portfolios in hedge fund and private equity investments • Overly conservative stable value fund investing • Failure to investigate alternatives to mutual funds

- Lessons learned:
  - Avoid hedge funds and private equity
  - Consider money market in lieu of stable value funds

401(k) Fee Litigation – New Lawsuits

- Highlighted summary from recent cases:

Category	Specific Allegations
Conflict of Interest	• Self-dealing with respect to plan assets

- Lessons learned:
  - Remain independent from the company
  - Employ an appropriate process for making fiduciary decisions

#2 – 401(K) PLANS COMPANY STOCK

Stock Drop Litigation – Overview

- Stock Drop cases typically involve claims for breach of fiduciary duty in connection with a plan's investment in employer stock

- *Fifth Third Bancorp v. Dudenhoeffer* (2014): Supreme Court rejects "Moench" presumption of prudence, but holds that actions based on over- or undervaluing the stock are generally implausible, in the absence of special circumstances
  - Having Court strike down the presumption of prudence seems like a loss for employers, but the new standard might make these cases more difficult for plaintiffs to win

- Similar claims dismissed
  - *Smith v. Delta Air Lines* (11th Cir. 2015)
  - *Taveras v. UBS* (2d Cir. 2015)

Stock Drop Litigation – Amgen

- *Amgen, Inc. v. Harris* (2016): First Supreme Court stock drop case decided after *Dudenhoeffer*
  - Plaintiffs alleged that plan fiduciaries – based on *non-public information* – had breached duty of prudence by allowing continuing investment in Amgen common stock
  - District Court granted Amgen's motion to dismiss; Circuit Court reversed (twice)

- Supreme Court held that Ninth Circuit failed to properly evaluate the complaint in light of the new standard
  - Claim for breach must "plausibly allege" that a prudent fiduciary in the same position could not conclude that the alternative action would do more harm than good. Remanded.

Stock Drop Litigation – RJR

- R.J. Reynolds sued for removing Nabisco stock fund from its 401(k) plan after spinning off Nabisco
  - The stock's value *increased* after the fund was removed
- Fiduciaries failed to follow a prudent process when deciding to eliminate the fund
  - Fourth Circuit holds that fiduciaries are absolved from liability if they can show that a prudent process "would have" produced the same decision
- District Court holds that process created by Ivins attorney Rosina Barker meets this standard

Stock Drop Litigation – The Ivins Process

- Step 1: Fiduciary hires an economist to determine that the employer stock fund is the most volatile (risky) fund in the plan's line-up.
  - The economist almost always will make this determination, because a single stock fund is inherently more volatile than a diversified fund.
  - The fiduciary uses the economist's finding to conclude that a single-stock fund is less appropriate for a retirement plan than a diversified fund.
  - This step is not necessary if the fiduciary decides to keep the stock fund because company stock funds are exempt from the ERISA duty to diversify.
- Step 2: The same economist determines that the stock trades in an efficient market.
  - The fiduciary uses this finding to conclude it is always prudent to sell the single-stock fund at the market price; there is no need to hang on to the stock waiting for extraordinary gains, because a stock trading in an efficient market has no foreseeable extraordianry gains.
  - The same process can be used to justify a decision to keep the company stock fund, because there is no way to predict the stock's future performance.

#3 – PENSION PLANS DE-RISKING

Sources of Risk in Pension Plans

- Financial Risk
  - Asset value risk
  - Interest rate risk
  - Inflation risk
- Demographic Risk
  - Longevity risk
  - Other (retirement, turnover)
- PBGC Premium Risk – easy target for revenue raiser

De-Risking Strategies

- Design Strategies – curtail growth of risk
  - Freeze accruals
  - Freeze plan to new entrants (i.e. soft freeze)
- Portfolio Strategies – manage risk
  - Liability Driven Investment (LDI)
  - Annuity contracts as pension assets (buy-ins)
- Settlement Strategies – eliminate risk
  - Lump sum distributions
  - Annuity distributions (buy-outs)
  - With or without plan termination

