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CSI: Missing Participant

Connecting Retirement Plan Participants with Their Money

Given the dearth of savings, you would think job-hoppers would keep track of their 401k's and pensions left behind at their former employers. You would be wrong, however: the U.S. Department of Labor (DOL) believes that up to 7 percent of participants may have lost touch with their benefits. This is on top of the participants whose "small"—$5,000 or less—benefit was involuntarily rolled over to an individual retirement account (IRA) when they failed to respond to their former employer's request about what to do with their money. There are no established best practice guidelines, regulations, or user-friendly database for ongoing retirement plans and lost participants to reconnect. A recent General Accountability Office (GAO) report—*Workplace Retirement Accounts: Better Guidance and Information Could Help Plan Participants at Home and Abroad Manage Their Retirement Savings*—has drawn welcome attention to this festering problem. Fortunately, this is one that is easily solved.

Disappeared. Participants disappear for a number of reasons. They move, marry, divorce, and change their names without informing their former employers. Worse is when someone dies or becomes mentally incapacitated without leaving a record to help heirs and loved ones to track down benefits or even know that there is something to look for. Another problem is what the GAO calls communication overload: plan participants receive so many legally required, but lengthy and poorly worded notices, that they overlook the important stuff. And with spam and fraudulent come-ons cluttering everyone's mailboxes and smartphones, even real benefits information can be disbelieved.

On the flip side, employers can do a poor job of following-up on returned mail and other early warnings that a former employee has gone missing but may be still traceable without too much effort. Plus, over time, changing HR staff, plan advisors, and record-keepers, and sketchy records from acquired businesses, only compound the problem. Employers can disappear too after a sale, merger, or spin-off, making it extremely difficult for an individual who knows he or she has a benefit coming to locate the company now controlling the retirement plan.

No winners. All parties lose when a participant goes missing. Of course, the individual loses out on an earned benefit. Employers waste money on recordkeeping, compliance, and search costs, plus Pension Benefit Guaranty Corporation (PBGC) premiums if a pension plan is involved. Local government is harmed by providing support to seniors

who unknowingly have money stashed away in a forgotten plan. In other words, the unclaimed benefit does not provide a windfall to anyone.

Existing solutions. Currently, the government does not offer much help. Employers are required to report to Social Security when an employee leaves the company with a vested benefit. When that person eventually retires, Social Security sends a notice that he or she may be entitled to a benefit from a former employer. As anyone involved in benefits administration will tell you, Social Security's information is often stale, causing the employer to scurry around looking for records showing that the benefit was paid years ago. Social Security blames employers for not providing updates when a benefit is paid, while employers claim that Social Security does a terrible job of maintaining its database. I would guess that it is some of each.

The PBGC helps when a plan terminates by running a program to connect lost participants with their benefits. The plan sponsor provides the government with the person's benefits and contact information, pony's up to the funding, and leaves it to the PBGC to find the participant. However, it is not clear how hard the PBGC tries to find the participant or what its success rate is. Per recent legislation, the PBGC extended the lost participant program to terminating 401(k)s and other defined contribution (DC) plans. This new extension was launched last December and allows employers, after a "diligent search" and payment of a $35 fee, to transfer the lost participant's DC account to the PBGC. The voluntary DC program is too new to evaluate. Neither of the PBGC lost participant programs are available to a plan that is not terminating.

The IRS and Social Security Administration (SSA) used to help, for a fee, by forwarding benefit statements and employer letters to a participant's address on their respective systems. This useful service was canceled in 2012 due to costs. (The IRS will forward communications for "humanitarian" reasons—for example, when a parent is dying.)

DOL says. The DOL position is that plan administrators have a fiduciary duty to search for missing participants and beneficiaries, and may deduct the reasonable cost of the search from their accounts. The effort should be commensurate with the size of the benefit, with larger amounts requiring more effort and justifying higher out-of-pocket expenses. In Field Assistance Bulletin No. 2014-01, the DOL lists four steps that must be undertaken before giving up:

1. Send certified mail to the last known address;

2. Check all plan and employer records, including health and welfare programs;

3. Check with designated beneficiaries; and

4. Use free e-tools.

After that, employers should consider using commercial locator services, credit reporting companies, and other databases. If the participant is still missing, the sponsor should consider establishing an IRA in the participant's name to hold the benefit. The IRA would be invested in a "safe" capital preservation-type investment. Other possibilities, according to the DOL, include opening a bank account in the person's name and making a taxable distribution to the account (less than 20 percent required withholding) or allowing the benefit to escheat to the state.

Not recommended are forfeiting the benefit to be restored if the person shows up (the IRS allows this) or 100 percent income tax withholding: paying the entire amount to the IRS in the participant's name. Disturbingly, the GAO report concluded that the IRS does not routinely credit a lost participant with the taxes withheld on his or her plan distribution. Instead, the IRS expects the taxpayer to claim the withholding when filing a federal tax return—which, of course, will never happen, since the person does not know about the payment or withholding.

Partly in response to the GAO report, the DOL is conducting a nationwide plan audit to get a better measure of the problem. However, anecdotal evidence and my own practice show that the auditors can be both aggressive and inconsistent about how much effort is enough to meet the fiduciary obligations. Given the lack of guidance and accepted best practices, the DOL's attempts to enforce unwritten rules is neither helpful nor reasonable.

It's easy. Information technology and social media make this an easy problem to solve.

First, the IRS and SSA should be required to make their resources available in finding lost participants. Their combined database includes everyone who has filed a recent tax return, collected Social Security, enrolled in Medicare or Medicaid, or died in this country (they are notified when a death certificate is issued or is serviced by a funeral home). This combined database should ensure that every person who wants to be found *is* found. Of course, it will not help with folks who, for whatever reason, do not respond.

Second, the IRS should automatically credit a taxpayer with all withholding and notify a taxpayer if they did not claim all of the taxes withheld in their name on a tax return.

Third, the DOL should update its rules for the reasonable steps a plan sponsor should take in looking for lost participants. Agents should be instructed not to apply unwritten shadow regulations that they feel that employers should follow.

Finally, even with the best plan sponsor efforts, strong databases, and government cooperation, some folks either will not be found or will ignore all communications. The government should establish a voluntary pension and DC "lost and found" for both ongoing and terminated plans. (Note, a hastily crafted bill was proposed last month, mostly for the optics of appearing to do something, but it is a start.)

For pension benefits, the logical choice would be to expand the existing PBGC program. After going through established steps to locate missing participants, the employer should be able to transfer the benefit (fully funded under reasonably conservative actuarial assumptions) to the PBGC.

For DC plans, a sensible approach would be to either revive the myRA program or expand the federal Thrift Savings Plan to accept employer rollovers of lost participant accounts. By matching Social Security numbers, each person would have only one account, even if they have gone missing from more than one employer. The account could be invested in safe short-term treasuries for the first year or two. After that, it should be invested in an age-appropriate target-date fund offered under the Thrift Savings Plan. The target-date fund should provide superior returns and insulate the individual from what could be years, or perhaps decades, of inflation.

The pension and DC benefit lost and found would make it simple and easy for anyone to check whether they've "misplaced" a benefit while allowing employers to meet their fiduciary responsibilities and clean up their plans. Of course, some people will never show up, and their benefits could revert to the Treasury to cover the costs of the lost and found the program and, perhaps, shore up the PBGC single and multiemployer insurance programs.

With a little common sense and technology, it really should be easy to connect participants with their benefits. Alternatively, employers could insert a participant-locating chip in each departing employee's earlobe.

The views set forth herein are the personal views of the author and do not necessarily reflect those of the law firm with which he is associated.

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Who's Minding the Baby? ERISA Plan Governance Considerations

Leslie E. DesMarteau

Operating an employee benefit plan is anything but simple. Benefit plan fiduciaries face personal liability if they breach their fiduciary duties, and the last decade has seen a surge in Employee Retirement Income Security Act (ERISA)-related litigation. Employers should consider the overall design of their benefit plan governance and operational structures with care, and be thoughtful about the individuals and vendors chosen to operate and oversee those plans.

Section 402 of ERISA provides that, "Every employee benefit plan shall be established and maintained pursuant to a written instrument. Such written instrument shall provide for one or more named fiduciaries who jointly or severally shall have authority to control and manage the operation and administration of the plan."

As any person (un)fortunate enough to serve as an ERISA named fiduciary will quickly discover, operating and administering a benefit plan is much easier said than done. As the Supreme Court observed, "An employer that makes a commitment systematically to pay certain benefits undertakes a host of obligations, such as determining the eligibility of claimants, calculating benefit levels, making disbursements, monitoring the availability of funds for benefit payments, and keeping appropriate records in order to comply with applicable reporting requirements."[1]

Section 404 of ERISA requires that a fiduciary discharge his, her, or its duties "with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims." Since Sections 409 and 502(a)(2) of ERISA impose personal liability on fiduciaries who breach this duty of care, the stakes are high when an employer selects its benefit plan fiduciaries and administrative staff.[2] Furthermore, even leaving aside the overarching legal risks associated with poorly operated benefit plans, many employers spend a lot of time and money on their benefit plans with the specific goal of recruiting and retaining quality employees. If the people responsible for operating the plans

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do a bad job, the employer is much less likely to accomplish these goals.

Accordingly, an employer should consider its options carefully when designing its fiduciary governance structure. Individual fiduciaries, in turn, should understand their legal obligations and make thoughtful decisions when selecting administrative staff and outside vendors.

THE NAMED FIDUCIARY

A "named fiduciary" is "a fiduciary who is named in the plan instrument, or who, pursuant to a procedure specified in the plan, is identified as a fiduciary (A) by a person who is an employer or employee organization with respect to the plan or (B) by such an employer and such an employee organization acting jointly."[3] Historically, it has been common for the plan document to identify the sponsoring employer as the "named fiduciary."[4] Most "off the shelf" plan documents are still written this way, but this is often not the best practice.

The Employer as Named Fiduciary

When a plan identifies a company as the named fiduciary, that company needs to carry out its fiduciary duties through individual human beings. ERISA does not limit fiduciary responsibilities (and associated liabilities) to "named fiduciaries." Instead, Section 3(21) of ERISA imposes "fiduciary" status on anyone with discretionary authority or control over the administration of the plan, anyone with control over the management or disposition of plan assets, and anyone who renders (or is obligated to render) investment advice for a fee with respect to the plan's assets. Furthermore, both the Department of Labor and ERISA caselaw take the position that a person with authority to appoint or remove a fiduciary is *also* a fiduciary and has a fiduciary responsibility to act prudently in selecting and monitoring the performance of the appointee and to take corrective action if the appointee ceases to be a prudent choice to serve as fiduciary.[5]

Accordingly, since a company acts in the first instance through its board of directors or other governing body, designating a company as "named fiduciary" typically renders the members of that governing body fiduciaries. (For the sake of convenience, this article assumes that an employer's governing body is a board of directors and uses the appropriate terminology, but the analysis holds true regardless of the design of the governing authority.)[6] If no one else is appointed to carry out fiduciary functions, the board members have full fiduciary responsibility. If they appoint subordinate fiduciaries or delegate some

or all of their responsibilities, they still have the fiduciary obligation to monitor their chosen fiduciaries and designees. In addition, Section 405(c) of ERISA forbids a named fiduciary from delegating "trustee responsibilities" (i.e., responsibilities under the plan's trust agreement to manage or control the assets of the plan) to anyone other than the plan's trustee or an "investment manager" (i.e., a bank, insurance company, or registered investment adviser that has acknowledged fiduciary status).[7] Ultimately, this means that the directors need to devote appropriate time and attention to the operation of the plan and the investment of its assets, if they retain direct responsibility, or to the oversight of the individuals they have selected to carry out these responsibilities on the company's behalf.

In the case of a small company whose directors are directly involved in the day-to-day management of the business, this governance structure often makes sense. The directors are accessible and familiar with the company and its employees, and thus have the capacity and insight to discharge their duties to the plan. Furthermore, a small company (depending on its line of business) may not even have other individuals with the necessary skills to oversee the plans and plan vendors.

In the case of a public company, however, or of any other type of business with directors who do not have day-to-day involvement with the business, imposing fiduciary responsibilities on the directors subjects them to unnecessary risk[8] and may even hamper the proper operation of the plans. Scheduling meetings with administrative staff and vendors often prove complicated when directors must attend but are not onsite on a daily basis. In many cases, as well, the directors have so many other demands on their time and attention that it is too easy for benefit plans to receive short shrift. In these circumstances, saddling public company directors with fiduciary responsibilities not only gives a plaintiff in an ERISA lawsuit the leverage that comes from being able to sue the directors individually, it also presents a picture of plan fiduciaries who have not involved themselves in plan operations to the extent necessary to meet their ERISA responsibilities. That, in turn, leaves the fiduciaries exposed to liability if the plan has suffered losses they could have been prevented with proper oversight. If the plan invests in company stock, directors' access to material nonpublic information poses additional complications, as discussed later.

Accordingly, an employer needs to consider the desired identity of its named fiduciary carefully. If the plan document does not align with its preferences, it should ask its document vendor whether it can change those provisions. The plan document itself, by its terms, must identify the desired person or persons (or committee) as the named fiduciary. If the document names the company and the company (acting through its board or through someone to whom the board has delegated authority) then charters a benefits committee to operate the

plan or adopts resolutions delegating authority, the company (and its board) are still fiduciaries responsible for overseeing the appointed committee members or other individual(s).[9] In contrast, if the plan document identifies an employee or a set of employees (by name or title) to serve as named fiduciary, or states that a committee to be appointed by a specified person (identified by name or job title) will be the named fiduciary, then only those individuals are fiduciaries.[10]

Unfortunately, not all documents give an employer this level of flexibility. Although the IRS recently confirmed that revisions to a plan's administrative provisions will not affect a qualified retirement plan's ability to use an IRS-preapproved document,[11] and although IRS preapproval is not an issue for qualified retirement plans using individually designed documents, welfare plans, or nonqualified deferred compensation plans, some document vendors will not permit alteration of their documents' governance provisions. Even if a document can be amended, doing so may be time-consuming and cumbersome, if the document has numerous references to the employer in a fiduciary capacity that need to be adapted.[12] An employer will need to review its options with its document provider. Once a decision is made, the employer must make sure that anyone who has a "named fiduciary" role, or who will be acting on behalf of the company as named fiduciary, understands and carries out his or her responsibilities.

Who Should Be the Named Fiduciary?

If the company will not be the named fiduciary, whom should the company select to fill this important role? In most cases, an employer will establish one or more committees to serve as the plan's fiduciary(ies). A committee is preferable to identifying a single employee. The involvement of multiple employees prevents a single employee's departure from leaving a plan without an available fiduciary, and allows for continuity when individual fiduciaries leave the company or transition out of the fiduciary job. In addition, if an individual serving as sole fiduciary develops a dispute with the plan, resolving that dispute within the confines of the plan's governance structure may be difficult.

Number of Committees

Some companies use a single committee for all plans, while others may use a separate committee for health and welfare plans on the one hand, and retirement plans on the other, or even appoint separate committees for separate plans. Still other companies use one committee for benefits administration, and one or more other committees

for investment oversight. As a result, a plan may have more than one named fiduciary, each with a distinct role.[13] In some cases, different subsidiaries may establish separate committees. The size of the company, the complexity of its benefit arrangements, and the availability of personnel with desired skills will drive this decision; there is no single "best" approach.[14]

Identifying the Committee Members

The plan document may identify the individuals to serve on the committee, either by name or by job title. Normally, using job titles with language that allows for replacement of an identified title by someone holding a successor title or acting in the capacity of the named position is preferable, since it minimizes the need for frequent plan amendments and accommodates ordinary changes in company personnel. As a further refinement of this design, which is especially helpful for companies that change job titles frequently or that want flexibility in committee membership, a plan may identify one or two individuals as an "appointing fiduciary" empowered to appoint committee members in turn. For example, a plan document may call for the "Senior Vice President of Human Resources, or the person holding a successor title or acting in such capacity" to serve as appointing fiduciary and name the committee members.

Ultimately, an employer or other appointing fiduciary selecting individuals to serve on a committee should consider the following:

- Will the chosen individuals be able to meet with the desired frequency? Will they have enough time to prepare for meetings and carry out any responsibilities requiring their involvement between meetings?

- Do the chosen individuals have sufficient expertise to carry out their duties, taking into account the professional assistance that will be available to them?

- Do the chosen individuals understand the role the plan plays in the employer's business and the needs of plan participants?

As is the case with committee structure, the number of individuals serving on committees varies from company to company. Committee sizes most often range from three to five,[15] since that number generally is large enough to provide some redundancy and continuity in the case of routine personnel changes while being small enough to allow the scheduling of meetings with appropriate frequency. Except in the case of multiemployer plans required to have an equal number

of labor and management votes on the joint board of trustees, most employers favor an odd number of committee members, to prevent the risk of a deadlock. As a practical matter, however, fiduciary committees typically prefer unanimous consensus, and strive to resolve differences rather than to settle disputes by majority vote. Accordingly, having the right people on a committee generally is more important than the specific number.

Of course, if a plan document requires that a specific number of people be on the committee, the committee must operate accordingly. To prevent an unnecessary breach of the plan's terms, a plan whose committee members are not directly appointed by the plan document usually should avoid specifying the number of members, and at the least should authorize the committee's operations to continue notwithstanding a vacancy.

Role of Counsel

Some plans have the company's attorney serve as a member of the fiduciary committee. Although this provides the committee the advantage of legal expertise and helps to ensure the attorney is well informed about and engaged in the committee's activities, the attorney's presence will *not* convert committee meetings into privileged legal discussions. It is often preferable to have an employee benefits attorney attend meetings but not serve as a voting member, in order to avoid the potential for confusion between decisions made by an attorney-fiduciary in his or her fiduciary role and legal advice.

