ERISA PREEMPTS STATE LAW CLAIM FOR BREACH OF CONTRACT OVER ESOP BENEFITS

The Six Circuit Court of Appeals rules that ERISA preempts state law claims against Fifth Third Bank.

In a complicated set of facts, Suburban Bancorp and Fifth Third Bank entered into a merger agreement that contained language covering Suburban's ESOP because the ESOP held shares of Suburban. The merger agreement provided that Suburban obtain determination from IRS that the ESOP satisfied relevant tax regulations and perform several other tasks associated with the ESOP because of a concern of the tax implication of distributing the ESOP shares prematurely. Pending the determination by the IRS, the merger agreement provided that Suburban maintain the ESOP for the benefit of individuals who were ESOP participants on or before the merger (the class members.) The merger agreement also included a contingency plan for the ESOP that provided that if the parties agreed in good faith that allocating the ESOP shares would violate IRS rules, then Suburban would apply to the IRS for approval allowing the ESOP funds to either revert to Fifth Third Bank or be transferred to one of Fifth Third's benefit plans. The merger agreement further provided that if and only if the IRS approved the transaction allowing for the reversion or transfer of shares to Fifth Third, or if Fifth Third proceeded with the reversion or transfer without IRS approval, that Fifth Third would pay class members out of its own corporate assets the amount of money in the ESOP at the time of the merger less administrative costs.

Suburban started the process necessary to distribute ESOP funds to class members, but did not finish the process or obtain the IRS determination regarding the tax issues. After the merger, Fifth Third, which became the successor ESOP sponsor and trustee, made amendments to the ESOP which effectively ensured that class members would no longer recover benefits from the ESOP. Thereafter Fifth Third terminated the ESOP distributing the proceeds to Fifth Third employees, and not to class members.

Hutchison, on behalf of the class members brought three types of claims—two of which were state-law claims relating to Fifth Third's breach of the merger agreement, misrepresentation and negligent misrepresentation as well as conversion and unjust enrichment relating to the alleged taking by Fifth Third of the ESOP's assets. The third claim was an ERISA claim. The lower federal court held that ERISA preempted the state law claims and dismissed the ERISA claim finding that Fifth Third did not breach any fiduciary duties owed to class members.

The appeal to the Sixth Circuit Court of Appeals only concerns the lower court's decision to dismiss the state law claims not the dismissal of the ERISA claim.

The Six Circuit Court affirmed the lower court ruling finding that the state law claims relating

to Fifth Third's alleged breach of the merger agreement were preempted by ERISA because the necessary elements of the state law claims (amending the plan to exclude class members) go to the heart of what Congress intended ERISA to govern. They ruled so even though some of the elements of the state law cause of action came into existence before Fifth Third was an ERISA fiduciary to the ESOP. The court concluded that because the class members sought damages for ERISA-regulated actions of an ERISA fiduciary, based on the merger agreement entered into before Fifth Third became a plan fiduciary, the state law contract claim would bind fiduciaries to particular choices, thereby functioning as a regulation of an ERISA plan.

Hutchison v. Fifth Third Bancorp, 6th Cir., No. 05-4389, 11/30/2006.
http://www.ca6.uscourts.gov/opinions.pdf/06a0448p-06.pdf

This is a reminder that as noted by the court here, ERISA is comprehensive and preempts virtually any state law claim relating to an employee benefit plan.

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PAY ATTENTION TO PENSION PROTECTION

The Pension Protection Act of 2006 was signed into law on Aug. 17, 2006. At a whopping 900-plus pages, the Act makes significant changes to the Code and ERISA. Although the Act has been widely publicized in its efforts to reform pension plans, much of it impacts defined contribution plans such as 401(k)s, 403(b)s and 457 plans, as well as IRAs. Below is a summary of some of the key provisions impacting defined contribution plans and IRAs.

EGTRRA permanency. The 2006 law made permanent many of the provisions of EGTRRA 2001 which were scheduled to expire in 2010. These include increased IRA and 401(k) contribution and deduction limits, age 50 and over catch-up contributions, Roth-type contributions to 401(k)s and 403(b)s, and more favorable rollover and vesting rules.

Investment advice. The Act provides fiduciary relief to plan fiduciaries. A prohibited transaction exemption is included for the provision of investment advice to plan participants. The exemption applies if the advice arrangement between the plan fiduciary and the investment adviser meets numerous requirements. It applies to flat fees and to advice using a computer model. Plan fiduciaries continue to have the fiduciary duty to prudently select and monitor the investment options as well as the investment adviser. Also, the fiduciary relief available under the exemption only applies to advice provided to participants, not to

plan-level investment advice provided to the fiduciary by an investment adviser or manager.

