Morgan Lewis

webinar

Hot Topics in Employee Benefits
– What We're Seeing

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Agenda

- Legislative update
- Health and welfare
- Fiduciary considerations
- Plan sponsor issues
- Executive compensation
- ESOPs
- Q&A

Legislative Update

Timothy Lynch

Pension and Retirement Legislative Developments

- USA Retirement Funds Act (S. 1979)
- Tax Reform
- Expiring Provisions of PPA Relating to Multiemployer Plans
- Obama Administration – myRA

Political Realities

- Divided Government
- Limited Congressional Calendar
- Critical Midterm Elections in November

Health and Welfare

Andy Anderson

90 Day Waiting Period Rules

90 Day Waiting Period Rules

- Final regulations permit eligibility criteria, but require participation within 90 days of meeting criteria (eligibility criteria cannot consist solely of the lapse of time)
  - All days counted (weekends, too)
  - NOT a 3 month rule!
    - *Is it simpler to adopt a 60 day or perhaps 2 month rule?*
- 90 day requirement alternative:
  - 1,200 hours (but only one time)
  - Variable hour employees

90 Day Waiting Period Rules

- New concept: Orientation period add-on
  - Maximum of one month (minus one day)
  - Proposed regulations
  - Designed to smooth differences with Shared Responsibility rules (which use a longer period)
- 90 day waiting period rule compliance required now
  - Do you foreshadow Shared Responsibility rules when designing eligibility criteria or wait until 2015/2016?

90 Day Waiting Period Rules

- Do not apply to “excepted benefits”
  - Dental
  - Vision
  - Hospital indemnity, etc.

COBRA Notices

COBRA Notices

- DOL released updated model COBRA notices in May
  - Companion:
    - *FAQs—Part XIX*
    - *Updated CHIP Notice*
    - *Proposed regulations to "decouple" DOL model COBRA notices from regulatory process*
- Revised COBRA notices:
  - Emphasize ACA Exchange opportunity
  - Highlight Exchange open enrollment issues

COBRA Notices

  - Almost an advertisement for Exchange coverage!

- Big opportunity to educate COBRA qualified beneficiaries about the merits of Exchange coverage and the risks and costs associated with COBRA coverage
- Highlights Exchange problems created by subsidized COBRA coverage
  - May not be able to move to Exchange coverage at end of subsidy
  - Evaluate continued viability of COBRA subsidy

COBRA Notices

  - Possibly move to taxable lump sum at termination of employment to replace subsidized COBRA coverage

- Possibly move away from customized COBRA notices to partial or full use of DOL Models
  - Proposed “decoupling” may lead to more frequent revisions of DOL model notices

Fiduciary Considerations

Julie Stapel

Recent DOL Interest in "Hard to Value" Assets

- What are "hard to value" assets?
  - Include "alternative investments," such as hedge funds and private equity funds
  - FASB fair value determinations—focus has been on Level 3 assets
    - *"Little, if any, market activity for the asset or liability . . ."*
    - *No "observable" inputs for valuation in the market*
    - *Must rely on use of internal information*
- What are the DOL's concerns?
  - Fiduciary responsibility for valuation
  - Impact of bad valuations on plan funding, benefits security

Background on DOL Interest in "Hard to Value" Assets

- GAO report from summer 2011 identifying valuation as a key risk for plans investing in alternative investments
- September 2013 report by the Office of Inspector General (OIG)
  - Reviewed Employee Benefits Security Administration's (EBSA's) examination and enforcement efforts on "hard to value" assets
  - Overall conclusion that plan sponsors need more guidance and EBSA needs to improve procedures
  - Critical of plan sponsors using values provided by sponsors/managers of alternative investment vehicles

Recent OIG Letters to Plan Sponsors

- Earlier this year, numerous plan sponsors who used the "limited scope" audit option received a letter from the OIG
- Letter states that OIG is examining EBSA's oversight of plans
- Includes questions about FASB Level 2 and Level 3 alternative investments
  - Who is the auditor
  - Who is responsible for certifying investments
  - Supporting documentation for valuation of hard to value assets
- Not yet aware of any OIG follow-up on the letters

What to Expect Next

- Would not expect a significant retreat from alternative investments as they are an important component of many plans' asset allocations
- Potential for plans to put pressure on trustees/custodians to provide independent review of valuations
- Potential for plans to demand more independent valuations from alternative investments
- Potential further DOL pronouncements
  - Not on the regulatory agenda so any further regulatory guidance not likely in the near term
  - More likely to see developments coming out of EBSA examinations