In addition, appointing the attorney as a committee member may pose complications for the attorney's role as counsel. An attorney serving as a voting member may be unable to represent the plan or company should disputes arise regarding the committee's activities. This is less of a concern if the lawyer in question is one member of a legal department with others capable of taking on this role than it may be for a sole general counsel or an outside law firm, but still can present an inconvenience in the event of litigation.

Furthermore, if the plan has employer stock, an attorney-fiduciary may face a conflict between ERISA obligations and insider-trading restrictions, as discussed later, or between his or her fiduciary obligations to the plan and his or her obligations to the company as its attorney. For example, if the attorney has been consulted by corporate management because concerns have arisen regarding the accuracy of the company's securities filings, the attorney's view of the best course of action for the company may not align with the best interests of the plan.

Regardless of whether counsel is simply in attendance or is acting as a member, the attorney and all the committee members and other meeting attendees should be aware of the limitations of attorney-client

privilege in the benefit plan arena.[16] For the most part, activities and discussions related to fulfillment of the committee's fiduciary role are not privileged, at least not as against the plan participants and government regulatory agencies representing their interests. Courts typically subject these functions to the "fiduciary exception" to the attorney-client privilege.[17] In contrast, legal advice connected to plan design decisions[18] and/or to potential fiduciary liability[19] generally will be privileged. Disputes with individual participants (or classes of participants) may at some point in their development become entitled to privilege, although courts vary as to the circumstances in which privilege will attach.[20] And of course, as always, a communication is not privileged unless it is a *confidential* communication that was *intended to provide (or enable the attorney to provide) legal advice to a client*.[21] Other types of communications are not privileged, and neither are communications that are not kept confidential. Likewise, underlying facts do not become privileged simply because they are shared with a lawyer.

The committee members also need to bear in mind that even when the attorney is acting as an attorney, the attorney typically is acting as counsel to the company and/or the plan. As such, the attorney may provide legal advice to the members for the benefit of the company with respect to the members' employment duties, or to the members in their fiduciary capacities for the benefit of the plan. In contrast, the attorney normally does not represent the members themselves. Should concerns about individual liability arise, the members may need their own counsel.

Who Should Be the Appointing Fiduciary?

Deciding on the appropriate person to serve as appointing fiduciary involves a similar analysis to the approach outlined above for selecting committee members. The appointing fiduciary should have the time, availability, and expertise to evaluate the qualifications of potential committee members and oversee their performance of their duties.

In some cases, the appointing fiduciary may appoint himself or herself to the committee, or attend committee meetings some or all of the time as an observer. In other cases, the appointing fiduciary may attend an occasional meeting, or oversee committee performance by written or oral reports. Regardless, however, the appointing fiduciary should be sure the committee maintains a record of his or her oversight activities in its files. Busy fiduciaries often overlook the need for documentation, but documentation will be essential if the appointing fiduciary ends up as the defendant in a lawsuit accusing him or her of failing to monitor the committee.

Special Considerations for Plans with Employer Stock Investments

Investing in employer stock poses special hazards for plan fiduciaries. If the stock price drops (even temporarily), plan fiduciaries may be sued for having failed to protect plan participants.[22] If the stock price rises significantly after a divestiture of some or all of the plan's stock, fiduciaries can be sued for having deprived participants of the opportunity to share in the price improvement.[23]

Insider Information

If a plan invests in employer stock, ensuring that board members, senior officers, and other individuals likely to have inside information regarding the employer's business are *not* plan fiduciaries can help prevent potential conflicts between ERISA's requirement that fiduciaries act prudently in the participants' exclusive interest, on the one hand, and insider trading rules, on the other hand. Recent caselaw in the wake of the Supreme Court's *Fifth Third Bancorp v. Dudenhoeffer*[24] and *Amgen Inc. v. Harris*[25] decisions has set an extremely high bar for plaintiffs seeking to hold fiduciaries accountable for non-use of insider information—a bar that plaintiffs have yet to clear in a case involving a public company, although that has not stopped plaintiffs from trying.[26]

Avoiding situations in which fiduciaries have insider information not only avoids placing fiduciaries between the rock of ERISA obligations and the hard place of insider trading prohibitions, it also removes this claim from plaintiffs' toolbox. If the fiduciaries did not know the problematic inside information, there is no need to debate whether they could have done something in response to it that, as *Amgen* requires, would not have done "more harm than good." In addition, avoiding fiduciary roles for these individuals helps prevent high-ranking officers and directors from facing a conflict between the company's best interests for investor relations and long-term survival and the plan's best interests. Finally, avoiding fiduciary status means that a company officer or director who does find himself or herself in the crosshairs of a securities investigation or lawsuit will not also need to defend an ERISA claim regarding the alleged disclosure violations and associated actions or inactions.

Private Companies

Private companies are not subject to the insider trading rules that govern public companies, so they do not face the same level of concern in connection with insider knowledge. They also often lack qualified individuals to serve as fiduciaries who are not intimately familiar with the business' projected performance. However, senior management

members serving as fiduciaries may encounter situations where their personal interests or those of the business conflict with the plan's. Accordingly, as always, the fiduciaries must be careful to understand the constraints under which they have to operate. If conflicts of interest are unavoidable, the plan's named fiduciaries may need or want to hire an independent fiduciary.

In assessing the risks associated with employer stock investments, fiduciaries of private-company plans with stock should also bear in mind that recent caselaw following the Supreme Court's *Dudenhoeffer* decision may not offer them the same level of protection it has offered to public companies. The *Dudenhoeffer* decision was premised on the efficient market hypothesis, and asserted that "where a stock is publicly traded, allegations that a fiduciary should have recognized from publicly available information alone that the market was over- or undervaluing the stock are implausible as a general rule, at least in the absence of special circumstances."[27] Subsequent public company cases have largely equated accurate pricing of the stock via the market with a finding that investment in the stock at that price with retirement plan assets was prudent.[28] Private companies by definition do not trade in an efficient market. Hence, private company fiduciaries cannot rely on the argument that the market confirmed the value of the stock held by the plan and that, *ipso facto,* investment at that price was prudent. Although some courts have nonetheless taken a *Dudenhoeffer*-type approach to at least some aspects of ERISA challenges to private company employee stock option plan (ESOP) transactions,[29] the scope of fiduciary responsibilities in this context remains at best debatable.

Aligning the Documentation

As noted above, the employer must draft its plan document to reflect its chosen named fiduciary. Contradictory provisions that place fiduciary responsibilities with the employer, the employer's board, or other people whom the employer does not intend to function as fiduciaries expose the relevant people to the risk of fiduciary liability.[30] A plaintiff can point to those clauses of the plan document and assert that the relevant person should be liable for having failed to discharge the stated function.

In addition, the employer and the plan fiduciaries will need to review other documents associated with the plan and make sure those documents, in turn, are consistent with the desired fiduciary structure. Frequently affected documents include:

- Summary plan description
- Trust agreement

- Insurance contracts
- Service agreements
- Informal plan communications, such as enrollment materials and "highlights" brochures

In many cases, insurance and service agreements form a major stumbling block. While it is acceptable (and often necessary) for the employer in its role as plan sponsor to be a party to these documents, the employer's role should be expressly limited to plan sponsor functions (such as plan amendment/termination and the provision of employment data from its records) and indemnification of the vendor. Fiduciary functions, such as approval of the vendor's terms of service, fees, and termination of the agreement, must be the responsibility of the relevant plan fiduciary. If it is not possible for the employer to negotiate a contract that reflects these limitations, the employer should at least seek to include a "patch" in the plan document confirming that any fiduciary functions assigned to the employer by the plan's various contracts may be exercised only at the direction and as the agent of the proper plan fiduciary.

PLAN ADMINISTRATOR

Section 3(16) of ERISA and Section 414(g) of the Internal Revenue Code of 1986 as amended (the Code) state that the plan administrator is the person named as such "by the terms of the instrument under which the plan is operated," and that in the absence of a named administrator, the plan sponsor is the administrator. The "plan sponsor," in turn, is the employer or, in the case of a multiemployer plan with a joint labor-management board of trustees, the joint board.

Employers often make the error of assuming that their insurance company, recordkeeper, claims administrator, or third-party administrator is the "plan administrator." This is a logical supposition; typically, one of these vendors operates (i.e., in ordinary English, "administers") the plan on a day-to-day basis. In a small minority of cases, this supposition is even correct, since some consultants and recordkeepers will offer (for an appropriate fee) to serve as the official "plan administrator." In most cases, however, a cursory read of the vendor's contract will generally turn up an express disclaimer of "plan administrator" status. These vendors perform only the "ministerial" tasks of plan operation, following the instructions of the plan document and the plan's official plan administrator and named fiduciary(ies).[31] "[A] person who performs purely ministerial functions … within a framework

of policies, interpretations, rules, practices, and procedures made by other persons is not a fiduciary because such person does not have discretionary authority or discretionary control respecting management of the plan, does not exercise any authority or control respecting management or disposition of the assets of the plan, and does not render investment advice with respect to any money or other property of the plan and has no authority or responsibility to do so."[32]

In contrast, the plan administrator is a plan fiduciary by definition.[33] Accordingly, a person empowered to appoint or remove the "plan administrator" also automatically is a fiduciary. Anyone serving as plan administrator or appointing the plan administrator (or the members of a committee serving as plan administrator) needs to operate in accordance with ERISA's standard of prudent care.

In addition to the general risk of liability applicable to all fiduciaries, the plan administrator can be assessed a variety of civil and/or tax penalties if he, she, or it fails to discharge certain statutory obligations. For instance, under Section 502(c) of ERISA, failure to respond in a timely fashion to a participant document request can generate penalties of up to $110 a day. As another example, the maximum penalty for failure to file Form 5500 currently stands at $2,140 per day.

Choosing the Plan Administrator

As in the case of the named fiduciary, most "off-the-shelf" documents provide for the employer to be the plan administrator. In contrast to the more limited design options often available for the named fiduciary, however, many allow an employer to write in an overriding designation of someone else as plan administrator.

For the most part, the decision of who should serve as plan administrator follows the same analysis that applies to the selection of a named fiduciary. Indeed, for the vast majority of plans, the plan administrator and the named fiduciary are the same person. There is, however, one potentially significant additional consideration. Since most courts have agreed that the statutory penalties discussed above for failure to discharge various plan administrator duties apply *only* to the plan administrator, and *not* to individuals empowered to appoint or remove the plan administrators or subordinates to whom the ministerial aspects of plan administration have been delegated,[34] there is some advantage to having the employer entity serve as plan administrator. With the business entity as the named plan administrator, individuals are protected from these potential liabilities.

However, if the employer opts to name itself as plan administrator, the individuals who carry out its fiduciary duties as plan administrator, and those individuals with the power to select those individuals, are

plan fiduciaries subject to personal liability under Sections 409 and 502(a)(2) of ERISA. This rule, therefore, brings the board of directors back into the fiduciary chain of command and back into potential exposure to fiduciary breach litigation and liability. If the plan holds employer stock, involvement by corporate insiders also raises the risk of ERISA claims attaching to what are intended to be corporate disclosures. For this reason, naming an individual or committee as plan administrator and providing for appropriate protection against penalties arising from error or ignorance (as opposed to misconduct) with indemnity and insurance generally is preferable for large companies (especially those offering investment in employer stock) and any other organization whose board is unsuited or unwilling to engage with plan operations.

Naming the Plan Administrator

As was the case for an employer seeking to designate an individual or committee as named fiduciary, the employer needs to be sure that all provisions of the plan document are consistent with the selected plan administrator's status as such. In addition, the plan administrator must be identified in the summary plan description, on Form 5500 (which will typically require obtaining an employer identification number for the plan administrator), and in various plan communications. Many vendors simply assume that the employer is the plan administrator and complete these documents accordingly. The employer's staff should proofread all filings and communications in any event. As part of that process, they should check that plan administrator contact information is accurate.

OUTSOURCING

Even the very largest employers blessed with sizeable in-house benefits departments outsource some aspects of benefit plan administration, such as actuarial functions, software design, investment platforms, and (of course) any required independent audits. Small employers usually outsource the vast majority of plan functions, and many large employers do so as well. Often, outsourcing not only is permissible, it is more cost-effective and/or efficient. For example, unless an employer is itself in the business of operating 401(k) plans, it would not be efficient (and in most cases, would not be possible) for the employer to construct its own 401(k) platform with daily traded investments, daily valuations, distribution processing capabilities, and so forth. Likewise, selecting an institutional trustee offers a

variety of protections and conveniences not available if an individual employee acts as trustee. Nonetheless, the plan's fiduciary in charge of the relevant plan function must make a thoughtful decision about what work should or must be performed in-house, and must select a cost-effective, qualified vendor for any work it decides to outsource.

Selecting a Vendor

While the fiduciary need not select the cheapest vendor if it feels that a different vendor offers a higher level of quality, additional services, or other advantages that justify a higher price,[35] Section 408(b)(2) of ERISA prohibits a plan from paying in excess of a reasonable price. Accordingly, fiduciaries must determine what constitutes a reasonable price.

For relationships that involve significant costs, long-term services, or otherwise are material to the plan's operations, the fiduciary typically should conduct a formal Request for Proposal process. Plan designs, fiduciary and sponsor priorities, plan demographics, and other factors vary widely among plans, and a Request for Proposal is usually the best way to facilitate an apples-to-apples comparison among vendors and identify arrangements suited to the specific plan.

Indeed, the Request for Proposal process does much more than lay the groundwork for a defense against charges that a fiduciary overpaid for a service or negligently selected an incompetent vendor. The process gives the fiduciary a chance to meet the vendor, think about desired services in detail, and gain comfort that he or she is selecting someone who will provide a positive working relationship. In many cases, a plan could obtain adequate, cost-effective service from more than one vendor, and will find various combinations of services and support on offer. A formal Request for Proposal process maximizes the odds that the fiduciary will identify the vendor with the combination of pricing, services, and personnel that best meets the needs of the fiduciary's particular plan and participants. Often overlooked, but very important in the long run, the process will also give the *vendor* the opportunity to set an appropriate price. While plan fiduciaries need to be cautious not to overpay, underpaying a vendor can result in poor service, fraught interactions, and the resulting need to make a disruptive vendor change sooner than the fiduciary would otherwise have hoped. Generally, the interests of plan participants are best served when a relationship is fair to all parties involved.

However, fiduciaries should balance the desire for comprehensive data against the time and expense of a Request for Proposal process, consider the extent to which vendors are willing to bid, decide which vendor relationships merit this effort, and consider how often the

process should take place. Even if a full Request for Proposal process is not practical, a fiduciary who is selecting a new vendor typically can obtain at least a few competing bids or engage in some other form of price and service benchmarking. The fiduciary also should establish a schedule for periodically benchmarking existing relationships to see if a Request for Proposal or some other more in-depth form of benchmarking is warranted. There may be some exceptions to this rule of thumb, but the fiduciary should start from this premise and document any decision that a Request for Proposal or other benchmarking process is not necessary.

Questions to Consider

When interviewing vendors and negotiating service contracts, the key points for discussion are, of course, services (or products, as the case may be) and price. For example, a fiduciary hiring a medical insurer wants to know what medical products and services are covered and what the premiums will be. A fiduciary hiring a 401(k) plan recordkeeper wants to know what plan investment options will be available; whether the recordkeeper will perform functions such as service tracking, contribution calculation and distribution issuance; and how much the plan will have to pay. However, plan fiduciaries should also bear in mind the same sorts of questions that any businessperson entering into a contract will want to address, such as:

- Indemnification clauses (in favor of and against the vendor)
- Dispute resolution and forum selection clauses
- Confidentiality
- Cybersecurity
- Quality control metrics (and penalties if established benchmarks are not met)
- Amendment clauses, particularly any provisions that give the vendor the right to unilaterally change key terms[36]
- Termination clauses, especially provisions that allow the vendor to terminate the agreement on short notice and perhaps leave the plan in the lurch or, conversely, clauses that may violate ERISA's prohibition on excessively lengthy contractual commitments[37]

- Situations likely to generate extra fees, details of how those fees are calculated, and provisions for alerting the fiduciary before extra fees are incurred

In-House Staff, Products, and Services

Even if an employer has outsourced the bulk of the plan administrative responsibilities, some level of employer interaction still will be necessary. For example, in most cases, a vendor will not know when an employee has been hired or terminated unless an employer contact person provides this information. Furthermore, the employer-fiduciaries who selected the vendors remain responsible for monitoring the quality of their performance and taking corrective action as needed. For long-term relationships, the employer-fiduciaries periodically need to reassess the reasonableness of pricing and the suitability of the overall relationship. Accordingly, the employer must be sure that any staff members working with the plans are familiar with their responsibilities under the law and under the specific terms of the employer's plans. That means, among other things, that staff should have copies of and actually read the plan documents, and should undergo appropriate training.[38]

Businesses engaged directly in the benefit plan industry face special considerations. While they have the advantage of in-house expertise, they also have the potential for conflicts of interest. To the extent that the business provides products and services to its own plan, it must be sure to operate within the confines of ERISA's "prohibited transaction" rules.[39] To provide a very basic description of very complicated rules, the "prohibited transaction" rules generally prohibit anyone affiliated with a plan sponsor, service provider, or fiduciary from dealing with plan assets for his/her/its own benefit, from exercising fiduciary discretion for his/her/its own benefit, and from engaging in transactions with the plan except within specified parameters. The upshot of these rules is that employers generally cannot profit by providing services or products to their own plans, although they can in most cases provide the service or product at cost. A person who violates these rules can be required to reimburse the plan for any costs or losses associated with the transaction, disgorge any profits, and pay an excise tax.[40]

Some exceptions apply. For example, a financial company is permitted to offer its own mutual funds in its plan and receive its usual management fee from the fund, so long as it adheres to certain safeguards and the mutual fund offering otherwise satisfies ERISA's standards of prudence.[41] However, if an exception is not available, the company must be careful that in-house service or product arrangements do not include a profit component. In addition, as in the case

of the mutual funds discussed earlier in this paragraph, the fiduciaries must make sure that their selection of the company's in-house offering is objectively prudent and that any costs reimbursed by the plans are reasonable.