Automatic enrollment 401(k) safe harbor. Under current law, employers can design 401(k) plans to include automatic enrollment provisions (also called negative elections). These provisions enable them to withhold a certain amount from an employee's pay as a salary deferral unless the employee affirmatively elects not to contribute to the plan. The employee must be notified in advance. Plans containing automatic enrollment provisions are still subject to the ADP/ACP test and top-heavy rules. Effective for plan years beginning on or after Jan. 1, 2008, if this provision meets the new law requirements as a "qualified automatic contribution arrangement," the plan will satisfy the ADP/ACP test and the top-heavy rules. The plan must contain provisions regarding the minimum and maximum deferral amounts allowed, employee notice requirements, and mandatory employer contributions and vesting.

Default investment safe harbor. The Act requires the DOL to make a change to ERISA Section 404(c) that will provide plan fiduciaries protection for certain types of default investments. Currently, ERISA Section 404(c) provides relief to plan fiduciaries of participant-directed plans if participants direct their investments. It also provides relief if the plan satisfies certain design and disclosure requirements. However, if participants do not make investment selections, plan fiduciaries remain responsible for the investment of those participant accounts. The procedure often used is to invest those accounts in a default investment. Usually, the default investment has the lowest volatility of investment options and is designed for principal preservation. That, however, may not be the most prudent investment choice for a participant who has decades until retirement. It is anticipated that the new Section 404(c) default investment requirements will allow for the use of asset allocation funds and models that take into account risk tolerance and estimated years to retirement.

Electronic display of Form 5500s. For plan years beginning in 2008, the Form 5500 must be provided electronically so that some information can be displayed by the Department of Labor (DOL) on the Internet. Plan sponsors who maintain intranet sites must also display the information on the sponsor's intranet site.

Benefit statement requirements. Currently, ERISA generally requires that defined benefit and defined contribution plans provide participants benefit statements upon request, but not more than once per year. In the case of participant-directed plans intending to qualify for fiduciary relief under Section 404(c) benefit statements must be provided automatically and, generally, at least quarterly. Beginning for 2007 plan years, participant-directed plans must provide participants and beneficiaries benefit statements at least quarterly. The statement must contain information regarding the importance of diversifying plan investments and a message that refers the participant to a DOL Web site with information on investing. Employer-directed defined contribution plans must provide participants and beneficiaries benefit statements annually.

Individual Retirement Accounts (IRAs). The Act makes a number of changes impacting IRAs.

- Indexing traditional and Roth IRA contribution limits. Beginning in 2007, the income limits for traditional and Roth IRA contributions will be indexed for inflation (rounded to the nearest $1,000).
- Direct deposit of tax refunds to IRAs. Beginning with the 2007 tax year, taxpayers may elect to direct deposit all or a portion of their tax refunds to an IRA of the taxpayer or spouse of the taxpayer in the case of a joint return. Previously, taxpayers only had the ability to elect direct deposit of their refunds to checking or savings accounts. This provision does not modify the rules relating to the timing and deductibility of IRA contributions or any other rules relating to IRAs.
- Direct rollover to Roth IRAs. For distributions made in plan years beginning on or after Jan. 1, 2008, participants in qualified retirement plans, 403(b) plans and governmental 457 plans will be able to roll over distributions directly from those plans into Roth IRAs, subject to current law.
- Tax-free distributions from IRAs for charitable purposes. For the 2006 and 2007 tax years only, IRA owners who are age 70½ and older can make distributions from traditional IRAs of up to $100,000 to tax-exempt charities.

Just as ERISA changed the retirement landscape for millions of workers over 30 years ago, so too does the Pension Protection Act change the landscape of existing laws affecting the private retirement system.

THE RISKS OF EXCLUDING PART-TIME AND SEASONAL WORKERS FROM QUALIFIED RETIREMENT PLANS

As more and more businesses are using part-time workers to address their hiring needs, it is important that employers consider how such workers affect their qualified retirement plans. In particular, employers and their service providers need to be very mindful of IRS guidance on the exclusion from qualified retirement plans of employees classified by the employer as part-time, seasonal, or temporary.