Plan Sponsor Issues

Lisa Barton

Defined Benefit Plan Overpayments

- When do overpayments occur?
- Are overpayments required to be recouped?
  - Qualification concerns
  - Fiduciary considerations
- What are correction options and considerations?
  - Internal Revenue Service
  - Department of Labor

Missing Participants

- When is a participant considered to be missing?
- What steps should be taken to locate missing participants?
  - Internal Revenue Service
  - Department of Labor
  - Pension Benefit Guaranty Corporation
  - Other

Uncashed Participant Benefit Checks

- What is the definition of an “uncashed check”?
  - Distributions from DC/DB plans
  - Tax withholding has occurred
- Is an uncashed check a “plan asset”?
- Should uncashed checks be re-deposited into the trust?
  - What about terminated plans?
- If checks are re-deposited into the plan, what are the considerations for DC vs. DB plans?
  - Forfeiture account issues

Executive Compensation

2014 Executive Compensation Proxy Challenges

Mims Zabriskie

Morgan Lewis

Proxy Challenges

- 2014 proxy challenges included:
  - Proxy advisory services (ISS/Glass Lewis) recommendations with respect to:
    - *Say on pay*
    - *Equity plan approval*
    - *Board member elections*
- Importance of effective outreach to shareholders

Proxy Challenges

- ISS makes a quantitative review of total shareholder return (TSR) and CEO pay
- If there is a disconnect resulting from the quantitative review, ISS makes a qualitative review of pay
  - Pay for performance
  - Problematic pay practices
- Important to review ISS/Glass Lewis report carefully. Mistakes of fact do occur.

Proxy Challenges

- The most common actions taken in response to a failed or less than favorable say on pay vote include:
  - Change balance of performance based vs. time based grants
  - Review performance metrics
  - Double trigger equity vesting
  - Consider eliminating tax gross-ups

Proxy Challenges

- The most common actions taken in response to a failed or less than favorable say on pay vote also include:
  - Better shareholder outreach
  - Clawback policy
  - Enhanced stock ownership guidelines

Proxy Challenges

- Companies should keep up with best practices and be aware of recent developments
- Points for companies to watch out for:
  - Disconnect between company's performance and CEO pay
  - Balance of time-based and performance-based equity grants
  - Large retention equity grants or bonuses, particularly without rigorous justification
  - Performance goals that may not be sufficiently challenging
  - Discretionary bonuses
  - Ensure checks and balances in preparation of proxy

Executive Compensation Proxy Litigation

- Lawsuits have been threatened to enjoin shareholder meetings based on inadequate or incorrect proxy disclosure
- Common allegation is breach of fiduciary breach for inadequate or incorrect proxy disclosures on
  - "Say on pay"
  - Proposals to increase the number of shares in an equity plan

Executive Compensation Proxy Litigation

- Most cases have been dismissed or settled
  - *Freedman v. Redstone et al*., 13-3372 (3d Cir. May 30, 2014) Third Circuit decision affirming dismissal of a shareholder challenge to Viacom's executive compensation plan.
- However, there are exceptions
  - Cheniere Energy, Inc. postponed annual shareholder meeting after shareholder lawsuit.

Executive Compensation Proxy Litigation

- Lawsuits have raised allegations that companies failed to meet 162(m) requirements by:
  - Granting awards in excess of the plan's per-person limits
  - Incomplete or misleading proxy disclosure of section 162(m) compliance policy
  - Failing to get re-approval of performance goals every five years

ESOPs

Brian Hector

Trends in ESOP Litigation

- Since the 1990s, there have been two predominant "waves" of stock-drop litigation
  - the first followed the accounting scandals of the early 2000s (think Worldcom and Enron)
  - the second (and still present wave) followed the great recession of 2008/early 2009
    - Valuation cases, of course, continue to be a common theme of ESOP litigation
    - A number of cases have specifically revolved around bankruptcy issues

Chesemore v. Alliance Holdings, Inc., 2013 WL 2445036 (W.D. Wis. June 4, 2013)

- *Chesemore* is a case involving claims of overvaluation related to a complex leveraged buyout transaction.
- Alliance was founded in 1994 by David Fenkell and was majority owned by the Alliance ESOP.
  - Fenkell was the president, CEO, only Board member, and sole Alliance ESOP trustee.
- In 2002 Alliance purchased 80% of Trachte Building Systems, Inc.
  - Trachte had an ESOP, and its participant accounts were merged into the Alliance ESOP.
- In 2007 Alliance tried, but failed, to sell Trachte to a third party.