When reimbursing company costs, regardless of whether the company is offering the plan a service that it offers to the general public or providing a special service through dedicated in-house benefits resources, the fiduciaries need to bear in mind that the plan can pay only "direct expenses" and cannot reimburse for "overhead" costs that the company would have incurred in any event.[42] For example, if benefits staff occupy three offices in the company's building, the company cannot charge the plan for a proportional amount of the building rent, mortgage payment, or maintenance costs. However, the Department of Labor has ruled that a company can bill the plan for salary costs associated with employees dedicated to a benefit plan that it would not employ if they were not providing services to the plan.[43] An employer considering taking advantage of this rule should be familiar with the Department's guidance in this area and proceed carefully, since the consequences of violating the prohibited transaction rules can be extremely expensive.

PLAN SPONSOR FUNCTIONS

The discussion to this point in the article has focused on fiduciary functions and the ministerial operational functions carried out under fiduciary oversight. However, an employer should also consider who will make decisions and take action on behalf of the business as sponsor of the plan. When making decisions as the sponsor (or settlor) of the plan, the employer is *not* subject to ERISA's fiduciary responsibilities and can act in its own business interests.[44] Nonetheless, any action must be taken by someone properly authorized to act on behalf of the organization and align with the amendment procedures specified by the plan document.[45] Failing to adhere to the proper governance procedures could lead to disapproval from officers or board members, shareholder discontent and litigation, or invalidity of important (and potentially expensive) plan actions.[46] For example, if the company's chief executive officer takes action to freeze a pension plan but was never authorized by the board of directors to do so, a participant may be able to challenge that action years later and force retroactive reinstatement of pension benefit accruals.

In deciding who should be empowered to make what decisions, a company will need to consider any state law rules not preempted by ERISA, its governing documents, and its particular needs and culture. For example, a large public company will not want to have to seek

formal board approval to increase the number of days per covered hospital stay under its medical plan, but may want to be sure that officers cannot terminate a multibillion-dollar pension plan or adopt a retiree medical benefit program without approval from the board or the board's compensation committee. In that case, the board might delegate the ability to make changes that do not exceed a specified cost level to one or more officers, but reserve to the board or its compensation committee the authority to make changes above that level as well as any actions dealing with certain types of plans or benefits that present particular concerns for that company.

Whatever governance structure a company selects, it should document any delegations of authority. The company also needs to make sure that actions taken are duly authorized in accordance with those delegations and that it retains documentation of the approval. Depending on the company's process, documentation may include signed amendments, board minutes or resolutions, or some other form of paperwork. In this regard, the employer should bear in mind that health and welfare plans are also "plans," and not reserve the formalities just for the retirement plans. The employer will also need to pay attention to any communications it receives from its plan document vendors. Amendments to plan documents often need to be approved by specific deadlines, and documentation of that approval must be retained in the plan's files.

CONCLUSION

The decision to establish a plan is never one to make lightly, and the choices and requirements only get more complex as the plan becomes operational. Thinking carefully about how the plan will operate and who will do the operating is essential to protect the employer and its employees who oversee the plan, as well as to enable successful provision of the intended plan benefits.

NOTES

1. *Fort Halifax Packing Co. v. Coyne,* 482 U.S. 1, 9107 S. Ct. 2211, 2216, 96 L. Ed. 2d 1, 10 (1987).

2. *See, generally,* Jacklyn Wille, "Employee Benefit Class Settlements Gleaned Over $500 Million in 2017," *Pension & Benefits Daily* (January 23, 2018).

3. Section 402(a)(2) of ERISA.

4. Multiemployer plans, typically required by law to be operated by a joint board of labor and management trustees, constitute the major exception to this historical practice of having a sponsoring employer serve as named fiduciary.

5. 29 C.F.R. 2509.75-8 Q&A D-4; *see, for example, Johnson v. Couturier*, 572 F.3d 1067 (9th Cir. 2009) (directors who have responsibility to appoint and remove ERISA trustees are fiduciaries, albeit only with respect to those functions); *Carr v. Int'l Game Tech.*, 770 F. Supp. 2d 1080 (D. Nev. 2011) (merely overseeing plan communications does not impose fiduciary status, but authority to appoint fiduciaries made directors fiduciaries); *c.f. Perez v. Bruister*, 823 F.3d 250 (5th Cir. 2016) (asserting that Fifth Circuit has not acknowledged "failure to monitor" liability but merely allowed the possibility of *respondeat superior* liability for knowing and active participation in an agent's breach); *In re BP P.L.C. Sec. Litig.*, No. MDL No. 4:10-MD-2185, 2015 U.S. Dist. LEXIS 147819 (S. D. Tex. Oct. 30, 2015) (confirming that plan sponsorship did not confer fiduciary status and denying appointing-fiduciary status arising merely from appointment of employees to employment roles that included plan responsibilities; denying that Fifth Circuit's heightened standard for *respondeat superior* in ERISA cases had been met when alleged superiors had not knowingly or actively participated in alleged breach or exercised requisite control over agent and noting that for the most part sufficient involvement to enable a claim of *respondeat superior* will occur only when superior is also itself a fiduciary); *Howell v. Motorola, Inc.*, 337 F. Supp. 2d 1079, 1092–1094 (N.D. Ill. 2004) (allowing claim against directors with appointment authority for failure to monitor; but holding that plaintiffs had not adequately alleged that company had such a role and hence had not adequately alleged that it was as a fiduciary; going on to permit on a preliminary basis a theory of *respondeat superior* liability against company itself; surveying cases on *respondeat superior* theory in ERISA context and noting division of authority on its viability).

6. In some cases, an entity's governing authority may be another entity. For example, a subsidiary may be a single-member LLC with a corporate member authorized to act as its manager. In that case, the fiduciary responsibility (and liability) keeps moving up the chain of command until it reaches individual humans.

7. Section 3(38) of ERISA.

8. *See* Lars C. Golumbic, *Who May Sue You and Why: How to Reduce Your ERISA Risks, and the Role of Fiduciary Liability Insurance (A Chubb Special Report)* (June 2017) (visited February 9, 2018), <*https://www2.chubb.com/us-en/_assets/doc/170101202-erisa-risks-&-role-of-fiduciary-liability-insurance-07.17.pdf*>; John J. Cannon III and Kenneth J. Laverriere, "Just Say No: Why Directors Should Avoid Duties That Will Subject Them to ERISA," *Pension & Benefits Reporter*, Vol. 42, No. 9, 475–477.

9. *See* Cannon and Laverriere, *supra* n.8.

10. *See, for example*, cases discussed *supra* n.5, especially *In re BP P.L.C. Sec. Litig.*; *Houssain v. Chenault*, 15 Civ. 8184 (PGG) (S.D.N.Y. September 28, 2017). <*https://www.bloomberglaw.com/public/desktop/document/Houssain_v_Chenault_et_al_Docket_No_115cv08184_SDNY_Oct_16_2015_C/1?1517700922*>.

11. Revenue Procedure 2017-41, 2017-29 I.R.B.

12. It has become more common in recent years for document vendors to acknowledge the growing demand for governance structure flexibility by using a "fill-in-the-blank" definition for the "named fiduciary" rather than automatically naming the sponsoring employer. However, many vendors do not carry this concept through the complete document. The documents often retain problematic references to an employer performing fiduciary functions (such as references to a plan's investment options being selected by the employer), or refer to the employer as "delegating authority to" or "appointing" the named fiduciary. In other cases, documents may simply be unclear about who one or more fiduciaries are and how they are appointed,

meaning that the employer needs to interject itself into the fiduciary identification process as a matter of practicality. Therefore, an employer seeking to clarify its governance structure needs to have ERISA counsel conduct a thorough review of the plan document.

13. Pursuant to Section 405 of ERISA, if specific fiduciary duties are allocated to different fiduciaries, each fiduciary generally will be liable only for the duties allocated to it. In those circumstances, a fiduciary will be liable for a breach of duty by a co-fiduciary only if the second fiduciary participates knowingly in, or knowingly undertakes to conceal, the breach, enables the breach by his/her own breach of duty, or knows of a breach and fails to make reasonable efforts to remedy the breach.

14. *See, for example, Unlocking Value from Effective Retirement Plan Governance: The 2016 Willis Towers Watson U.S. Retirement Plan Governance Survey* (2016) (visited February 3, 2018), *<https://www.willistowerswatson.com/en/insights/2016/05/strategies-in-retirement-plan-governance>*.

15. *See 2016 Willis Towers Watson U.S. Retirement Plan Governance Survey, supra* n.14, at 6 (average committee size 4.7).

16. *See, generally,* Leslie E. DesMarteau, "Employee Benefits Exceptions to Attorney-Client Confidentiality (and the Exceptions to the Exceptions)," *Benefits Law Journal*, Vol. 23, No. 3 (Autumn 2010).

17. *See, for example, Washington-Baltimore Newspaper Guild, Local 35 v. The Washington Star Company,* 543 F. Supp. 906, 910 (D. D.C. 1982).

18. *In re Long Island Lighting Co.*,129 F.3d 268, 272 (2d Cir. 1997).

19. *See U.S. v. Mett*, 178 F.3d 1058 (9th Cir. 1999).

20. *C.f., for example*, *Geissal v. Moore Medical Corp.*, 192 F.R.D. 620 (E.D. Mo. 2000) and *Tatum v. R.J. Reynolds Tobacco Co.*, 247 F.R.D. 488 (M.D. N.C. 2008).

21. *See Upjohn Co. v. U.S.*, 449 U.S. 383, 389, 101 S. Ct. 677, 66 L. Ed. 2d 544 (1981).

22. *See, for example, Fifth Third Bancorp v Dudenhoeffer*, ___US___, 134 S. Ct. 2459, 189 L. Ed. 2d 457 (2014); *see, generally,* Corey Rosen, "The Year in Employer Stock Litigation," *Pension & Benefits Reporter* Vol. 44, No. 46 1387 (November 21, 2017) (reviewing a number of cases; while the article notes that "stock drop" claims have generally been unsuccessful, readers should bear in mind that all of these resulted in expenditure of defendants' time and money, and no doubt caused significant stress for individual fiduciaries).

23. *See, for example*, *Tatum v. RJR Pension Inv. Comm.*, 761 F.3d 346 (4th Cir. 2014) (this ruling represents one decision in a long-running lawsuit involving the fiduciaries' sale of R.J. Reynolds stock while the stock price was at a low point); Jacklyn Wille, *Wawa* Inks $25M Deal in Challenge to Forced Stock Sell-Off, Pension & Benefits Reporter Vol. 45 No. 2 49 (January 9, 2018).

24. *Fifth Third Bancorp v. Dudenhoeffer*, ___ U.S.___, 134 S. Ct. 2459, 189 L. Ed. 2d 457 (2014).

25. *Amgen Inc. v. Harris,*____ U.S. ____, 136 S. Ct. 758, 193 L. Ed. 2d 696 (2016).

26. *See, for example,* Rosen, *supra* n.22; Jacklyn Wille, *HP Scores 9*th *Cir. Win in Challenge to Stock in 401(k) Plan*, Pension & Benefits Reporter Vol. 45, No. 3 13 (January 16, 2018) (collecting list of cases recently resolved in favor of employers).

27. *Dudenhoeffer*,*supra* n.24, 134 S. Ct. at 2471.

28. *See*, for example, *Rinehart v. Lehman Bros. Holdings Inc*., 817 F.3d 56 (2d Cir. 2016).

29. *See Hill v. Hill Bros. Constr. Co.,* No. 3:14CV213-SA-SAA, 2016 U.S. Dist. LEXIS 40225 (N.D. Miss. Mar. 28, 2016); *Fish v. Greatbanc Tr. Co*., No. 09 C 1668, 2016 U.S. Dist. LEXIS 137351 (N.D. Ill. September 1, 2016).

30. *In re BP P.L.C. Sec. Litig*., *supra* n.5, the plaintiffs pointed to an investment management agreement as demonstrating the company's fiduciary status. The defendants explained that the investment management agreement was outdated, and that the company no longer had fiduciary status. The court concluded that there was no evidence that the plan sponsor had in fact acted as a fiduciary, that the investment management agreement was not a governing plan document, and that subsequent amendments reflected the proper fiduciary authority (i.e., the investment committee named by the plan document). Accordingly, the court dismissed the claims. However, the defendants could have avoided this risk by updating their documentation in the first place.

31. To the extent a vendor has actual authority to decide claims without recourse to a final decision from the employer, the vendor will be a fiduciary for that purpose. This commonly arises in connection with insurance companies deciding claims under their insurance policies, and with claims administrators for self-insured welfare plans if the employer has not reserved the authority to override the vendor. These claims vendors are not, however, general-purpose plan administrators.

32. 29 C.F.R. 2509.75-8 Q&A D-2.

33. 29 C.F.R. 2509.75-8 Q&A D-3.

34. *See, for example,*, *Caffey v. Unum Life Ins. Co*., 302 F.3d 576 (6th Cir. 2002) (insurance company not plan administrator; not liable for penalties); *McKinsey v. Sentry Ins*., 986 F.2d 401 (10th Cir. 1993) (claim could not be asserted against entity that was not "plan administrator").

35. The US Department of Labor has confirmed that fees should not be considered in a vacuum, since fees "are only one part of the bigger picture including investment risks and returns and the extent and quality of services provided." *A Look at 401(k) Fees*, (August 2013), p. 9 (visited February 10, 2018) <*https://www.dol.gov/sites/default/files/ebsa/about-ebsa/our-activities/resource-center/publications/a-look-at-401k-plan-fees.pdf*>.The Department require that a warning to this effect be included in disclosures to participants regarding defined contribution plan fees (*see* 29 C.F.R. 2550.404a-5(d)(1)(iv)(4)).

36. Clauses of this type require careful review. A vendor that gives itself the right to change its fees or other key contract provisions unilaterally without a realistic right for the plan fiduciary to end the contract before the alterations take effect may have converted itself into a plan fiduciary (at least if it actually exercises that right) and may therefore have committed a cardinal ERISA sin. Section 406 of ERISA prohibits plan service providers and in particular fiduciaries from dealing with plan assets for their own benefit, and a fiduciary that has just set its own fee has in most cases violated that prohibition. *See* 29 C.F.R. 2550.408b-2(e).

37. 29 C.F.R. 2550.408b-2(c)(3).

38. Department of Labor auditors may inquire about the adequacy of education for fiduciaries and staff.

39. Sections 406–408 of ERISA. Section 4975 of the Code also imposes excise taxes on "disqualified persons" who violate the prohibited transaction rules.

40. *See* Sections 409 and 502(a)(2) of ERISA; Section 4975 of the Code.

41. *See* PTE 1977-03, 42 Fed. Reg. 18734 (April 8, 1977). While the exemption means that proprietary mutual funds can be included as plan investments without violating the prohibited transaction rules, a company ignores the "prudence" caveat at its peril. Numerous fund companies recently have been or currently are the subject of lawsuits alleging that they loaded their plans with proprietary overpriced, underperforming funds. *See* Carmen Castro-Pagan, *Huntington Bancshares, Execs Sued Over High Fees in 401(k) Plan*, Pension & Benefits Reporter Vol. 45 No. 2 53 (January 9, 2018) (discussing allegations that Huntington Bancshares filled the company's 401(k) plan with "high-fee, poorly performing in-house funds" and listing other recent lawsuits against other financial companies making similar allegations).

42. 29 C.F.R. 2550.408c-2(b)(3).

43. Department of Labor Advisory Opinion 1993-06A (March 11, 1993).

44. *Lockheed Corp. v. Spink*, 517 U.S. 882, 116 S. Ct. 1783, 135 L. Ed. 2d 153 (1996).

45. Section 402(b)(3) of ERISA requires that a plan include a procedure for amending the plan document and identify the person(s) with amendment authority.

46. *See Eckert v. Chauffeurs, Teamsters & Helpers Local Union 776 Profit Sharing Plan*, No. 1:15-CV-1920, 2018 U.S. Dist. LEXIS 12533 (M.D. Pa. Jan. 26, 2018); (finding that plaintiffs had submitted adequate documentation that union executive board in fact approved amendment); *Johannssen v. Dist. No. 1 - Pac. Coast Dist., MEBA Pension Plan*, 136 F. Supp. 2d 480 (D. Md. 2001) (finding that amendment was valid under amendment procedure specified in plan; plan administrator's directive that amendment not be enforced was invalid since she lacked authority to amend the plan or to disregard valid amendments); *Collins v. Seafarers Pension Trust*, 846 F2d 936 (4th Cir. 1988) (amendment invalid since trustees failed to follow legally required amendment process).