Settlement Strategies

	Lump Sums Permitted? (With Consent)	Annuity Contract Permitted? (No Consent Required)
Active Employees	**NO except with plan termination - expensive**	**NO except with plan termination - expensive**
Terminated Vested (not in pay status)	**YES**	**YES *(but may be expensive)***
Retirees in Pay Status	**NO – IRS has closed the door on PLRs (Notice 2015-49)** **YES with plan termination – spinoff termination typically contemplated**	**YES without plan termination** **YES with plan termination – spinoff termination typically contemplated**

Settlement Strategies Become More Attractive

- **PBGC premiums increased** – MAP-21, Bipartisan Budget Acts of 2013 and 2015
- **New mortality table** (RP-2014) and projection scale (MP-2014) finalized by Society of Actuaries
- **Pension plan funded status improved** (up from 77% to 88% in 2013)
  - Asset values increased (e.g., S&P up 30%)
  - Interest rates increased (80% bps), reducing liabilities
  - Approximately 20% of pension plans fully funded on accounting basis
- Pension Buyouts totaled $8B during the first three quarters of 2015
  - $3.8B in 2013 and $8.5B in 2014
- PBGC reports that more than 1 million pension plan participants affected by de-risking from 2009-2013

Source of first three bullets: Milliman 100 Pension Funding Index

Settlement Strategies Become More Controversial

	Who Opposes	And Why
Lump Sum Payments (especially to retirees in pay status)	Retiree advocates But NOT actual retirees PBGC Treasury? Unclear. Moratorium imposed on PLRs for lump sums to retirees in pay status	Retirees' election of lump sum may be ill-informed or irrational Retirees vulnerable to coercion and manipulation by family members
Annuity Settlements	Retiree advocates Some retirees - *See Lee v. Verizon Communications, Inc.*	State guarantees may be less protective than PBGC guarantees (but see comments of PBGC Director before ERISA Advisory Council)

Impact of PBGC Premium Increase

	Estimated Flat Rate Premium Per Ppt (Single Employer)		Estimated Variable Rate Premium Per $1000 Underfunding		Variable Rate Premium Cap	
	Prior Law	Bipartisan Budget Act	Prior Law	Bipartisan Budget Act	Prior Law	Bipartisan Budget Act
2013	$42		$9		$400	
2014	49		14		412	
2015	50	$57	19	$24	424	$418
2016	52	64	20	30	437	500
2017	54	69	20	33	450	500
2018	52	74	20	37	437	500
2019	54	80	20	41	450	500

Impact of New Mortality Table

- RP 2014 and projection scale MP-2014 reflect that Americans are living longer, with longevity improvements each year
- Plan sponsors with traditional ongoing defined benefit plans will see liability increases of 6% to 9%
- IRS expected to adopt new mortality table in the next few years
- For accounting purposes, no table is mandated, but auditors will require use of best estimate
  - Difference between FAS liability reported to shareholders and cost of annuity contract may shrink, as financial reporting catches up with insurance company pricing

Lump Sum Offers Announced in 2014-15

Announcement Date	Employer	Offer Made To
08/24/105	Newell Rubbermaid Inc.	3,300 former employees
0821/2015	The E.W. Scripps Company	4,300 former employees
10/22/2015	Ryder	11,000 former employees
Q3 2014	CAN Financial Corporation	11,000 former employees
09/25/2014	Motorola Solutions, Inc.**	32,000 former employees
09/23/2014	Newell Rubbermaid Inc.	5,700 former employees
09/23/2014	Magnetek	2,800 former employees
09/23/2014	American Axle	6,000 former employees
09/15/2014	Boeing	40,000 former employees
08/29/2014	The Brinks Company	9,000 former employees
08/05/2014	Archer-Daniels-Midland Corp.	7,500 former employees
07/11/2014	RockTenn	9,000 former employees
06/10/2014	NCR Corporation	20,000 former employees in pay status
05/09/2014	Alcatel-Lucent	45,000 retirees and former employees
02/26/2014	Heinz	5,173 active, former and retired employees
Source: The Pension Rights Center		