Chesemore v. Alliance Holdings, Inc.

- In August 2007 Trachte was sold to a newly formed Trachte ESOP.
  - The Trachte employees' Alliance ESOP accounts were spun off to the newly formed Trachte ESOP and their shares of Alliance stock were exchanged for Trachte stock.
  - Trachte ultimately became 100% owned by the Trachte ESOP.
  - The Trachte ESOP paid $38 million for the shares and Trachte had taken on $36 million in debt.
  - Alliance executives then received payment from Trachte pursuant to a phantom stock plan that was created when Trachte was purchased by Alliance.

Chesemore v. Alliance Holdings, Inc.

- Trachte ESOP participants filed suit, alleging that Alliance, the Alliance ESOP, the Alliance founder David Fenkell, and the Trachte ESOP Trustees engaged in prohibited transactions and breached their fiduciary duties
- District court ruled, among other things, that the Trachte ESOP overpaid for the stock and that defendants knew that the price exceeded FMV
- Court said that no one was looking out for the interests of the Trachte employees whose accounts were spun off
  - *Court said Fenkell picked the valuation firm, would not negotiate, had no independent fiduciary, and had authority over Trachte ESOP trustees*
- Relief:
  - *Alliance ordered to pay $7.8 million to the Alliance ESOP*
  - *Fenkell ordered to pay $2.8 million to the Trachte ESOP (disgorgement of phantom stock)*
  - *Alliance required to indemnify the Trachte ESOP trustees for $6.5 million*

Fish v. GreatBanc Trust Co., 2014 WL 1910867 (7th Cir. May 14, 2014)

- The central issue in *Fish* is the application of the statute of limitations for fiduciary breach claims under ERISA (normally 6 years from the date of the violation, but the time is shortened to 3 years from the time the plaintiff had "actual knowledge" of the violation).
- The plaintiffs in this case were employees of Antioch Company who participated in Antioch's ESOP.
- Their claims arose from a buyout transaction at the end of 2003 in which Antioch borrowed money to buy all of the company's stock, except the stock owned by the ESOP.
  - Company become 100% ESOP owned
  - All shareholders other than ESOP tendered shares
  - ESOP retained outside trustee
    - *Voted to NOT tender shares*

Fish v. GreatBanc Trust Co.

- Extensive disclosures during and after transaction describing the transaction
  - *Proxy statement*
  - *Antioch's intranet*
  - *Employee meetings*

- Post-Transaction
  - Rapid decline in business, Antioch went bankrupt, and the ESOP shares were rendered worthless

Fish v. GreatBanc Trust Co.

- In March 2009, ESOP participants filed suit, alleging that the 2003 transaction was a prohibited transaction and that fiduciaries breached their duty to the ESOP because the shares were redeemed at a price in excess of adequate consideration (i.e., were overvalued), and that such overvaluation led to Antioch's bankruptcy.
- Defendants maintained that no breach occurred and the allegations were barred by ERISA's 3-year statute of limitations.

Fish v. GreatBanc Trust Co.

- Court granted summary judgment to defendants, ruling that plaintiffs' claims were time barred by ERISA's 3-year statute of limitations.
  - Materials sent to plaintiffs (proxy statement, FAQs, letters, etc.) disclosed all the relevant facts of the alleged breaches.
  - Plaintiffs were willfully blind to facts disclosed to them by Company and Trustee – and willful blindness was equivalent to actual knowledge.
    - *Court rejected argument that plaintiffs were incapable of understanding the information provided to them.*
  - Plaintiffs appealed and the 7th Circuit reversed, finding that the plaintiffs' claims for breach of fiduciary duty did not depend solely on the disclosed substantive terms of the buyout transaction. The court said that their claims also depended on the processes that the Trustee used to evaluate, negotiate, and approve the buyout transaction. The plaintiffs' knowledge of the substantive terms of the buyout transaction itself, therefore, did not give them "actual knowledge of the breach or violation" alleged in this matter.