Taxing Times for Tax-Exempt Organizations

Steven D. Einhorn and Dominick Pizzano

With the enactment of tax reform legislation on December 22, 2017, frequently referred to as the Tax Cuts and Jobs Act of 2017 (the Tax Act), and its addition of Section 4960 to the Internal Revenue Code of 1986, as amended (the Code), many tax-exempt organizations may now face an excise tax on certain compensation payments that will increase the cost for the organizations to attract and retain top talent. This article first examines several requirements already faced by tax-exempt organizations with respect to structuring compensation packages, then discusses the new excise tax that will now be imposed on certain tax-exempt organizations as a result of the addition of Section 4960 to the Code. Finally, the article considers possible steps that organizations may wish to consider in light of these new rules. While many of the same considerations exist for compensatory arrangements for employees of many governmental employers as for other tax-exempt organizations, this article does not address the special rules applicable to governmental employers. This article reflects the text of the Tax Act and the information available as of May 31. There are many aspects of the Tax Act and its application to tax-exempt organizations that require additional guidance. On February 7, the United States Department of Treasury updated its 2017–2018 Priority Guidance Plan, which stated that Treasury hopes to issue guidance on the executive compensation provisions applicable to tax-exempt organizations under new Code Section 4960 by June 30.[1]

EXCESS BENEFIT TRANSACTIONS

Prior to the enactment of Code Section 4960, the Internal Revenue Service (IRS) could impose significant penalties for a tax-exempt organization paying excessive executive compensation. Under Code

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Section 4958, if the IRS determines that an applicable tax-exempt organization[2] provides a benefit to a disqualified person in excess of the value of the services being provided, Code Section 4958 imposes an initial tax of 25 percent of the excess benefit on the disqualified person who received the excess benefit.[3] Furthermore, an additional tax of 200 percent of the excess benefit will be owed by the disqualified person unless the excess benefit is promptly repaid.[4] Besides the tax on the recipient of the payment, Code Section 4958 imposes a tax of 10 percent of the excess benefit on managers in the organization if they knowingly participated in the excess benefit transaction (unless such participation was not willful and was due to reasonable cause).[5] Since the term "disqualified person" includes a person with the ability to exercise substantial influence over the affairs of the organization, the excess benefit penalties under Code Section 4958 generally apply to the organization's executives and senior management.[6]

THE PRE-TAX ACT CHALLENGES OF STRUCTURING COMPENSATION PACKAGES

Generally, when establishing employee benefit programs, tax-exempt organizations may select from a similar array of qualified retirement plan options that are available to employers in the for-profit sector, such as defined contribution and defined benefit plans.[7] In addition, many tax-exempt employers also have the option of establishing Code Section 403(b) plans. Although the executives of tax-exempt organizations may participate in such plans, their ability to accumulate benefits under such vehicles is limited by various restrictions (such as the limitations on contributions imposed by the Code and the requirements that nongovernmental qualified plans, including employer contributions to Code Section 403(b) plans, not discriminate in favor of highly compensated employees). To provide additional benefits for their executives, employers in the for-profit sector often structure compensatory arrangements for their executives using compensatory equity grants, such as stock options, restricted stock, and restricted stock units, as well as nonqualified deferred compensation arrangements. Tax-exempt organizations often seek to provide their executives with compensatory arrangements in excess of that which is permissible under qualified retirement plans that, ideally, could be structured in ways that would defer taxation to achieve a result similar to what for-profit employers are able to accomplish. However, tax-exempt employers face additional obstacles in this effort because compensatory equity grants generally are not available to tax-exempt employers, and the treatment of nonqualified deferred compensation is very different from that of employers in the for-profit sector.

Code Section 457 Restricts Executive Deferred Compensation Options

Many employers and executives, both in the tax-exempt world and the for-profit world, find the rules governing nonqualified deferred compensation plans restrictive since the passage of the American Jobs Creation Act of 2004 created Code Section 409A and the IRS began issuing guidance under Code Section 409A. The enactment of Code Section 409A did not prevent employers from implementing nonqualified deferred compensation arrangements for their employees, but Code Section 409A did create new statutory requirements that such arrangements must comply with both in form and operation to avoid adverse tax treatment. While tax-exempt employers and their employees generally are subject to the requirements of Code Section 409A, tax-exempt organizations face an additional hurdle when structuring nonqualified deferred compensation arrangements that generally do not apply to employers in the for-profit sector—Code Section 457.

Code Section 457 establishes the framework for nonqualified deferred compensation arrangements that can be offered by tax-exempt employers.[8] Generally, Code Section 457 permits tax-exempt organizations to offer two types of plans. First, Code Section 457 provides for "eligible" Code Section 457(b) plans that allow participants to defer taxes on amounts up to a specific annual limit until the amounts are paid or otherwise made available to the participant. The annual deferral limit under a Code Section 457(b) plan is generally $18,500 for 2018, subject to annual adjustment (which is inclusive of both employer and employee contributions), with additional catch-up contributions permitted in certain circumstances. Second, Code Section 457 provides for "ineligible" Code Section 457(f) plans, which are nonqualified deferred compensation arrangements that allow participants to defer taxes on compensation with no specific dollar limit under which taxation generally can be deferred until the compensation is no longer subject to a substantial risk of forfeiture (i.e., until it vests). Code Section 457(f) plans are subject to the rules governing nonqualified deferred compensation under Code Section 409A, but Code Section 457(b) plans are not.

Code Section 457(b) Plans: Limited Contributions but Taxes Deferred

Apart from the annual contribution limits discussed above, there is a great deal of appeal for tax-exempt organizations to implement Code Section 457(b) plans. Code Section 457(b) plans can be structured to

permit employer contributions or employee elective salary deferrals, or the plan could be structured so that contributions are based upon certain other metrics such as unused sick or vacation pay. Generally, a participant is not permitted to take a distribution from a Code Section 457(b) plan until the earliest of reaching age 70½, incurring a severance from employment with the organization, or facing an unforeseeable emergency.[9] A participant is not taxed on amounts deferred under a Code Section 457(b) plan until the amounts are actually paid or otherwise made available to the participant.[10] Code Section 457(b) plans are subject to the required minimum distribution rules under Code Section 401(a)(9), which generally require that a participant must begin taking minimum distributions by the April 1st following the year the participant reaches age 70½ or, if the plan allows, the April 1st following the year that the participant retires, if later.[11]

Code Section 457(f) Plans: Unlimited Contributions but Limited Ability to Defer Taxes

In contrast to rules applicable to Code Section 457(b) plans, arrangements governed by Code Section 457(f) are permitted to allow unlimited contributions, but, in exchange, much of the ability to defer taxation of deferred amounts is removed. This is because amounts deferred under an arrangement subject to Code Section 457(f) remain tax deferred only so long as the amounts are subject to a substantial risk of forfeiture (i.e., the amounts are unvested). Under Code Section 457(f), when deferred amounts are no longer subject to a substantial risk of forfeiture, the amounts become taxable to the recipient, regardless of whether the deferred amounts will be paid at that time.[12] This means that in order to prevent the immediate inclusion of deferred amounts being taxable to the recipient, the recipient's right to receive the deferred amounts must be conditioned upon the future performance of substantial services, and there must be a substantial possibility that such benefits will be forfeited if the participant fails to complete such service. As with many IRS determinations, compliance comes down to a facts-and-circumstances test. This is very different from the tax treatment of nonqualified deferred compensation provided by employers in the for-profit sector. Employers in the for-profit sector generally can structure large deferred compensation payments to be compliant with Code Section 409A so that the deferred amounts may be fully vested in one year but will not be taxable until the amounts are paid (which could be in a later year).

In limited circumstances, tax-exempt organizations may put in place arrangements that are exempt from Code Section 457(f) and which would allow accrued amounts under such arrangements to not be

included in taxable income until actually paid. Arrangements exempt from Code Section 457(f) include: (1) short-term deferrals of compensation that a recipient actually or constructively receives on or before the last day of the period ending on the later of the 15th day of the third month following the end of the calendar year in which the right to the payment is no longer subject to a substantial risk of forfeiture, or the 15th day of the third month following the end of the employer's taxable year in which the right to the payment is no longer subject to a substantial risk of forfeiture;[13] (2) bona fide severance pay arrangements that provide benefits upon a participant's involuntary severance from employment, pursuant to a window program that is offered for a limited amount of time or a voluntary early retirement incentive arrangement where the amount payable under such a plan must not exceed two times the participant's annual compensation and the severance must be paid no later than the end of the second calendar year following the calendar year in which the severance from employment occurs;[14] (3) disability plans;[15] (4) bona fide sick or vacation plans;[16] and (5) death benefit plans.[17]

Employers must take extreme care to ensure that their nonqualified deferred compensation arrangements are drafted and administered in such a way as either to be exempt from Code Section 457(f) or to maintain a bona fide substantial risk of forfeiture until the benefits are intended to be included in the recipient's taxable income. Thus, apart from the limited amounts that can be accumulated using a 457(b) plan or a tax-qualified retirement plan, including a Code Section 403(b) plan, tax-exempt organizations generally are deprived by Code Section 457(f) from providing the benefits of substantial deferred compensation to employees beyond the time that such deferred amounts become vested.

CONGRESS TAKES INSPIRATION FROM EXECUTIVE COMPENSATION RESTRICTIONS IMPOSED ON FOR-PROFIT EMPLOYERS

Before the enactment of Code Section 4960, there already were adverse tax consequences in place intended to dissuade for-profit entities from providing excessive compensation to executives. Congress clearly was inspired by Code Section 162(m) and Code Section 280G when drafting Code Section 4960:

- Code Section 162(m) generally provides that a publically traded company is limited to a $1 million annual deduction paid to the CEO, CFO, and three highest compensated officers; and

- Code Section 280G generally denies a deduction to a corporation for certain parachute payments made to a disqualified individual that are in the nature of compensation and are contingent upon a change of control if the payments exceed a specific amount. In addition, under Code Section 4999, the individuals must pay a 20 percent excise tax on these parachute payments that are not deductible by the corporation.

While the application differs, Code Section 4960 extends the general concepts applicable to certain employers in the for-profit sector with respect to using the Code to penalize both annual compensations provided to certain executives over $1 million and certain parachute payments. Although perhaps intended as a means to impose similar restrictions on employers that are tax-exempt organizations and employers in the for-profit sector, the actual effect of Code Section 4960 may further decrease the flexibility of a tax-exempt organization when structuring its executive compensation arrangements—flexibility which was already significantly less than that of employers in the for-profit sector. Code Section 162(m) generally only applies to publicly traded companies (including companies with publicly traded equity or debt, as well as foreign private issuers). Private companies in the for-profit sector do not face adverse tax consequences for paying annual compensation packages over $1 million. The penalties imposed by Code Sections 162(m) and 280G on the employer are targeted primarily at eliminating tax deductions that an employer can take with respect to certain executive compensation payments (and an additional tax placed on the executive for parachute payments under Code Section 280G through Code Section 4999). Depending on an employer's specific circumstances, the significance of the denial of a tax deduction will have a different punitive effect on various employers. However, since tax-exempt organizations generally are exempt from taxes, denying a tax deduction to such organizations obviously would fail to provide a meaningful deterrent to tax-exempt organizations. Thus, though inspired by Code Sections 162(m) and 280G, Code Section 4960 addresses the issue differently by imposing a new tax on tax-exempt organizations with respect to certain compensatory payments rather than denying any tax deductions.

The New Excise Tax Imposed by Code Section 4960

Code Section 4960 begins by imposing a tax on tax-exempt organizations, simply stated as 21 percent of the sum of the following amounts:[18]

- Any remuneration (other than an excess parachute payment) by an applicable tax-exempt organization for the taxable year with respect to employment of any covered employee in excess of $1 million; plus

- Any excess parachute payment paid by the applicable tax-exempt organization to any covered employee.

The new excise taxes imposed by Code Section 4960 are placed on the tax-exempt organization and not on the individuals receiving the payments.

While there are many unanswered questions with respect to Code Section 4960, an initial issue is the lack of the definition of the term "taxable year." The manner in which such term is used throughout the statute raises the question of whether it refers to the taxable year of the employee or the taxable year of the tax-exempt organization. This will, of course, not affect those organizations with fiscal years that match the calendar year (since the organization's tax year corresponds to their employees' calendar year taxable year); however, organizations with a different fiscal year will need guidance regarding which taxable year to use to make the determinations mandated by the statute.

As discussed earlier, tax-exempt organizations already were tasked with meeting the "reasonable compensation" standard for its executive employees. However, this new excise tax under Code Section 4960 now creates an absolute maximum threshold for their executives' compensation before tax penalties are automatically imposed, regardless of whether the employer can establish that such pay levels are reasonable. For example, assume that a tax-exempt organization can justify that annual compensation of $1.2 million is reasonable for its CEO because of the CEO's talent, experience, responsibilities, and distinguished performance. To evidence the reasonableness of the compensation package, the organization retained a compensation consultant who provided a detailed report demonstrating that not only is the CEO's compensation reasonable under the facts and circumstances but the compensation is also actually significantly less than what likely would be paid by a similar tax-exempt organization. While the organization in this scenario avoids any intermediate sanctions penalty under Code Section 4958, it still faces an excise tax under Code Section 4960 because the executive's annual remuneration exceeds $1 million. In this example, the tax-exempt organization would be subject to an excise tax of $42,000 for the applicable year, which is 21 percent of the amount that the CEO's annual remuneration exceeded $1 million.

If a tax-exempt organization pays annual compensation over $1 million that is determined to be an excess benefit, not only will the penalties under Code Section 4958 apply (discussed earlier) but also the new 21 percent excise tax under Code Section 4960 (though guidance is necessary to understand how the penalties interact, particularly with respect to any compensation that is repaid to the tax-exempt organization by the employee).

To Which Employers Does Code Section 4960 Apply?

The excise tax in Code Section 4960 applies to applicable tax-exempt organizations. The term "applicable tax-exempt organizations" is defined as an organization which for the taxable year:[19]

- Is exempt from taxation under Section 501(a);
- Is a farmers' cooperative organization described in Section 521(b)(1);
- Has income excluded from taxation under Section 115(1); or
- Is a political organization described in Section 527(e)(1).

While this definition generally includes most tax-exempt organizations, it remains unclear how Code Section 4960 will apply to public institutions, such as state colleges and universities. The definition of applicable tax-exempt organizations includes organizations exempt from tax under Code Section 115(1). Code Section 115(1) states that gross income "does not include income derived from any public utility or the exercise of any essential governmental function and accruing to a State or any political subdivision thereof, or the District of Columbia…." The intent behind Code Section 4960 may have been to capture public institutions within the definition of "applicable tax-exempt organizations." However, many public institutions do not rely upon Code Section 115(1) as the basis for their tax exemption, but rather rely on the doctrine of implied statutory immunity.[20] Given the size of the compensation packages currently in place for certain individuals employed by some public institutions (for example, high-profile coaches and athletic directors at some public universities), exempting these organizations from the new excise tax would result in a significant loss of tax revenue for the federal government. It also would result in very different treatment for public and private universities with respect to their compensation packages for highly compensated individuals, thereby creating a significant financial

advantage for the former in their ability to recruit and retain high-level employees.

To Which Employees Does Code Section 4960 Apply?

The excise tax under Code Section 4960 applies to certain remuneration and excess parachute payments paid to a covered employee. A "covered employee" means any employee (including a former employee) of an applicable tax-exempt organization if the employee is one of the five highest compensated employees of the organization for the current tax year or any prior tax year that began after December 31, 2016.[21] Notably, once an employee becomes a covered employee, the individual will remain a covered employee who is subject to these rules indefinitely. Thus, a tax-exempt organization may, and likely will, at some point, have more than five covered employees. In order to comply with Code Section 4960, a tax-exempt employer should maintain a cumulative list of covered employees, regardless of whether any of its employees currently earn annual compensation in excess of $1 million.

While Code Section 4960 provides that remuneration of covered employees is aggregated for purposes of the tax (discussed below), the statute does not contain a controlled-group rule for purposes of determining covered employees. Thus, it appears that, absent guidance to the contrary, organizations will be faced with determining covered employees and applying Code Section 4960 on an entity-by-entity basis. Such an interpretation would create administrative stress for multitiered tax-exempt organizations (e.g., if a health care system maintains separate entities for each organization in the system, each of those entities will maintain its own list of covered employees). If it is confirmed that the determination of covered employees is on an entity-by-entity basis, this may affect decisions with respect to which organization within a multiorganizational system should be treated as the employer of newly hired highly compensated employees in order to minimize the number of covered employees for whom the new excise tax may apply.

As noted earlier, the definition of covered employees under Code Section 4960 is made of up employees and former employees. Code Section 4960 is silent regarding independent contractors and consultants. However, the new statute states that "the Secretary shall prescribe such regulations as may be necessary to prevent avoidance of the tax under this section, including regulations to prevent the avoidance of such tax through the performance of services other than as an employee…." Thus, tax-exempt organizations should be cautious

before attempting to use employment classification as a means to avoid the new excise tax.[22]

How Is Remuneration Calculated for Purposes of Code Section 4960?

In order to determine the remuneration to which the 21 percent tax will be applied with respect to a covered employee, an applicable tax-exempt organization must consider not only the remuneration that it pays but also the remuneration paid to the covered employee by any related organizations.[23] Generally, remuneration for purposes of determining the excise tax under Code Section 4960 consists of Code Section 3401(a) wages less any designated Roth contribution (as defined in Code Section 402A(c)).[24] Code Section 3401(a) wages are similar to wages reported on Form W-2, and generally include compensation received from sources such as base salary, overtime, bonuses, commissions, fees for professional services, taxable fringe benefits, reimbursements, and expense allowances, but exclude items such as deferrals under Code Section 401(k) plans, Code Section 403(b) plans, and Code Section 457(b) plans, as well as distributions from retirement plans that are reported on Form 1099-R (i.e., qualified plans and governmental Code Section 457(b) plans).[25]

In contrast, distributions from nongovernmental Code Section 457(b) plans are treated as wages reportable on Form W-2 when paid (or otherwise made available) and, thus, would be included under the determination of remuneration with respect to the 21 percent excise tax on annual payments in excess of $1 million in such year. However, as noted later, such amounts are explicitly excluded from the tax on severance parachute payments.[26]

As explained below, remuneration for purposes of determining the excise tax under Code Section 4960 includes nonqualified deferred compensation that is required to be included in income under Code Section 457(f) and excludes certain remuneration paid for the performance of medical services.