2016: De-Risking Trends

- Several economic factors may increase the appetite for de-risking in 2016
  - Interest rates trending upwards
  - New mortality table delayed until 2017 or later
  - IRS guidance provides more certainty on what is (and is not) allowed

#4 – EXECUTIVE COMPENSATION

Section 409A: General Requirements

- Section 409A covers all forms of deferred compensation (unless specifically excluded from coverage) and prescribes general rules for:
  - Elections to defer compensation
  - Payment of deferred compensation
  - Mandatory six-month payment delay for payments to "specified employees" following termination
  - Reporting and withholding of deferred compensation
- Even if plan documents are compliant, operational failures may result in additional taxes and interest
- Recent IRS audit efforts have focused on top 10 officers
- Audit activity expected to pick up after IRS issues final income inclusion regulations

Section 409A: Consequences of a Violation

- Current taxation of vested deferred compensation under the plan
- 20% penalty tax
- Premium interest tax equal to federal underpayment plus 1% back to vesting date, on all vested amounts under plan
- Under plan aggregation rule applicable to operational failures, the "plan" may include all arrangements of the same type covering the same service provider
  - Example: Parachute payment of $100,000 paid to executive A immediately upon termination of employment in violation of 6 month rule. Executive A vested in SERP with PV of $4 million. If failure not corrected, and assuming parachute payment and SERP in same aggregated plan, 409A tax and penalties triggered on $4.1 million.
  - Aggregation rule does not apply to stock options or stock appreciation rights

Section 409A: IRS Correction Programs

- IRS Notice 2008-113 (issued December 2008) is the only sanctioned method for correcting 409A operational failures
  - IRS Notices 2010-6 and 2010-80 allow for the correction of plan document failures, and include important updates to Notice 2008-113
- Different rules apply depending on how long it takes to correct the failure
- The longer it takes to correct, the more significant the tax and reporting consequences
- Correction under the Notice is not permitted after the end of the second year following the year in which the error occurred

Section 409A: IRS Correction Programs

- Advantages of Corrections Program
  - Limits the violation to amounts directly involved in the failure; no other plans affected
  - No premium interest; in some cases no additional taxes at all
  - IRS claims that employers are not more likely to be audited after using the program
- Limitations of Corrections Programs
  - Only specified types of failures can be corrected
  - Can't correct operational failures more than 2 years old
  - Detailed reporting on tax returns filed for correction year (exception for employee's tax return for operational failure corrected in failure year)
  - Operational failures are not corrected unless employer takes commercially reasonable steps to prevent recurrence; need good story for repeat offenses
  - Early payments cannot be corrected if the employer experienced a substantial financial downturn during the year of payment

Section 409A: Common Deferral Errors

- Definition of compensation not administered correctly
- Mid-year enrollment for newly eligible participants
  - May only defer amounts earned following enrollment; bonuses may be pro-rated
  - Prior participation in, eligibility for other plans can make this rule unavailable
- Bonus deferral elections often apply to amounts paid in the second year after the election is made
- May be able to correct errors before year-end without using the corrections program

Section 409A: Common Payment Errors

- Identifying Section 409A Separation from Service
  - Reduction in hours
  - Leave of absence
  - Transfer to affiliates, especially if the affiliate is on a different payroll system
  - Ongoing consulting work after termination of employment
  - Rehire following termination
  - Acquisitions & dispositions

Section 162(m): General Rule

- Compensation paid to a "covered employee" in excess of $1 million generally is not deductible by the corporation
  - Certain types of compensation are disregarded
  - Does not affect employee's tax treatment
- Applies only to public companies
- Applies in the year in which the payment otherwise would be deductible
- Covered employees include the CEO, and the four highest paid officers for SEC disclosure purposes
  - Notice 2007-49: Generally does not include the CFO