Earlier this year, the IRS issued a Quality Assurance Bulletin (QAB) to its employee plan agents regarding qualified retirement plans excluding part-time employees. In the QAB, the Service indicated that, effective with the opening of the EGTRRA Pre-Approved and Determination Letter Programs, agents will begin requesting that plan administrators remove or clarify language if a plan includes a provision that defines an exclusion classification by

service and the plan provision could result in the exclusion, by reason of a minimum service requirement, of an employee who has completed a year of service. In particular, any plan containing a part-time, seasonal, temporary, or any other classification of employees will be scrutinized.1

The emphasis by the IRS on class exclusions is not new. In 1994, the Service issued a Field Directive indicating that a plan may not exclude any part-time employee where it is possible for that employee to complete one year of service. Such exclusion, although not directly referring to age or service, may result in imposing a service requirement not consistent with § 410(a)(1) or § 410(b) of the Code. Section 410(a)(1) of the Code imposes certain minimum participation standards on qualified retirement plans. If a plan requires, as a condition of participation, that an employee complete a period of service with the employer extending beyond the later of the date on which the employee attains age 21 or completes one year of service,2 then the plan will not be considered a qualified plan.

For example, a calendar-year plan requires one year of service and excludes part-time or seasonal employees if their employment is not for more than 20 hours per week or five months in any plan year.3 Joe, whose date of hire is January 1st, is classified as a part-time employee and consistently works 20 hours per week. Code Section 410(a) defines a year of service as a 12-month period during which the employee has not less than 1,000 hours of service.

Joe, by consistently working 20 hours per week from January through the end of December works 1,040 hours per year. Because the part-time/seasonal plan definition requires employees to work more than 20 hours per week, the exclusion has the effect of requiring more than one year (1,000 hours) of service. The plan could not maintain its qualified status despite the fact that the plan could satisfy the coverage requirements under 410(b) after excluding all part-time and seasonal employees.

The IRS’s Position Develops

Although the IRS treated part-time and other class exclusions with suspicion, its position as stated in a Technical Advice Memorandum (TAM) issued in 2000 was not to reject or require clarification of plan provisions that may impose impermissible age or service requirements at the time a determination letter was requested. Rather, the approach was to identify impermissible age and service conditions during the plan audit process. This was, however, after some determination letters were issued containing a caveat that the letter could not be relied on with respect to whether a plan’s exclusion classifications, if any, violate the minimum age or service requirements of Section 410 by indirectly imposing any impermissible age or service requirements.

In 2001, the IRS revised Publication 794, which explains the limitations and scope of

determination letters. Publication 794 indicates that a determination letter cannot be relied upon for purposes of § 410(a)(1). Thereafter, the IRS ceased issuing determination letters with the caveat included. In the QAB issued earlier this year, the IRS cautioned that an employer who received a determination letter on or after July 1, 2001 (after the release of revised Publication 794) cannot rely on its determination letter to protect the plan from retroactive disqualification if the plan contains an impermissible age or service requirement. Employers receiving determination letters before July 1, 2001, whose plans contain impermissible age or service provisions, may be able to rely on their determination letters, but only if the determination letters do not contain the caveat regarding non-reliance with respect to class exclusions.

Employers with plans containing part-time or other class exclusions need to review their plans to determine if the plan language provides a fail-safe in the event a part-time employee completes 1,000 hours of service in an eligibility computation period. Such a provision would act to allow those part-time employees into the plan, despite the part-time classification. If an employer's plan does not have a fail-safe provision, the employer should consult its attorney regarding using the IRS Voluntary Correction Program (VCP) to correct the document failure. Employers should also consult their attorneys if, despite a fail-safe provision in the plan, part-time workers who complete 1,000 hours of service have been excluded from participation.

Costly Correction

It can be costly for employers to correct this kind of plan defect. The correction method required under VCP is for the employer to include the improperly excluded employees into the plan and make contributions (plus attributable earnings) on behalf of those employees for the plan years in which they were improperly excluded. In the case of a 401(k) plan, the required contribution for each improperly excluded employee would be an amount equal to the average deferral percentage of the employee's testing group for non-discrimination testing purposes (highly or non-highly) plus a matching contribution (if the employer made a match) and attributable earnings on the deferral and match amounts, for each plan year in which the employee was excluded.4 This puts each employee in the same position he or she would have been in had he or she not been excluded from the plan. Despite the costs of voluntary correction, going through the correction program is much more cost effective than having the plan defect discovered during an IRS audit because the IRS would impose a sanction in addition to requiring the employer to provide contributions and earnings for the excluded employees.

The 1,000 Hour Exception

Employers can continue to use certain class exclusions as long as the plan also provides that employees working at least 1,000 hours will be eligible to participate. For example, a plan requires one year of service for participation and excludes part-time or seasonal employees.