Application to Nonqualified Deferred Compensation

Remuneration includes any nonqualified deferred compensation that is required to be included in income under Code Section 457(f) (i.e., nonqualified deferred compensation that is required to be included in income because it is no longer subject to a substantial risk of forfeiture even if not yet paid).[27] The inclusion of these amounts in the determination of the applicability of the excise tax may

increase the potential to extend the excise tax to organizations that otherwise pay compensation packages under the $1 million annual threshold. For example, assume an organization pays its executive director $500,000 in 2018; however, the organization also maintains a Code Section 457(f) nonqualified deferred compensation plan, under which $60,000 is deferred for the executive director each year for 10 years, and the entire deferred amount of $600,000 vests in 2018 but is not paid until a later year. Even though the $600,000 represents accruals over a decade of service with the organization, and even if the organization never actually pays remuneration in excess of $1 million in 2018, the organization will be subject to an excise tax of $21,000 (21 percent of $100,000) for the 2018 tax year because the $600,000 that was deferred under the Code Section 457(f) plan is taxable to the employee in 2018.

Likewise, since remuneration is treated as being paid when there is no substantial risk of forfeiture and not when it is actually paid, nonqualified deferred compensation that was vested and included in an employee's income prior to January 1, 2018, will not be subject to the 21 percent excise tax under Code Section 4960 even if it is paid after January 1, 2018.

Treatment of Remuneration Paid for Medical Services

Code Section 4960 specifically excludes from the definition of remuneration "the portion of any remuneration paid to a licensed medical professional (including a veterinarian) which is for the performance of medical or veterinary services by such professional."[28]

Although this exception is appreciated by the medical community, the "performance" limitation may prove troublesome and difficult to both interpret and administer. Tax-exempt organizations that provide medical and veterinary services may now be forced to track and categorize compensation for executives and senior management who perform multiple functions within the organization. For example, if an experienced surgeon who is on staff at a hospital is promoted to head of surgery, the hospital may be required to determine and document what portion of the individual's compensation is for performing medical services and what is not. In addition, the determination of what constitutes providing medical services may not always be clear. Although compensation paid for purely administrative duties will not be attributable to performing medical services, there may be the performance of other services that are not as clear. For example, what if the individual is not performing the actual medical service but is playing a significant role in the performance of medical services through direct supervision? What about various training

activities that may involve patients? Hopefully, these are issues that the IRS will address.

While the statute is clear that the amounts paid to a medical professional for the performance of medical services are not used for purposes of determining remuneration (and also for determining excess parachute payments), there is no indication in Code Section 4960 itself whether such amounts should be excluded when determining the group of "covered employees." A joint House-Senate conference committee reconciled the differences between the House-passed and Senate-passed versions of the new tax legislation and issued a report that states: "For purposes of determining a covered employee, remuneration paid to a licensed medical professional which is directly related to the performance of medical or veterinary services by such professional is not taken into account. . . ."[29] This statement indicates that Congress intended that payments to a medical professional for the performance of medical services are not used when determining the group of covered employees. However, since similar language was not included in the statute, the question remains as to whether the omission was intentional.

Remuneration Paid by Related Organizations

Code Section 4960 provides that the remuneration paid to a covered employee by an applicable tax-exempt organization includes any remuneration paid with respect to the employment of such employee by any related person or governmental entity.[30] For this purpose, a person or governmental entity will be treated as related to an applicable tax-exempt organization if such person or governmental entity (1) controls, or is controlled by, the organization; (2) is controlled by one or more persons who control the organization; (3) is a supported organization (as defined in Code Section 509(f)(3)) during the taxable year with respect to the organization; (4) is a supporting organization described in Code Section 509(a)(3) during the taxable year with respect to the organization; or (5) in the case of an organization that is a voluntary employees' beneficiary association described in Code Section 501(c)(9), establishes, maintains, or makes contributions to such voluntary employees' beneficiary association.[31]

Code Section 4960 provides that if remuneration is paid by one or more employers that are related organizations, each employer will be liable for its proportional share of the excise tax.[32] While the statute describes a method for application of the excise tax among related exempt entities, guidance is needed with respect to exactly how the related-party rule will work in cases where an employee performs

services for and receives compensation from both a tax-exempt organization and a related taxable entity.

In the meantime, employers that may otherwise consider restructuring their payroll practices in an effort to minimize or eliminate exposure to the excise tax should be aware that the statute warns that "the Secretary shall prescribe such regulations as may be necessary to prevent avoidance of the tax under this section, including regulations to prevent the avoidance of such tax … by providing compensation through a pass-through or other entity to avoid such tax."[33]

What Is an Excess Parachute Payment?

As noted previously, Code Section 4960 imposed a 21 percent tax on tax-exempt organizations that pay excess parachute payments.[34] This applies to compensatory payments that are contingent on the covered employee's separation from employment. This excise tax is reminiscent of the concepts contained in Code Section 280G with respect to excess parachute payments paid in connection with a change of control.

Under Code Section 4960, if parachute payments equal or exceed three times the covered employee's base amount, then the 21 percent excise tax applies to the portion of the parachute payments that are in excess of the employee's base amount.[35] For these purposes, parachute payments include any payments in the nature of compensation to (or for the benefit of) a covered employee if (1) such payments are contingent on the employee's separation from employment with the tax-exempt organization, and (2) the aggregate present value of such payments equals or exceeds three times the covered employee's base amount.[36] The "base amount" is determined by applying the current rules of Section 280G, which generally will provide that a covered employee's base amount is the individual's average annual taxable income from the organization over the five-year period immediately preceding the year in which the separation from service occurs (or any shorter period of service with the organization if less than five years).[37]

Code Section 4960 provides that the following payments generally are excluded when determining the amount of a parachute payment:[38]

- Payments to or from qualified retirement plans (including defined contribution plans, defined benefit plans, Code Section 403(b) plans, and Code Section 457(b) plans);

- Payments to a licensed medical professional (including a veterinarian) to the extent that such payments are for the

performance of medical or veterinary services by such professional; and

- Payments to an individual who is not a highly compensated employee (as defined in Code Section 414(q), the threshold for which in 2018 is $120,000, subject to annual adjustment).

Once any payment to be paid in connection with a covered employee's separation from service qualifies as a parachute payment, all amounts in excess of the base amount become subject to the excise tax. For example, assume that the average compensation of an executive over the last 5 years was $150,000 but, because of a promotion and pay increases during this time, the executive's current salary is $200,000. Assume that the executive director has a severance agreement to receive three times his compensation if he is terminated without cause. He is later terminated and receives $600,000 in severance (three times his current compensation of $200,000). In this example, there is a parachute payment because the payment that is contingent on the termination of employment ($600,000) equals or exceeds three times the base amount (three times $150,000, which is $450,000). Thus, the excise tax that is due under Code Section 4960 is 21 percent of the excess of the amount paid in connection with the termination of employment ($600,000) over the base amount ($150,000), which equals 21 percent of $450,000 or $94,500.

Although the exclusion of payments to a licensed medical professional (including a veterinarian) for the performance of medical or veterinary services from the calculation of parachute payments is welcomed by the medical community, as previously discussed, guidance is needed addressing how to apply this exception. The need for guidance on this issue seems particularly necessary for an organization trying to determine when payments that are contingent on a separation from employment should be considered to be paid for the performance of medical or veterinary services.

INTERIM ACTION PLAN WHILE AWAITING FUTURE GUIDANCE

A number of items with respect to Code Section 4960 require additional guidance regarding the applicability and determination of the new excise tax. Accordingly, tax-exempt organizations should carefully review Code Section 4960 and also consult with their legal counsel regarding the applicability, and potential adverse effect, of the new law. Listed below are a number of initial steps that a tax-exempt organization should begin to consider:

- Review the organization's payroll for 2017 and 2018 in order to identify which employees are "covered employees" under Code Section 4960. This list should be maintained and updated annually.

- Once the covered employee group has been determined, review all compensation arrangements with the individuals in the covered group, including any employment agreements, bonus agreements, retention agreements, and severance agreements in order to determine whether the organization anticipates any current liability under the new excise tax or whether there are compensatory payments that may be made in the future that may cause potential liability.

- Those responsible for making high-level compensation decisions within the organization should consider how the new excise tax may affect new compensation plans and agreements in light of the organization's desire to attract and retain talented individuals, while also being sensitive to the potentially negative public perception that the organization may face as a result of the imposition of this tax.

- Develop a strategy for minimizing the potential impact of the new excise tax, both in terms of current and deferred compensation arrangements already in place as well as those that will be offered to future employees.

- Code Section 457(b) plans should be considered. If not already doing so, consider whether Code Section 457(b) plans should be implemented or whether existing plans could be better maximized for key executives. In addition, subject to further guidance on this issue, tax-exempt organizations should examine whether a distribution from a nongovernmental Code Section 457(b) plan could impose unexpected liability by causing a covered employee's annual remuneration to exceed $1 million for purposes of Code Section 4960. Accordingly, sponsors of nongovernmental Code Section 457(b) plans may wish to review participants' distribution options under these plans and whether it may be beneficial, or permissible, to modify the distribution options permitted under such plans.

- Consider the role of qualified retirement plans, including Code Section 403(b) plans, in the organization's compensation and benefits structure, and how such plans could be

better utilized in light of the excise tax imposed by Code Section 4960.

- Determine when any nonqualified deferred compensation will vest and become taxable under Code Section 457(f), and, thus, potentially be subject to the excise tax under Code Section 4960. If large amounts will become taxable in specific years, review the applicable agreements and consider whether any amendments to such agreements would be permitted or beneficial (for example, in certain circumstances amending vesting schedules may be possible).

- Monitor any future guidance with respect to Code Section 4960. Code Section 4960 states that "the Secretary shall prescribe such regulations as may be necessary to prevent avoidance of the tax under this section. . . ."[39] Tax-exempt organizations should be mindful of this provision when considering the structure of their compensation packages.

There will be many variables for each tax-exempt organization to evaluate when considering the effect of the new excise tax imposed by Code Section 4960. Prior to the enactment of the Tax Act, executive compensation packages paid by tax-exempt organizations required careful planning and structuring. On top of the challenges faced by tax-exempt organizations prior to the enactment of the Tax Act, Code Section 4960 imposes a new set of challenges for tax-exempt organizations, on top of the challenges they faced prior to the enactment of the new law that will require even more careful analysis on the structuring of compensation practices and employee benefit plans and programs.

NOTES

1. *https://www.irs.gov/pub/irs-utl/2017-2018_pgp_2nd_quarter_update.pdf*.

2. These sanctions apply to organizations described in Code §§ 501(c)(3), 501(c)(4), or 501(c)(29) and are exempt from tax under Code § 501(a), or an organization that fits such description during a 5-year lookback period. *See* Code § 4958(e) and Treasury Regulation § 53.4958-2.

3. Code § 4958(a)(1).

4. Code § 4958(b).

5. Code § 4958(a)(2) and Treasury Regulation § 54.4958-1(d).

6. Code § 4958(f)(1) and Treasury Regulation § 54.4958-3.

7. After May 6, 1986, state and local governments generally are not eligible to adopt Code § 401(k) plans except for rural cooperatives and Indian tribal entities. Under grandfather provisions, plans established prior to that date may continue to operate and add new participants. *See* Treasury Regulation § 1.401(k)-1(e)(4).

8. A Code § 457(b) plan is a special type of employer-sponsored retirement plan that many tax-exempt and governmental organizations can establish for their employees. However, there are different rules for Code § 457(b) plans maintained by nongovernmental tax-exempt organization compared with those established by governmental entities. Although the former must generally be structured as a "top-hat plan" available to only a select group of employees to avoid certain requirements under the Employee Retirement Security Act of 1974, as amended (ERISA), the latter do not need to be limited to the top-hat group because they are exempt from ERISA. This article will not focus on the special rules applicable to § Section 457(b) plans sponsored by governmental employers.

9. Code § 457(d).

10. Code § 457(a)(1). This refers to federal income and generally state income taxation. However, amounts deferred under a Code Section 457(b) plan is generally required to be taken into account for purposes of FICA and FUTA employment taxes as of the later of when the services are performed or when there is no substantial risk of forfeiture of the rights to such amount. Thus, to the extent a Code Section 457(b) plan provides that annual deferrals are immediately vested, the annual deferrals are subject to FICA and FUTA employment taxes at the time of deferral. *See* Code §§ 3121(a)(5), 3121(v), 3306(b)(5) and 3306(r); Treasury Regulation §§ 31.3121(v)(2)-1(a) and 31.3306(r)(2)-1(a).

11. Code § 457(d)(2) and Treasury Regulation § 1.457-6(d).

12. Code § 457(f)(1).

13. Proposed Treasury Regulation § 1.457-12(d)(2).

14. Proposed Treasury Regulation §§ 1.457-11(c)(1) and 1.457-11(d).

15. Code § 457(e)(11)(A)(1) and Proposed Treasury Regulation § 1.457-11(e).

16. Code § 457(e)(11)(A)(1) and Proposed Treasury Regulation § 1.457-11(f).

17. Code § 457(e)(11)(A)(1) and Proposed Treasury Regulation § 1.457-11(e).

18. Code § 4960(a).

19. Code Section 4960(c)(1).

20. *See generally* Rev. Rul. 71-131, Rev. Rul. 71-132, *Estate of Shamberg*, 3 T.C. 131 (1944), and *State of Michican v. United States*, 40 F. 3d 817 (6th Cir. 1994).

21. Code § 4960(c)(2).

22. Code § 4960(d).

23. Code § 4960(c)(4).

24. Code § 4960(c)(3)(A).

25. Code § 3401(a).

26. Code § 4960(c)(5)(C)(ii).

27. Code § 4960(c)(3)(A).

28. Code § 4960(c)(B).

29. Joint Explanatory Statement of the Committee of Conference under the Tax Act, p. 349.

30. Code § 4960(c)(4)(A).

31. Code § 4960(c)(5)(B).

32. Code § 4960(c)((4)(C).

33. Code § 4960(d).

34. Code § 4960(a)(2).

35. Code § § 4960(a)(2) and 4960(c)(5)(A) and (B).

36. Code § 4960(c)(5)(A).

37. Code § 4960(c)(5)(D) and Treasury Regulation § 1.280G-1, Q/A-34.

38. Code § 4960(c)(5)(C).

39. Code § 4960(d).

How the Tax Cuts and Jobs Act Affects Employee Benefits and Executive Compensation

Jack M. Amaro

On December 22, 2017, President Trump signed the Tax Cuts and Jobs Act (TCJA or the Act) into law.[1] While the new law seeks to create more jobs and to provide workers with more take home pay as a corollary of imposing fairer taxes,[2] collapsing tax brackets[3] and providing the average middle-income family with higher tax cuts,[4] the Act also tweaks certain existing tax-advantage benefits provisions. These limited changes apply to a select number of individuals and create certain economic effects.

This article first focuses on the changes that the TCJA made to provisions governing retirement plans, then discusses how the TCJA attacks the central component of the Patient Protection and Affordable Care Act (ACA): the individual mandate. The final section examines the changes made to deferred compensation arrangements for company executives, which are typically used to attract and retain high-level talent at the executive level.

CHANGES TO RETIREMENT BENEFITS

Although the TCJA made relatively few changes to employee retirement benefits, the changes may prove significant to those affected by them. The changes described in this section are generally effective for the tax years beginning after December 31, 2017. First, the Act provides relief to qualified plan participants with outstanding plan loans "at the time of a distribution arising due to a termination of employment."[5] Instead of a 60-day deadline to roll over the offset amount into a qualified account before incurring tax liability, the TCJA extends this deadline beyond the usual 60-day due date to mitigate its sometimes harsh effects.[6] Second, the Act limits the ability to recharacterize Roth contributions once made. Finally, because casualty losses may only be deducted on account of a federally declared disaster,[7] the Act

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may have imposed some inadvertent hurdles on hardship distributions from qualified plans.

Extended Rollover Period for Qualified Plan Loan Amounts

Under both the prior law and the TCJA, participants could take loans from qualified plans that satisfy the requirements of Section 401(a), from annuity plans that satisfy the requirements of Sections 403(a) or 403(b), and from governmental plans.[8] Although the Employee Retirement Income Security Act (ERISA) does not require retirement plans to offer plan loans, for those that do, taking a loan means that participants borrow money from themselves and gradually pay themselves back over time.[9] A number of limitations govern, *inter alia*, the amount of a loan, its funding, and the amount of time to repay the loan.[10]

When an employee takes a loan from a qualified retirement plan, the plan administrator uses a formula to determine the amount to be withheld from the employee's paycheck to repay the loan.[11] If, for some reason, the plan or employment is terminated while the employee has an outstanding plan loan, the employee must either repay the loan or contribute the outstanding balance to an individual retirement account (IRA) to avoid a taxable distribution.[12] Prior to the TCJA, the employee had 60 days from the date of termination to act. The new law extends the due date for repayment or contribution to an IRA to the due date of the employee's tax return for that year plus extensions.[13] By granting individuals more time to roll over funds, the Act attempts to mitigate the sometimes harsh effects that result following termination from employment with an outstanding plan loan.

Recharacterizing Contributions to Roth IRAs

Generally, a participant may make monetary contributions into a Roth IRA in one of the several ways: directly, as a rollover, or by conversion.[14] To contribute money directly into a Roth IRA, an individual makes annual payments to the account, subject to some limitations.[15] An individual may also roll funds over into a Roth IRA from another qualified account, such as a 401(k) or 403(b) plan, subject to limitations if, for example, an individual is still working.[16] Finally, an individual may convert a Roth IRA to a traditional IRA.[17] Doing so, however, results in a taxable event where "any untaxed amounts that are … transferred to the Roth IRA are subject to income taxation." Thus, an individual who opts to convert his or her traditional IRA or to transfer funds from a qualified plan into a Roth IRA could do so in an attempt

to leverage a potentially favorable tax result, so long as the conversion or transfer occurred prior to the end of the calendar year in the taxable year for which the income is to be included (e.g., by December 31, 2017, for the income to be included in 2017).