Issue to Watch: DOL Targets ESOPs

- DOL has a national ESOP enforcement strategy
  - Increase in reviews and investigations of ESOPs
  - Closer scrutiny of ESOPs
- What does this mean?
  - More aggressive investigations
  - More administrative subpoenas
  - More lawsuits filed by Secretary of Labor (majority involve overvaluation)
  - ESOP sponsors need to treat all DOL inquires as potentially leading to litigation

Register for the next webinar in this series:

September 17, 2014

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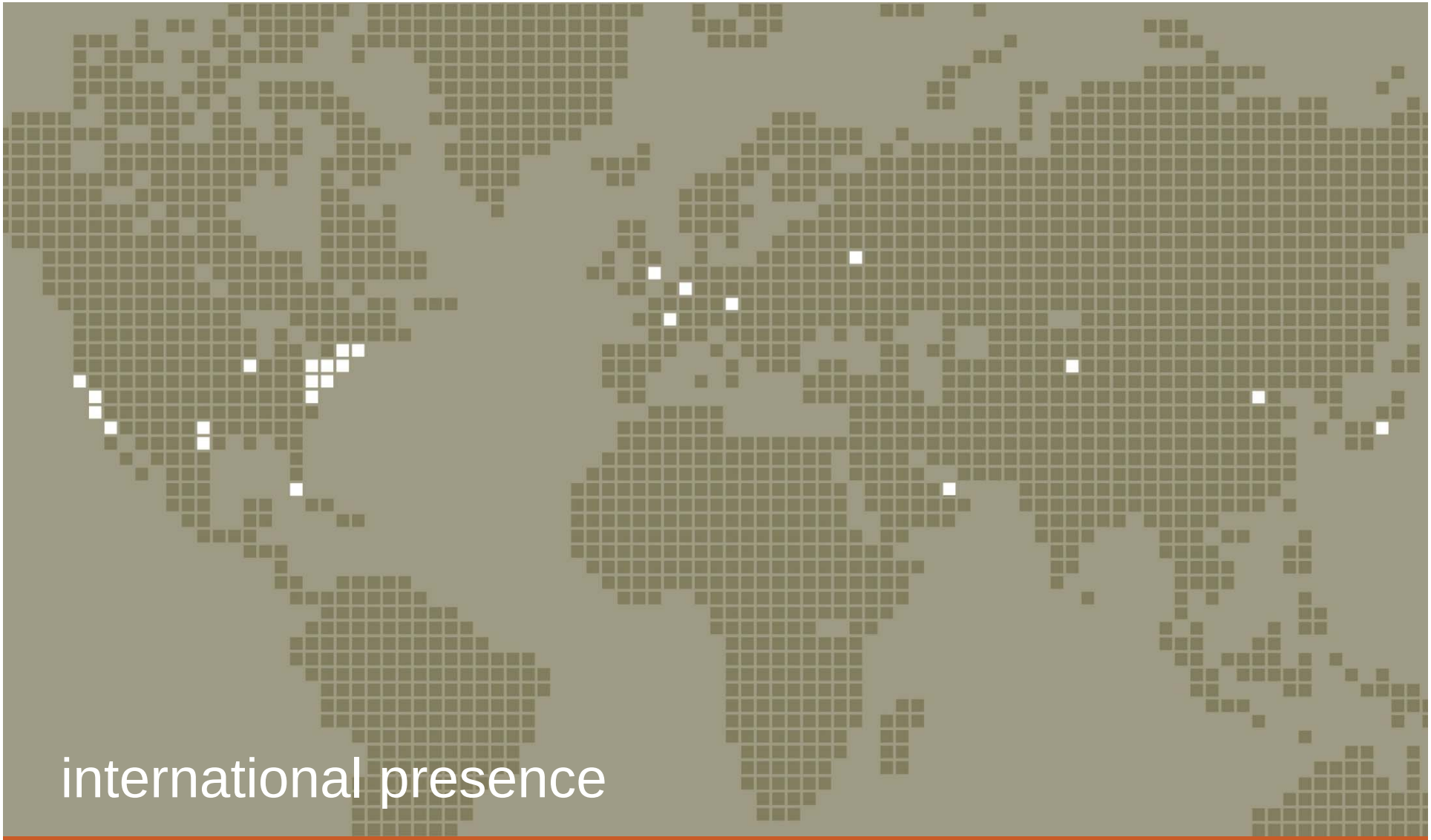

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