The plan further defines a part-time or seasonal employee as one who works less than 1,000 hours of service in an eligibility computation period. The QAB indicates that this is an acceptable class exclusion. Likewise, the QAB states that a plan provision that requires one year of service for participation and excludes hourly paid employees (those employees defined by the plan as receiving an hourly wage for their services) would not be challenged by the IRS because the plan is not excluding the hourly paid employees based on an age or service requirement.

Careful plan design can allow employers to accomplish their objectives while not running afoul of IRS guidance.
Notes 1. Employee Plans Determinations Quality Assurance Bulletin, Part-Time Employees Revisited, FY-2006 No.3, February 14, 2006. 2. Two years of service under § 410(a) (1) (B) (i). 3. QAB noted in endnote 1 above, citing Treasury Regulation § 1.410(a) (3) (e) (2), Example 3. 4. See Revenue Procedure 2003-44.

HARASSMENT – HOW TO PROTECT YOUR COMPANY AND YOURSELF

“I think I’m being harassed.” These words, spoken by an employee, strike fear into the hearts of most employers. Fear no more. This article will answer some common questions about harassment in order to provide you with the knowledge you need and empower you to properly react to a harassment situation.

What is harassment? While sexual harassment receives most of the attention, harassment claims based on other protected categories (such as religion, age, race, national origin or disability) are prevalent. For example, immediately after 9/11, claims of harassment on the basis of religion and national origin increased. Wisconsin law also recognizes sexual orientation as a protected characteristic. Employers and their managers must understand that it is not just about sex and that complaints of non-sexual harassment must be treated as seriously as sexual harassment claims.

Generally the courts refer to two types of harassment: “quid pro quo” or “hostile work environment.” Quid pro quo (this for that) refers to the obvious harassment such as a supervisor demanding sexual favors from a subordinate in order for the subordinate to keep his job. Hostile work environment is more nebulous and includes unwelcome physical or verbal conduct that is so severe or pervasive that it creates an intimidating hostile or offensive work environment. Examples of conduct that can constitute hostile work environment harassment are sexual advances, epithets, slurs, negative stereotyping,

threatening or intimidating acts, physical assault or written or graphic materials that denigrate or show hostility toward an individual or group based on a protected characteristic (sex, race etc.). In addition to hostile work environment and quid pro quo harassment, Wisconsin law also defines an additional type of sexual harassment: any type of unwelcomed verbal or physical conduct of a sexual nature by an owner, supervisor or manager. Under Wisconsin law, even one instance of inappropriate conduct by a manager in a position of authority can create liability for an employer.

I can't control my customers or vendors, can I? You can and you must. It is your responsibility as an owner to protect your employees from harassment, even if by outside parties. For example, if a restaurant's regular customer is sexually harassing a waitress, the restaurant must stop the harassment even if that means barring the patron from the restaurant. Similarly, if a truck driver who delivers to a company constantly refers to a warehouse worker using a racial epithet, the employer should contact the truck driver's employer and demand that the conduct cease or that another driver be assigned. If the trucking company refuses, the employer may have to cease doing business with that company.

If no one complains, I can ignore it, right? No. Because the law requires an employer to provide a harassment free environment, even if no one complains, you may need to take action if you observe harassing conduct in the workplace.

How should I protect my company from harassment claims? Create a compliance program. A compliance program sends a message to employees that you take harassment seriously and allows you to be prepared to handle harassment complaints. Your program should include:

- A written policy that prohibits harassment based on all protected categories, not only sex, and prohibits retaliation against anyone who complains about harassment
- A reporting mechanism by which individuals can report any harassment observed by or directed toward them. The reporting procedure must give employees at least two different people to whom they can report harassment (in case one of the people is the harasser)
- A training program for managers in which they learn about inappropriate behavior, their responsibility to comply with and enforce the policy and how to handle a harassment complaint
- Prompt response to all claims of harassment that includes an investigation procedure to be followed with all harassment complaints and provides follow up to the complaining party as to the outcome
- Consistent discipline for those who have committed harassment and for managers who fail to report or address harassment.

The Supreme Court has stated that these types of programs are a way for employers to protect themselves against employment claims. While you may not be able to stop

harassment from occurring, you must be able to deal with it in a prompt and effective way to end it.

How can I protect myself from third party harassment? As a business owner, you cannot sue another business for harassment. You can, of course, take your business elsewhere, demand to deal with someone different in the organization or “fire” the client or vendor. If the conduct rises to the level of an assault or battery, you would have legal recourse.

While harassment is a frightening issue for most employers, being prepared to address it is the best protection you can have for you and your company.