Prior to the TCJA, a participant could undo a conversion.[18] In other words, an individual could convert his or her traditional IRA into a Roth IRA, assess what his or her tax liability would be, then "undo" the transaction by "recharacterizing" the Roth conversion and having the converted money sent back to the original IRA or account.[19] Taxpayers took advantage of this procedure when the Roth conversion resulted in unfavorable tax consequences. Under the old law, a participant could elect a recharacterization until the taxpayer's return date plus extensions, effectively ignoring the contribution to the first IRA.

Beginning January 1, 2018, a traditional IRA or qualified plan converted into a Roth IRA cannot be undone.[20] However, under a short grace period, any Roth conversion made in 2017 may still be recharacterized if the recharacterization is made before October 15, 2018.[21] Practically, taxpayers must now assess potentially unfavorable tax consequences as they consider converting. The new law should not deter conversions entirely, though. Sophisticated taxpayers may seek the help of professionals to calculate the potential tax consequences, unless doing so would cost more than any estimated tax savings.

Inadvertent Narrowing of Circumstances for Hardship Withdrawals

Prior to the TCJA, taxpayers could claim a deduction for casualty losses to, say, the taxpayer's home resulting from any "fire, storm, … or other casualty," so long as the loss was not otherwise compensated for.[22] For taxable years 2018 to 2025, however, a casualty loss is only deductible under Section 165 to the extent [the casualty loss] is *attributable to a federally declared disaster*.[23] This added language could indirectly affect whether some 401(k) plans permit a hardship withdrawal.[24]

To qualify for a hardship distribution in the first place, the distribution must meet an "immediate and heavy financial need" and the amount must be "necessary to satisfy the financial need."[25] Often, withdrawals that satisfy the "immediate and heavy financial need" requirement cover expenses for the repair of damage to a plan participant's principal residence.[26] When plan language, however, specifically cross references Section 165 of the Internal Revenue Code (the Code), "permitting a withdrawal for expenses that result from an isolated incident [i.e. not from a [f]ederally declared disaster] could now be contrary to the plan's terms," even if the withdrawal would have covered expenses incurred as a result of a fire or thunderstorm.

Congress may not have intended that changes to the Code affect hardship distributions, and the Internal Revenue Service (IRS) may issue guidance obviating the need to impose the federally declared disaster requirement in the hardship context. Until then, plan sponsors must administer their plans in accordance with the plan terms. Alternatively, plan sponsors may need to amend plan documents to eliminate the cross reference to the Code and, thus, to avoid risking improper distributions.

CHANGES TO WELFARE(ISH) BENEFITS

In 2010, the Obama Administration enacted the ACA[27] because millions of Americans lacked health insurance, yet still actively consumed millions of dollars in health care services for which they did not pay.[28] Beginning in 2019, individuals will no longer face a penalty for electing not to purchase the minimum coverage required under the ACA.[29] Although some studies suggest that many Americans will continue to purchase insurance, eliminating the penalty for the mandate may influence the insurance markets before the zero penalty even takes effect. This section describes the ACA's individual mandate and speculates about the Act's fate after the TCJA eliminated the tax penalty imposed for failing to comply with the individual mandate.

The Individual Mandate

As the touchstone of the ACA, the individual mandate aims to "increase the number of Americans covered by health insurance" and thereby "decrease the cost of health care."[30] The individual mandate provision requires most Americans to maintain "minimum essential" health coverage.[31] Although the Act exempts some individuals from purchasing the required coverage,[32] those not exempt faced a "[s]hared responsibility payment" for failing to purchase insurance.[33] The Act characterized this payment as a penalty, "calculated as a percentage of household income, subject to a floor based on a specified dollar amount and a ceiling based on the average annual premium the individual would have to pay for qualifying private health insurance."[34] The Act provided that an individual pay the penalty to the IRS with the individual's taxes.[35]

At the time the ACA passed, most experts generally agreed that, without the individual mandate, the ACA would crumble.[36] Thus, the ACA's critics challenged Congress's authority to impose, *inter alia*, the individual mandate, arguing that it exceeded Congress's enumerated power under the Commerce Clause,[37] the Necessary and Proper Clause,[38] and the Taxing and Spending Clause[39] of the United States

Constitution.[40] The Supreme Court ultimately upheld the minimum coverage provision, not under the Commerce Clause but rather as a valid exercise of Congress's power "to lay and collect taxes."[41]

To reach this conclusion, Justice Roberts and the majority of justices who signed on to this portion of his opinion recognized that statutory text may have multiple meanings. As a general rule, the Court observed, where one interpretation of the statute would violate the Constitution but the other would not, the Court should adopt the constitutionally valid interpretation.[42] So, despite reading the mandate "most naturally" as a command to purchase insurance, the Court need only ask whether it was "fairly possible" to instead read the mandate as imposing a tax on those without insurance.[43] In doing so, the Court took a functional approach,[44] looking not at how Congress "designat[ed]" the mandate, but at its "substance and application."[45] Even though the mandate "seek[s] to influence conduct" by imposing a penalty,[46] the penalty is not a penalty in the strict sense of the word.[47] Rather, because the penalty "generates at least some revenue for the Government," it has "the essential feature of any tax."[48] Therefore, the Court held that the individual mandate could reasonably be characterized as a tax and, thus, a constitutional exercise of congressional authority.[49]

Eliminating the Penalty and Resulting Economic Effects

Rather than repealing the individual mandate, the TCJA eliminated the penalty for failing to purchase and maintain the minimum required coverage.[50] Consequently, nonexempt individuals may now elect not to purchase any health insurance coverage, knowing that they will incur no tax penalty.[51] Thus, the individual mandate is effectively no longer a tax because it generates no revenue for the government.

As a practical matter, however, an individual's goals in purchasing or declining to purchase health insurance vary. As both medical care and the cost of treatment increase, individuals who purchase health insurance must bear only some of the associated costs.[52] Insured individuals also seek routine preventive care in hopes to avoid high medical costs in future years. People who purchase health insurance understand and accept that paying insurance premiums pools risk to help others, and that one day they may benefit from that pooling.

However, some people wait until they get sick before purchasing health insurance, although doing so presents its own risks. First, health insurance can be purchased only during "open enrollment,"[53] if one were to get sick at an inopportune time, he or she may have to wait until the next open enrollment to buy insurance. Second, health insurance does not typically take effect until a waiting period ends. Third,

as a basic principle of economics, the price of coverage generally increases when fewer people buy into the health insurance market because the associated costs are spread among fewer people.

By mandating that individuals purchase a minimum level of coverage, the ACA tried to combat increasing costs associated with purchasing health insurance. In November 2017, after the Trump Administration released its tax proposal, the Congressional Budget Office (CBO) and the Joint Committee on Taxation (JCT) opined that repealing the individual mandate (or, alternatively, eliminating the associated penalty) could have both positive and negative effects on the economy going forward. Although it is difficult to predict with certainty, the CBO estimated that eliminating the tax penalty associated with the mandate would gradually reduce federal budget deficits by up to $338 billion between 2018 and 2027.[54]

Is This the End for the ACA?

Now that the individual mandate contains nothing but an empty threat, 20 states filed a lawsuit asking the Supreme Court to declare the ACA unconstitutional in its entirety and to enjoin its enforcement.[55] The states argue that the Court's reasoning in *National Federation of Independent Business (NFIB) v. Sebelius*,[56] upholding the validity of individual mandate as a tax, can no longer support its conclusion because the tax penalty no longer has "the essential feature of any tax" (i.e., it will raise zero dollars in revenue staring in 2019).[57] As such, the states contend that the Court's saving interpretation in *NFIB* can no longer be applied, and the ACA—or, at the very least, the individual mandate—is, therefore, unconstitutional.[58]

Can the ACA survive without the individual mandate provision?[59] The states argue that if the individual mandate is unconstitutional so too is the ACA, because Congress made clear that health insurance markets would not function properly—or, for that matter, even be effective—absent the requirement that individuals buy health insurance.[60] Even the Supreme Court opined in *NFIB*: "[T]he guaranteed issue and community rating requirements *would not work* without [Section 5000A]."[61] Thus, the states conclude that, since "the remainder of ACA does not 'function in a manner consistent with the intent of Congress,' the whole [ACA] must fall with the mandate."[62]

When arguing *NFIB*, the government also submitted that Section 5000A (the individual mandate) "is integral to the Affordable Care Act's insurance reforms" and "necessary to make effective the [ACA]'s core."[63] Congress also made this "finding" in the ACA itself: "[T]he [f]ederal [g]overnment has a significant role in regulating health insurance. The requirement [that individuals purchase health insurance] is

an essential part of this larger regulation of economic activity, and the absence of the requirement would undercut [f]ederal regulation of the health insurance market."[64] Under the ACA's approach, it would be impossible to control the cost of health care unless everyone is forced to buy insurance. Interestingly, though, even in the absence of a penalty for failing to purchase insurance, the CBO estimates that people will still purchase insurance "because of a willingness to comply with the law."[65] Nonetheless, the cost of health insurance is likely to increase as scofflaws stop purchasing it.

CHANGES TO DEFERRED COMPENSATION FOR EXECUTIVES

Finally, the Act makes some far-reaching changes to provisions implicating trade or business expenses, including excessive employee remuneration. It also alters the tax treatment of certain qualified equity grants. This section discusses those changes in detail. In some ways, the TCJA makes it more difficult for corporations to structure their executive compensation packages on an equity-based system. Instead, because they will no longer be able to deduct compensation in excess of $1 million, corporations may begin raising executive salaries and eliminating performance-based incentives.[66] In addition, the Act allows certain individuals to delay the tax consequences of receiving qualified stock options and restricted stock units (RSUs) for up to 5 years.[67]

Excessive Employee Remuneration

Generally, Section 162(m) of the Code prohibits a publicly held corporation from deducting compensation paid to "covered employee[s]" in excess of $1 million.[68] Prior to the TCJA, an exception existed whereby corporations could claim a deduction for qualified performance-based compensation or compensation payable on a commission basis.[69] To do so, corporations had to satisfy several criteria to ensure that incentive compensation arrangements were "solely conditioned on the achievement of performance criteria established and certified by a duly constituted compensation committee and approved by company shareholders."[70] The TCJA expands the previous definition of "covered employee" and eliminates the performance-based compensation exceptions.[71]

Expanding "Covered Employee"

A covered employee, for purposes of the TCJA, includes any individual who (1) is a "principal executive officer or a principal financial

officer" during the taxable year; (2) is among the three "highest compensated officers for the taxable year," other than the principal executive officer and the principal financial officer; and (3) is already a "covered employee" for any taxable year after December 31, 2016.[72] Not only does the Act expand the definition of a covered employee but it also adheres to the principle that "once a covered employee, always a covered employee,"[73] because "[r]emuneration shall not fail to be applicable employee remuneration merely because it is includible in the income of, or paid to, a person other than the covered employee, including after the death of the covered employee."[74]

Practically, becoming a "covered employee" perpetually means that any individual who becomes a covered employee during 2018 will remain a covered employee even if he or she no longer qualifies as one of the three highest paid officers in a subsequent year, or even if he or she continues to be classified as a covered employee after his or her separation from service.[75] One practitioner predicts that corporations may now take extra efforts to spread compensation and payments (severance pay, deferred compensation, or otherwise) over a period of years to avoid being subject to the deduction cap's effect.

Eliminating Performance-Based Compensation Exception

Next, the TCJA eliminates a corporation's ability to deduct qualified performance-based compensation and commissions, except under a narrow transition rule if the compensation is paid under a written binding contract in effect on November 2, 2017.[76] Because most compensation packages remain "skewed heavily in favor of performance-based compensation,"[77] corporations may push to implement non-equity-linked compensation, such as straight cash bonuses[78] and profit interests.[79]

Some commentators, however, predict that the changes may not substantially affect the payment of performance-based compensation because "[o]bjectively administered performance-based compensation models have become an integral tool for structuring executive compensation arrangements."[80] Corporations will thus have a "freer hand" in pushing the incentive-pay system without bearing the burden of complying with the requirements that Section 162(m) previously imposed.

Expanding the Application of Section 162(m) to Foreign Entities

Section 162(m) also expands the definition of publicly held corporations to include "any corporation which is an issuer ... (A) the securities of which are required to be registered under section 12 of

[the Securities and Exchange Act of 1934], or (B) that is required to file reports under section 15(d) of such Act."[81] As a result, many foreign entities publicly traded in the United States may no longer claim a deduction for compensation paid to covered employees in excess of $1 million.[82]

Qualified Equity Grants

A more employee-favorable provision in the TCJA allows certain individuals to elect to defer recognizing income on qualified stock options or RSUs.[83] Prior to the Act, an employee who held nonstatutory stock options or RSUs recognized income when the company transferred the underlying stock to him or her.[84] Under the new Act, however, certain individuals may elect to defer recognizing income for up to 5 years.[85]

Conditions on Tax Deferral Elections

To successfully defer the realization of income under Section 83(i), an employer must transfer "qualified stock" to a "qualified employee," who makes an election to defer, for up to 5 years, income that would have otherwise been recognized upon exercise. Employees who work at least 30 hours per week generally may make this election, so long as the employee makes the election no more than 30 days after he or she exercises the option or the RSU vests.[86] However, an employee may recognize income before 5 years if:

1. The qualified stock becomes transferable;

2. An employee becomes an "excluded employee";

3. Any stock of the corporation issuing the qualified stock becomes readily tradable on an established market; or

4. An employee revokes the deferral election.[87]

The employer's stock becomes "qualified stock" if:

1. An employee receives the stock "in connection with the exercise of an option or in settlement of an RSU";

2. The corporation grants the option or RSU "for the performance of services as an employee during a calendar year in which the corporation" (a) "did not have readily tradable stock on an

established market for any preceding year," and (b) "had a written plan under which at least 80 percent of all of the company's employees in the [United States]" received stock options or RSUs "with the same rights and privileges to receive qualified stock"; and

3. The employee does not have a right to sell the stock to the corporation at the time of the option exercise or RSU vesting.[88]

Reporting and Notice Requirements

In addition, the Act imposes reporting and notice requirements on corporations issuing stock. If a corporation has outstanding "deferral stock"[89] at the beginning of a calendar year and it purchases any of its outstanding stock during that year, the corporation must include the total dollar amount of outstanding stock purchased on its tax return for that same year.[90] Moreover, a corporation transferring qualified stock to a qualified employee must give the employee reasonable notice that the value of the stock would be includable in the employee's gross income, unless he or she elected to defer the income under Section 83(i).[91] If the employee makes the deferral election, the corporation must then notify the employee of how much income he or she will recognize at the end of the deferral period.

CONCLUSION

In summary, the TCJA did not substantially overhaul the existing rules related to employee benefits and executive compensation. The changes it did make, however, affect an identifiable subset of individuals. For retirement benefits, the Act eases the burden on individuals who lose their jobs while they have outstanding plan loans by allowing them more time to repay the loans or to roll over the outstanding balances to IRAs. Additionally, when converting a traditional IRA to a Roth IRA, individuals must now make certain that doing so is in their best interest as they will no longer be able to undo such a conversion. Moreover, by limiting casualty loss deductions to those flowing from a federally declared disaster, Congress may have put an unexpected constraint on some individuals' ability to take a hardship withdrawal from a 401(k) plan.

With respect to welfare benefits, the ACA's fate is unknown. Several states brought suit in a Texas federal court seeking an injunction enjoining the enforcement of the individual mandate on the grounds that it no longer conforms to the savings construction afforded to it

by the Supreme Court. Because the mandate no longer generates any revenue for the government, the states argue, it cannot be characterized as a tax and, thus, is unconstitutional.

Finally, the TCJA eliminates the provision previously providing publicly held corporations a deduction for excessive performance-based compensation; now employers may begin to structure compensation packages based on non-equity-linked criteria instead. The Act also creates new tax deferral options for certain qualified equity grants by private corporations, allowing individuals to defer recognizing income for up to 5 years.

NOTES

1. Tax Cuts and Jobs Act, Pub. L. No. 115–97 (2017).

2. U.S. House of Representatives, Tax Cuts and Jobs Act Policy Highlights 1 (2018), *https://waysandmeansforms.house.gov/uploadedfiles/policy_highlights.pdf*.

3. Pub. L. No. 115–97 § 11001. The rate table for married individuals filing joint returns for taxable years 2018–2025 is as follows:

If taxable income is:	**The tax is:**
Not over $19,050	10% of taxable income
Over $19,050 but not over $77,400	$1,905, plus 12% of the excess over $19,050
Over $77,400 but not over $165,000	$8,907, plus 22% of the excess over $77,400
Over $165,000 but not over $315,000	$28,179, plus 24% of the excess over $165,000
Over $315,000 but not over $400,000	$64,179, plus 32% of the excess over $315,000
Over $400,000 but not over $600,000	$91,379, plus 35% of the excess over $400,000
Over $600,000	$161,379, plus 37% of the excess over $600,000

4. A family of four earning $59,000 per year (the median household income) would, on average, receive over $1,000 in tax cuts. U.S. House of Representatives, *supra* n.2, at 1.

5. Richard Lieberman, *2017 Tax Act Impact on Employee Benefits and Executive Compensation*, LexisNexis (Feb. 26, 2018), *https://advance.lexis.com/api/permalink/000d533b-1182-4be8-8acd-01be7045f7aa/?context=1000522*.

6. Pub. L. No. 115–97 § 13613.

7. *See* 26 U.S.C. § 165(5)(A).

8. Internal Revenue Service, *Retirement Plans FAQs Regarding Loans*, IRS (February 15, 2018), *https://www.irs.gov/retirement-plans/retirement-plans-faqs-regarding-loans*.

9. *Retirement Plans Loans*, Smart401k (2015), *https://www.smart401k.com/resource-center/retirement-strategy/retirement-plan-loans*.

10. *See* Internal Revenue Service, *supra* n.8.

11. *Retirement Plan Loans*, *supra* n.9.