Section 162(m): Performance Pay Exception

- Must be granted by a compensation committee consisting solely of two or more outside directors
- Compensation may be paid only upon the attainment of one or more pre-established, objective performance goals
  - Outcome of performance goals must be substantially uncertain at the time the award is issued
  - A performance goal is objective if a third party having knowledge of the relevant facts could determine whether the goal has been achieved
  - The performance goal must be established in writing no later than 90 days after the start of the performance period, and after no more than 25% of the performance period has elapsed
  - Compensation Committee may have discretion to decrease an award, but not to increase the award
- The award must preclude discretion to increase the amount payable following the 90-day and 25% deadlines set forth above
- Before any payment is made, the compensation committee must certify that the goals have been satisfied

Section 162(m): Performance Pay Exception

- Shareholders must approve the "material terms" of awards to covered employees. These include:
  - The employees or categories of employees that are eligible to receive the compensation;
  - The business criteria upon which the performance goal(s) may be based (but not specific targets); and
  - Maximum amount that could be paid to any employee, or the formula used to calculate compensation if the performance goal is reached. For equity awards, a share limit will suffice.
- Mechanics of shareholder approval
  - Separate shareholder vote
  - No deduction if the awards would be paid anyway
  - Re-approval required every five years if the Compensation Committee has the authority to change the targets under a performance goal

Section 162(m): Common Failures

- Failure to specify individual share limits for options and SARs
- Performance requirements waived in the event of retirement, or involuntary or "good reason" termination
- Dividend rights not subject to performance metrics
- Use of performance metrics that were not approved by shareholders
- Performance goals adjusted to reflect changed circumstances without specific plan language that allows for the change
- Committee fails to certify performance results
- Failure to obtain shareholder re-approval of performance metrics

FICA Treatment of Nonqualified Deferred Compensation

- Code Section 3121(v)(2) provides that nonqualified deferred compensation generally is subject to FICA tax on the later of:
  - The date the underlying services are performed, or
  - The date the compensation is no longer subject to a substantial risk of forfeiture
  - For non-account balance plans, FICA taxation may be delayed to the extent the amount deferred is not "reasonably ascertainable;" alternatively, earlier inclusion is permitted, with a subsequent true-up
- This is a pro-taxpayer rule because employees' other earnings are more likely to exceed the Social Security wage base when they are still performing services for their employers
- If FICA tax is not paid in accordance with this rule, benefits and related earnings are subject to FICA tax when paid

Section 3121(v)(2): Treatment of Earnings

- For account balance plans, earnings attributable to an amount that has been taken into account for FICA purposes are not subject to FICA tax, as long as earnings are based on either
  - A "reasonable rate of interest" or
  - A "predetermined actual investment"
- For non-account balance plans, earnings are not subject to FICA as long as the amount taken into account is determined using "reasonable actuarial assumptions"
- Earnings in excess of these limits are subject to FICA tax as they accrue
- If the employer fails to take the excess earnings into account, all benefits attributable to earnings in excess of AFR are subject to FICA tax when the benefits are paid

Section 3121(v)(2): Common Errors

- "Unreasonable" fixed interest rates
  - This is fairly typical for older account balance plans
- Failure to take employer contributions into account
  - Unlike company contributions to 401(k) plans, company contributions to nonqualified plans are FICA wages
- Failure to tax earnings generated before benefits are "taken into account" for FICA purposes
  - E.g., contributions are credited/taken into account at year-end, but earnings are calculated as if contributions were made ratably throughout the year
- Failure to tax retirement-age vesting of RSUs

Section 3121(v)(2): Recent Court Decision

- In *Davidson v. Henkel Corp.* (E.D. Mich., 1/6/15), a federal district court ruled that Henkel violated ERISA by failing to timely withhold FICA taxes from employees' nonqualified deferred compensation benefits
  - The court held the company liable under ERISA for the resulting reduction in vested plan benefits
  - Henkel's failure to follow the special timing rule in Section 3121(v)(2) violated the plan's express terms requiring that the company "properly handle tax withholding" and caused the retirees to lose part of their vested benefit payments in violation of ERISA
- Employers should ensure that their plan documents disclaim responsibility for any negative tax consequences
- This decision raises the specter of employer liability for Section 409A violations, which can be significantly more expensive

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