12. Grant Thornton, *Final Tax Reform Bill—Employee Compensation and Benefits Provisions* 4 (2017), *https://www.grantthornton.com/-/media/content-page-files/tax/pdfs/tax-reform-bill-employee-compensation-benefits.ashx?la=en&hash=89BAA1920876B40172CDDAC6078442846423BF96*.

13. 26 U.S.C. § 402(c)(3); Pub. L. No. 115–97 § 13613. *See also* Lieberman, *supra* n.5, at 6.

14. Jamie Hopkins, "Tax Reform Changes to Recharacterizations and Roth IRA 2018 Contribution Limits," *Forbes* (January 4, 2018, 9:19 AM), *https://www.forbes.com/sites/jamiehopkins/2018/01/04/tax-reform-changes-to-recharacterizations-and-roth-ira-2018-contribution-limits/#42234a13309a*.

15. *Id*. Individuals cannot contribute more than $5,500 if under age 50, and no more than $6,500 if age 50 or older. However, contributions may never exceed an individual's taxable compensation for the year.

16. *Id*. In addition, individuals do not immediately pay taxes when rolling over a retirement plan distribution. Rather, tax is paid when money is withdrawn from the new plan. Thus, even after a rollover, money continues to grow tax-deferred. *See* Internal Revenue Service, *IRA FAQs—Recharacterization of IRA Contributions*, IRS (April 9, 2018), *https://www.irs.gov/retirement-plans/ira-faqs-recharacterization-of-ira-contributions*.

17. Hopkins, *supra* n.15.

18. 26 U.S.C. § 408A(d); Grant Thornton, *supra* n.12 at 4.

19. Hopkins, *supra* n.15. *See also* Internal Revenue Service, *supra* n.18. ("To recharacterize a regular IRA contribution, [individuals can] tell the trustee of the financial institution holding [his or her] IRA to transfer the amount of the contribution plus earnings to a different type of IRA . . . in a trustee-to-trustee transfer or to a different type of IRA with the same trustee.")

20. *See* 26 U.S.C. § 408A(d)(6)(B)(iii) (this applies to conversions made on or after January 1, 2018).

21. Internal Revenue Service, *supra* n.18.

22. 26 U.S.C. § 165(c)(3).

23. 26 U.S.C. § 165(5)(A).

24. Conditioning hardship distributions on a federally declared disaster should not affect other provisions that allow individuals to take distributions for disaster relief stemming from Hurricanes Harvey, Irma, and Marie, or from the California wildfires. *See generally* Internal Revenue Service, *Tax Relief in Disaster Situations*, IRS (May 9, 2018), *https://www.irs.gov/newsroom/tax-relief-in-disaster-situations*. Moreover, the Bipartisan Budget Act directs the IRS to modify its administrative guidance to eliminate the six-month prohibition on contributions to retirement plans after a hardship withdrawal; this change will allow an employee who takes a hardship distribution to continue contributing to his or her plan. Stephen Miller, *Budget Law Eases 401(k) Hardship Withdrawals*, SHRM (February 14, 2018), *https://www.shrm*.

org/resourcesandtools/hr-topics/benefits/pages/bipartisan-budget-act-eases-401k-hardship-withdrawals.aspx. In addition, the budget bill removes the requirements that participants take a plan loan prior to taking a hardship withdrawal, and it also permits employers to extend hardship withdrawal sources by allowing participants to "withdraw the plan sponsor's qualified nonelective contributions, qualified matching contributions and profit-sharing contributions." These modifications are effective beginning after December 31, 2018. *Id.*

25. Treas. Reg. 1.401(k)-1(d)(3)(i) (2009).

26. Rebecca C. Davenport, *Impact of Recent Legislation on 401(k) Hardship Withdrawals*, Benefits & Compensation Blog (February 13, 2018), *https://www.usbenefits.law/2018/02/tax-reform-impact-on-401k-hardship-withdrawals/*.

27. Patient Protection and Affordable Care Act, Pub. L. No. 111–148, 124 Stat. 119 (2010).

28. *See generally Nat'l Fed'n of Indep. Bus. v. Sebelius,* 567 U.S. 519, 538–42 (2012) [hereinafter *NFIB v. Sebelius*].

29. Pub. L. No. 115–97 § 11081 (effective after December 31, 2018).

30. *NFIB*, 567 U.S. at 538.

31. 26 U.S.C. § 5000A.

32. Individuals exempt from the penalty included prisoners, undocumented aliens, certain low income individuals, and individuals who faced certain hardships. *See* Matthew Rae, Anthony Damico, Cynthia Cox, Gary Claxton, and Larry Levitt, "The Cost of the Individual Mandate Penalty for the Remaining Uninsured," Kaiser Family Foundation *Issue Brief* (Dec. 9, 2015), *https://www.kff.org/health-reform/issue-brief/the-cost-of-the-individual-mandate-penalty-for-the-remaining-uninsured/*.

33. 26 U.S.C. § 5000A(b)(1).

34. *NFIB*, 567 U.S. at 539; 26 U.S.C. § 5000A(c).

35. *NFIB*, 567 U.S. at 539; 26 U.S.C. § 5000A(g)(1).

36. The dissenting justices in *NFIB* noted several times that the ACA "describes the individual mandate as working 'together with the other provisions of th[e] Act.'" *NFIB*, 567 U.S. at 696 (quoting 42 U.S.C. § 18091(2)(C)). To be sure, the justices opined that, without the invalid provisions, the Act's other major provisions "could impose enormous risks of unexpected burdens on patients, the health-care community, and the federal budget." *Id.* at 698–699.

37. U.S. Const. art. I, § 8, cl. 3.

38. U.S. Const. art. I, § 8, cl. 18.

39. U.S. Const. art. I, § 8, cl. 1.

40. *NFIB*, 567 U.S. at 546–547.

41. Chief Justice Roberts emphasized that the Court had no duty to consider the savings construction had it not first decided the Commerce Clause question. Because the individual mandate read "more naturally as a command," he argued, the Court had to consider whether Congress had the authority to enact it under the Commerce Clause. *Id.* at 575–576. Justice Ginsburg, however, questioned whether the Chief Justice had to undertake the Commerce Clause analysis because that holding was not "outcome determinative." *Id.* at 623 n.12. She argued that his opinion as to the Commerce Clause

is thus dicta because the Court upheld the individual mandate as a valid exercise of Congress's power to "lay and collect taxes." *Id.* at 623.

42. *See Parsons v. Bedford,* 28 U.S. 433, 448 (1830) ("No court ought, unless the terms of an act rendered it unavoidable, to give a construction to it which should involve a violation, however unintentional, of the constitution."); *Blodgett v. Holden,* 275 U.S. 142, 148 (1927) ("[T]he rule is settled that as between two possible interpretations of a statute, by one of which it would be unconstitutional and by the other valid, our plain duty is to adopt that which will save the Act.").

43. *NFIB*, 567 U.S. at 562–563 (quoting *Crowell v. Benson,* 285 U.S. 22, 62 (1932)).

44. *See, for example*, *Quill Corp. v. North Dakota,* 504 U.S. 298, 310 (1992) ("[M]agic words or labels" should not "disable an otherwise constitutional levy."); *United States v. Sotelo,* 436 U.S. 268, 275 (1978) ("That the funds due are referred to as a 'penalty' . . . does not alter their essential character as taxes."); *Nelson v. Sears, Roebuck & Co.,* 312 U.S. 359, 363 (1941) ("In passing on the constitutionality of a tax law, we are concerned only with its practical operation, not its definition or the precise form of descriptive words which may be applied to it.").

45. *NFIB*, 567 U.S. at 564–566 (quoting *United States v. Constantine*, 296 U.S. 287, 294 (1935)).

46. The Court notes that taxes often seek to influence conduct (e.g., state and federal taxes on cigarettes may "compose more than half the retail price . . . to encourage people to quit smoking"). *Id.* at 567. To be sure, virtually "[e]very tax is in some measure regulatory. To some extent [taxes] interpose[] an economic impediment to the activity taxed as compared with others not taxed." *Id.* (quoting *Sonzinsky v. United States,* 300 U.S. 506, 513 (1937)).

47. Here, the Court explains that penalties often act as "punishment for an unlawful act or omission." *Id.* But the ACA does not attach any "negative legal consequences to buying health insurance" other than the payment to the IRS. *Id.* at 567–568.

48. *Id.* at 564.

49. *Id.* at 574.

50. 26 U.S.C. § 5000A(c)(3)(A).

51. Abby Goodnough, "Many See I.R.S. Penalties as More Affordable than Insurance," *NY Times* (January 3, 2016), *https://www.nytimes.com/2016/01/04/us/many-see-irs-fines-as-more-affordable-than-insurance.html*; *see also* Rae et al., *supra* n.41 (finding that, in 2016, more than seven million people who were eligible for exchange coverage would pay less in penalties than for the least expensive insurance available to them).

52. U.S. Dep't of Health & Human Servs., *Why Do You Need Health Insurance?* (2007), *https://archive.ahrq.gov/consumer/insuranceqa/insuranceqa3.htm*.

53. Elizabeth Davis, *Why Not Wait Until I'm Sick to Buy Health Insurance?*, Verywell: Health (April 19, 2018), *https://www.verywell.com/why-not-wait-until-im-sick-to-buy-health-insurance-1738938*.

54. Cong. Budget Office, *Repealing the Individual Health Insurance Mandate: An Updated Estimate* 1 (November 2017), *https://www.cbo.gov/system/files/115th-congress-2017-2018/reports/53300-individualmandate.pdf*; *see also* Jennifer Haberkorn, *CBO: Obamacare Mandate Repeal Would Cut Deficit by $338 Billion*,

Politico (November 8, 2017, 5:17 PM), *https://www.politico.com/story/2017/11/08/cbo-score-obamacare-repeal-244688*.

55. *See* Complaint for Declaratory and Injunctive Relief at 5, *Texas v. United States*, No. 4:18-cv-00167-O (N.D. Tex. 2018).

56. 567 U.S. 519 (2012).

57. Complaint for Declaratory and Injunctive Relief at 3, *Texas v. United States,* No. 4:18-cv-00167-O (N.D. Tex. 2018) (quoting *NFIB v. Sebelius*, 567 U.S. 519, 564 (2012) (Scalia, Kennedy, Thomas, and Alito, JJ., dissenting).There are instances where a statutory tax provision permits assessment of an amount that provides an incentive for certain conduct but does not specify an amount and is not enforced for years, yet the absence of any amount for the tax incentive in the statute does not invalidate the provision describing conduct that the tax incentive is supposed to encourage (or discourage). For example, states may impose what are colloquially referred to as "sin taxes" on goods such as alcohol and tobacco to discourage the use of these products because they pose a danger to people's health. *See* Scott Drenkard, *How High Are Cigarette Taxes in Your State?*, Tax Foundation (June 3, 2015), *https://taxfoundation.org/how-high-are-cigarette-taxes-your-state/*. Although states typically define the amount of the tax, the taxes act as a way to keep people from activelyparticipating in commerce (i.e., by discouraging individuals from purchasing harmful goods). If the individual abstains from purchasing cigarettes, he has complied with the desired social policy and never pays the tax. Even if the state quit imposing the cigarette tax, but kept it on the books, the tax would not raise any revenue, but it would likely be constitutional should the state choose to impose it once again later.

By analogy, if the individual mandate is viewed as a means of discouraging individuals from living without health insurance (an economically harmful activity), then it would be constitutionally permissible to impose a penalty in an attempt to encourage individuals to purchase insurance (and thereby actively participate in commerce). Sin taxes, however, can be distinguished from the penalty imposed by the individual mandate. Unless nobody purchases a pack of cigarettes, the repressive tax on cigarettes may potentially raise revenue; all it takes is for one individual to purchase a pack of cigarettes, and the state may impose a tax on him or her in attempt to discourage future conduct. The individual mandate, however, cannot possibly, under any circumstances, raise revenue for the government after December 31, 2018, because the federal government cannot apply the penalty against individuals at all. Whether this distinction makes the ACA unconstitutional, though, rests with the Supreme Court. *See* Richard Rubin, "GOP Tax Bill Would Set Up Years of Challenges: Expiration Dates Guarantee Any Changes Would Be Revisited," *Wall Street Journal:* Politics (December 17, 2017, 7:42 PM), *https://www.wsj.com/articles/gop-tax-bill-would-set-up-years-of-challenges-1513557742?mod=searchresults&page=2&pos=3*.

58. *Id*. at 4.

59. Generally, when one part of a law is struck down as unconstitutional, the remainder may be upheld if (1) it will be "fully operative" in the way Congress intended, unless (2) it is evident that Congress would not have enacted the remainder without the invalid part. *Alaska Airlines v. Brock,* 480 U.S. 678, 684–86 (1987). *See also* Matt Miller, "Anxiety Over the Individual Mandate," *The Washington Post* (March 27, 2012), *https://www.washingtonpost.com/blogs/post-partisan/post/anxiety-over-the-individual-mandate/2012/03/27/gIQAT8qbeS_blog.html?utm_term=.0352a29b588e* ("The only way to push toward universal coverage via private health plans is to have a mandate that gets everyone in the pool.... If [the ACA] bars insurers from turning people away,

... the system implodes in a spiral of accelerating premiums."); Jonathan Cohn, "Let's All Take a Moment to Breath, OK?," *New Republic* (March 26, 2012), *https://newrepublic.com/article/102098/obamacare-kennedy-roberts-severability-mandate-insurance-reform* (concluding that without the individual mandate, the ACA would "fall short of the universal coverage that [it] is supposed to achieve").

60. Complaint for Declaratory and Injunctive Relief at 4, *Texas v. United States,* No. 4:18-cv-00167-O (N.D. Tex. 2018) (citing 41 U.S.C. § 18091(2)(I)).

61. *King v. Burwell,* 135 S. Ct. 2480, 2487 (2015) (emphasis added).

62. Complaint for Declaratory and Injunctive Relief at 4, *Texas v. United States, supra* n.60 (quoting *Alaska Airlines, Inc. v. Brock,* 480 U.S. 678, 684–85 (1987)).

63. Brief for Petitioners (Minimum Coverage Provision) at 24, *Dep't of Health & Human Servs. v. Florida,* 2012 WL 37168 (11th Cir. January 6, 2012) (No. 11–398).

64. 42 U.S.C. § 13091(2)(H).

65. Cong. Budget Office, *Repealing the Individual Health Insurance Mandate: An Updated Estimate* 1 (November 2017), *https://www.cbo.gov/system/files/115th-congress-2017-2018/reports/53300-individualmandate.pdf*.

66. *See* Scott Price, Michael Krasnovsky, Andy Barton, and Tiffany Wong, *2017 Tax Cuts and Jobs Act Eliminates Section 162(m) Performance-Based Pay Exemption and Expands Section 162(m) Coverage Generally*, Kirkland & Ellis: Kirkland Alert (February 1, 2018), *https://www.kirkland.com/siteFiles/Publications/2017_Tax_Cuts_and_Jobs_Act_Eliminates_Section_162(m)_Performance-Based_Pay_Exemption_and_Expands_Section_162(m)_Coverage_Generally.pdf* (noting that "public corporations have traditionally relied heavily on the performance-based pay exemption").

67. 26 U.S.C. § 83(i); Lieberman, *supra* n.5, at 3.

68. 26 U.S.C. § 162(m).

69. 26 U.S.C. § 162(m)(4)(B)–(C) (effective 2014–2017 and removed under TCJA).

70. Lieberman, *supra* n.5, at 1.

71. Pub. L. No. 115–97 § 13601.

72. Pub. L. No. 115–97 § 13601. Under prior law, the covered employee included only the chief executive officer of the corporation and the four highest compensated officers for the taxable year, other than the chief executive officer. 26 U.S.C. § 162(m)(3)(A)–(B) (no longer in force).

73. Lieberman, *supra* n.5, at 2.

74. 26 U.S.C. § 162(m)(4)(F).

75. Lieberman, *supra* n.5, at 2.

76. However, the parties may not modify terms of the contract in any material way after November 2, 2017. Pub. L. No. 115–97 § 13601(e)(2); *see also* Lieberman, *supra* n.5, at 2.

77. Price et al., *supra* n.79.

78. *See* Trey Williams, "Tax Law Ushers in Higher Executive Salaries at Netflix," *Wall Street Journal* (December 28, 2017, 6:22 PM), *https://www.wsj.com/articles/tax-law-ushers-in-higher-executive-salaries-at-netflix-1514503321*.

79. Although profit interests are not deductible either, in some circumstances, individuals may pay capital gains-based tax rates rather than ordinary income rates. *See* Price et al., *supra* n.79.

80. Lieberman, *supra* n.5, at 2.

81. 26 U.S.C. § 162(m)(2).

82. The expansion in Sec. 162(m) will also reach "certain privately held corporations with publically traded debt and foreign private issuers with equity traded through American depository receipts." Price et al., *supra* n.79.

83. 26 U.S.C. § 83(i).

84. One practitioner notes that several members of Congress drafted proposals to address this concern, however, despite bipartisan support, Congress failed to act on them. *See* Lieberman, *supra* n.5, at 3.

85. 26 U.S.C. § 83(i).

86. Noneligible employees include: 1% owners; CEOs and CFOs (including their spouses, children, grandchildren, and parents); and any of the four highest paid officers in the corporation for the taxable year in which the option is exercised or the RSU vests, or any of the 10 preceding taxable years. Lieberman, *supra* n.5, at 4.

87. *Id. See generally* 26 U.S.C. § 83(i).

88. Lieberman, *supra* n.5, at 4.

89. This term refers to stock for which a Sec. 83(i) election is in effect. 26 U.S.C. § 83(i).

90. 26 U.S.C. § 83(i)(4)(C)(iv).

91. *Id.* At this point, the employer must also certify to the employee that the stock is qualified stock eligible for a Sec. 83(i) deferral.

Internal Statutes of Limitation under ERISA

Barry L. Salkin

In light of the heightened frequency of 401(k) plan litigation, it is appropriate for plan sponsors to include favorable procedural rules as part of their claims procedures. One such rule is an internal statute of limitations, which the Supreme Court has held is permissible in an Employee Retirement Income Security Act (ERISA) plan so long as it is reasonable and there is no controlling statute to the contrary. As a best practice, notice of any internal statute of limitations should be provided.

In civil procedure class in law school, we learned that the line between substance and procedure is a fluid one, a teaching affirmed by the Supreme Court in *Gasperini v. Center for Humanities, Inc.*,[1] when the Supreme Court confirmed the long-acknowledged observation that substance and procedure are inextricably intertwined. A rule that on its face regulates procedure may be intended to serve a substantive purpose.[2] Statutes of limitation, which establish the period within which a claimant can bring an action,[3] illustrate those general propositions. Although statutes of limitation are an affirmative defense on which a defendant bears the burden of proof,[4] a statute of limitations also has substantive elements to it. Thus, one reason for the existence of statutes of limitation is that "just determinations of fact cannot be made when, because of the passage of time, the memories of witnesses have faded or evidence is lost."[5] Similarly, in *Lozzano v. Montoya Alvarez,* the Supreme Court stated that statutes of limitation "characteristically embody a policy of repose, designed to protect defendants," and "foster the elimination of stale claims and certainty about a defendant's potential liability."[6]

ARE CONTRACTUAL LIMITATIONS PERIODS IN ERISA ACTIONS ENFORCEABLE?

In general, the ERISA does not provide a statutory limitations period for Section 502(a)(1)(B) claims, so courts generally apply the most

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closely analogous statute of limitations under state law.[7] However, a federal court will only borrow a state limitations period in the absence of a reasonable contractually agreed upon period.[8] "An ERISA plan is nothing more than a contract, in which parties as a rule are free to include whatever limitations they desire."[9] Consequently, "there are two parts to the determination of whether a claimant's ERISA action is timely filed … first whether the action is barred by the applicable statute of limitations and second whether the action is contractually barred by the limitations provision in the policy."[10]

The leading case in this area is *Heimeshoff v. Hartford Life & Accident Ins. Co.,*[11] in which the Supreme Court resolved a circuit split concerning the enforceability of contractual limitations periods, reaffirming the doctrine first established in *Order of United Commercial Travelers of America v. Wolfe*[12] and specifically holding that a contractual provision in an ERISA plan is enforceable even if the window for filing a legal claim opens before the plaintiff has completed the ERISA-mandated internal review process. (Note that although the text of ERISA does not require exhaustion, "the courts of appeal have uniformly required that participants exhaust internal review before bringing a claim for judicial review under ERISA Section 502.")[13] The Court announced its principal holding by stating that "absent a controlling statute to the contrary, a participant in a[n ERISA] plan may agree by contract to a particular limitation period, even one that starts to run before the cause of action accrues, as long as the period is reasonable." The Supreme Court noted the importance of the time "in which to file suit" after the end of the ERISA internal review process in evaluating whether a limitations period is reasonable. The Court also indicated that a limitations provision would be unreasonably short where it leaves a claimant with little chance of bringing a claim not barred. The Court in *Heimeshoff* concluded that ERISA was not a controlling statute to the contrary, because it does not contain a relevant statute of limitations[14] or any language that prohibited the parties from choos[ing] a shorter [limitations] period by contract."[15] The decision contained some qualifying language. First, "if the administrator's conduct causes a participant to miss the deadline for judicial review, waiver or estoppel may prevent the administrator from invoking the limitations provision as a defense."[16] For example, in *Occidental Life Insurance Corp. of California v. EEOC*,[17] a case discussed in *Heimeshoff,* the Supreme Court did not enforce a one-year statute of limitations for Title VII employment discrimination actions, when the Equal Employment Opportunity Commission (EEOC) faced a backlog of 18 to 24 months. With respect to the doctrine of equitable estoppel as it applies to the affirmative defense of statute of limitations, the Court of Appeals for the Ninth Circuit explained in *Lamantia v. Voluntary Plan Administrators, Inc.*[18] [a]s a general rule, a defendant will be estopped from setting up

a statute of limitations defense when its own prior representations or conduct have caused the plaintiff to run afoul of the statute and it is equitable to hold the defendant responsible for that result. Estoppel may apply not only against a party asserting a statutory statute of limitations but also against a party asserting a contractual limitations defense based on a specified time period in an ERISA … plan."

Hughes v. Life Insurance Company of North America[19] indicates the type of conduct by a defendant that allows a court to apply the equitable estoppel doctrine. However, a plaintiff may not cite discrepancies between plan documents as justification for delay in filing suit when there is no evidence that plaintiff relied upon those discrepancies in deciding when to file suit.[20] Similarly, a plaintiff could not be misled into a late filing by a document which she did not receive until many months after the deadline for filing the action had passed.[21]

Second, the Supreme Court indicated "to the extent the participant in an ERISA plan has diligently pursued both internal review and judicial review but was prevented from filing suit by extraordinary circumstances, equitable tolling may apply."[22] In a 2014 decision in the Southern District of New York, the court held that a plaintiff's failure to consult the provisions of the plan within months after final denial of his long-term disability claim did not constitute extraordinary circumstances.[23] Also in 2014, an Alabama district court held that a participant could not cite ignorance of the workings of a 3-year limitations provision when the plaintiff waited more than 3 years after accrual of his action under Section 502 of ERISA to file suit or to request the plan document at issue. [24] Another district court held that an appellant was not laboring under extraordinary circumstances where the time limit for plan participants to file a legal action and the manner in which the plan calculated time were set forth in the group policy.[25]

Although broad in application, equitable tolling can be defined narrowly as "the doctrine that if a plaintiff files a suit in one court and then refiles in another, the statute of limitations does not run while the litigation is pending in the first court if various requirements are met."[26] Generally speaking, it is reserved for instances where a claimant "has made a good faith error (e.g., brought suit in the wrong court) or has been prevented in some extraordinary way from filing [her] complaint in time."[27]

IS THE CONTRACTUAL LIMITATIONS PERIOD REASONABLE?

Whether an internal statute of limitations is reasonable is generally fact specific, although the Court of Appeals for the Eleventh Circuit, in a pre-*Heimeshoff* case,[28] set forth a three-part test:

1. Was there a subterfuge to prevent lawsuits;

2. Was the limitations period commensurate with other provisions in the plan that are designed to process claims with dispatch; and

3. Was an ERISA-required internal appeals process completed.

However, although there is no question after *Heimeshoff* that contractual limitations periods[29] in ERISA actions are enforceable, regardless of state law, provided that they are reasonable,[30] in some instances it will be unclear as to what the applicable internal limitations period under an ERISA plan is, or the manner in which it should be interpreted. The limitations period must be contained in the plan document itself. In *Hughes v. Life Insurance Company of North America*,[31] the district court did not enforce a 180-day time limit for filing appeals contained in a benefits termination letter and indicated, without deciding, that in light of *Cigna Corp. v. Amara*,[32] it was unlikely to enforce such a limitations even if it was contained in a summary plan description.

In *St. Alexius Medical Center v. Roofers Unions Welfare Trust Fund*,[33] in order to resolve the issue as to whether the complaint was timely filed, the district court needed to determine whether the historical plan or the summary plan description was the governing document. The historical plan contained a 2-year internal statute of limitations, which would have barred the action, while the summary plan description was silent, meaning that the applicable state law statute of limitations—in this case, Illinois' 10-year statute of limitations—would apply. After careful review of the record, the district court concluded that the summary plan description was the governing document, so the plaintiff's cause of action was not time-barred. In *Bell v. Xerox Corp.,*[34] the contractual limitations period as defined under the plan did not apply to plaintiff's cause of action, because clarification of future rights was not a denial of benefits. In *Sandefur v. Iron Workers St. Louis District Council Pension Fund*,[35] defendant's motion to dismiss on statute of limitations grounds was denied because the court could not determine whether the plan submitted to the court was the controlling document. In *Perris Valley Community Hospital, LLC v. Southern California Pipe Trades*,[36] a case in which under the plan document it was unclear as to whether the applicable 2-year limitations period began to run when a claim was initially denied or when an appeals committee subsequently denied an appeal, the ambiguity was read against the insurer and the claim was held to be timely. In *Mogck v. Unum Life Insurance Company of America*[37] and *Nelson v. Standard Insurance Company*,[38] statute of limitations defenses were unsuccessful because the courts could not determine the commencement date of the internal statute of limitations. However, attempts

to read a contractual limitations period narrowly to avoid having an action time-barred are frequently rejected. Thus, there is no case suggesting that the phrase "proof of loss" is ambiguous because it is undefined;[39] there is no distinction between an action based on a denial of benefits and an action challenging the amount of benefits;[40] no case holds that a different statute of limitations applies to an estate,[41] nor is there any distinction between a limitations period in the health care context and a limitations period in the disability context.[42]

With respect to reasonableness challenges, except in those instances in which the limitations period ended before the claim could have accrued[43] or the appeals process was so protracted that the claimant was unable to file suit within the contractual period, such challenges are generally dismissed summarily. *Hansen v. Aetna Health and Life Ins. Co.* is an illustrative case. As the district court explained: "Defendants propose that this court construe the imposition of a contractual two-year suit limitation period against plaintiff as reasonable, despite the fact that Aetna's internal review process of plaintiff's claims has consumed the entire period. Enforcement of a two-year suit limitation in this case, after plaintiff has diligently pursued her appeal rights in a protracted internal review process would render that provision unreasonable in practical terms." [44]

On occasion a court will seek to cabin its decision. For example, in *Northlake Regional Medical Center v. Waffle House Sys. Employee Benefit Plan*, the Court of Appeals for the Eleventh Circuit approved a 90-day period as reasonable, but cautioned that such a provision may not always be reasonable or that a still shorter period will ever be reasonable.[45] Thus, courts have routinely held as reasonable 3-year periods running from the deadline for filing proof of loss,[46] and shorter periods have also been upheld as reasonable.[47] However, otherwise applicable doctrines applicable to statute of limitations matters, such as the relation back doctrine, remain in effect.[48]

Note that it may not be necessary for the period within which to file a claim to have completely expired for an internal statute of limitations to be held unreasonable. Thus, in a case in which the internal statute of limitations was the earlier of 2 years from the date that the expense was incurred or 1 year from the date that a completed claim is filed, whichever occurs first, the Fifth Circuit implied that a contractual limitations period that as applied provided a claimant only 35 days within which to file suit is unreasonable.[49]

IS THE INTERNAL STATUTE OF LIMITATIONS A CONTROLLING STATUTE?

With respect to the second limitation on internal statutes of limitations, a statute of limitations is a controlling statute to the contrary

only if it specifically targets the type of action at issue.[50] *Caldwell v. Standard Insurance Company*[51] indicates when a law is a controlling statute to the contrary and the type of analysis that a court must conduct to reach that conclusion. The policy in that case contained a standard provision providing that no action could be filed more than 3 years after the earlier of the date the insurer received proof of loss or the time within which proof of loss was required to be given. The policy also contained a time limit for filing proof of loss—90 days after the end of the benefit waiting period, which under the policy was a 90-day period. Caldwell's disability began on January 4, 2011; 180 days from that date—i.e., 90 days after the expiration of the benefit waiting period—was July 3, 2011. Therefore, under the policy, the time period for filing a suit ended July 3, 2014. Caldwell filed suit on August 29, 2014, almost 2 months after the contractual limitations period had expired. However, the defendant did not deny her claim for disability benefits until almost 24 months had expired, when the definition under the policy changed from "your occupation" to "any occupation."

Caldwell timely appealed that denial, and Standard denied her appeals on September 23, 2013, and December 5, 2013. Caldwell argued that the policy limitation was unenforceable under West Virginia Code 33-6-14, which prohibits the parties from agreeing to a limitation, such as the one set forth in the policy, which sets the deadline for filing suit less than two years after the cause of action accrued. The policy limitation and the West Virginia statute were not inherently incompatible, because a claimant's receipt of a formal denial letter could provide a claimant with more than 2 years to file a legal action; however, in Caldwell's circumstances, application of the policy would be inconsistent with the West Virginia statute. In agreeing with Caldwell that the contractual provision, as applied, violated West Virginia law, the district court first concluded that "absent the applicability of other doctrines, neither the language nor reasoning of *Heimeshoff* prevents the application of 33-6-14 simply because it is a state statute." It then held that the West Virginia statute was not subject to ERISA preemption because of the savings clause. Finally, the court rejected appellee's argument that the policy statute of limitations was exactly the same 3-year statute of limitations under another section of the West Virginia insurance law. The Court explained that "[t]he timeframe imposed by the required provision from 33-15-4(k) (which is virtually identical to the limitation contained in the policy) is not automatically voided by the statutory floor provision imposed by 33-6-14. It is possible for a deadline set by 33-15-4(k) to fall more than two years after a plaintiff's legal cause of action accrues and, in such a case, that deadline will be undisturbed by 33-6-14. But when as here the deadline falls less than two years after a plaintiff's cause of action accrues, 33-6-14 applies,

and nothing in the language of 33-15-4(k) prohibits such application." As a result, appellant's action was not time-barred.

In *Mulholland v. MasterCard World Wide,*[52] the applicable long-term disability plan provided that legal action of any kind could not be brought more than three years after proof of disability was required to be filed "unless the law in the state where [the plan participant] live[s] allows a longer period of time." The district court determined that the action was time-barred under *Heimeshoff,*[53] but the Court of Appeals for the Eighth Circuit reversed. The appeals court found that the district court had overlooked the critical distinction between the contractual provision in the instant case and the contractual provision addressed in *Heimeshoff*. The court explained that "the provision in *Heimeshoff* did not contain the additional language allowing a participant to file suit beyond three years if the law of the state provided for a longer period, and thus we conclude that the instant suit was not time-barred."[54] In *Halpern v. Blue Cross Blue Shield of New York,*[55] the district court held a New York state statute regulating insurance to be a controlling statute to the contrary. In *Carey v. United of Omaha Life Ins. Co.,*[56] Section 40350.11 of the California Insurance Law, which requires that a statute of limitation be at least 3 years from proof of loss, was a controlling statute to the contrary with respect to a policy provision providing a contractual limitation of 2 years from the date proof of loss is due.

Munro-Kienstra v. Carpenters Health and Welfare Trust Fund of St. Louis illustrates the type of analysis a court applies in determining that a state statute is not a controlling statute to the contrary. In that case, the plan specified that any civil action for wrongful denial of benefits under ERISA Section 502(a) must be brought within 2 years of the final date of denial. Appellant brought her claim almost two-and-a-half years after she learned that her claim had been denied. Appellant argued in the district court that the plan's contractual 2-year statute of limitations was invalid because the plan's rules of construction stated that its terms should be read to comply with Missouri law, under which a 10-year statute of limitations governed ERISA claims.[57] The district court agreed, and the Eighth Circuit affirmed. Munro-Kienstra's argument was based on the plan's governing law section, which provided that the plan would be construed in accordance with the Internal Revenue Code and ERISA, and secondly in accordance with the laws of the State of Missouri. The court of appeals found this argument unpersuasive. The court indicated that there was no conflict between Missouri law and the contractual provision. State law does not "apply of its own force to a suit based on federal law-especially a suit under ERISA, with its comprehensive preemption provision."[58] Appellant next argued that even if Missouri's 10-year statute of limitations did not apply of its own accord, Missouri Revised Statutes Section

431.030, which prohibits parties from shortening the limitations period for enforcing a contract, is a controlling statute to the contrary that prevents enforcement of the plan's two-year internal statute of limitations. Again, the Eighth Circuit disagreed. It explained that although parties may specifically choose to incorporate state law when drafting the substantive terms of the plan setting forth the time limits for bringing claims,[59] they may not broadly "contract to choose state law as the governing law of an ERISA-governed benefit plan."[60] As a result, the plan's rule of construction did not specifically incorporate the Missouri statute that prohibits shortening the limitations period for enforcing a contract. Rather, Munro-Kienstra had to establish that the Missouri statute was not preempted by ERISA. Because the plan was self-funded, appellant was unable to establish that the Missouri statute would not be preempted. (Munro-Kienstra also argued that the savings clause applicable to multiple employer welfare arrangements should apply, but that argument was rejected because that savings clause does not apply where plans are maintained pursuant to collective bargaining agreements, which appellant acknowledged that the record established.) In other instances, assertions that a controlling statute to the contrary applied have been rejected because on its face the statute was inapplicable to the challenged provision.[61]

From a procedural perspective, the reasonableness of a contractual limitations period is properly considered by a court at the motion to dismiss stage.[62] Under Rule 8(c) of the Federal Rules of Civil Procedure (FRCP), a party must ordinarily raise such affirmative defenses as the statute of limitations at the pleading stage,[63] although there is ample authority that an affirmative defense raised for the first time in a summary judgment motion proceeding is sufficient notice.[64] Although a dismissal under FRCP 12(b)(6) is irregular, because the statute of limitations is an affirmative defense,[65] a motion to dismiss on such grounds should be granted "where the allegations of the complaint itself set forth everything necessary to satisfy the affirmative defense."[66] Furthermore, the application of a statute of limitations in an ERISA case is a question of law that a court of appeals reviews *de novo*.[67]

IS NOTICE OF LIMITATIONS PERIOD REQUIRED?

There is a split of authority among the circuits, and in some instances within a circuit,[68] as to whether notice of the contractual limitations period must be included in a denial letter to plan participants under the Department of Labor's (DOL's) claims review procedures. The First Circuit,[69] Third Circuit,[70] and Sixth Circuit[71] have all held that the DOL regulations require denial letters to include the contractual limitations period for filing an ERISA claim, while the Ninth Circuit,[72]

Tenth Circuit,[73] and Eleventh Circuit[74] have concluded to the contrary, concluding that the initial denial letters are only required to include time limits applicable to internal review procedures.

The split among the circuits results from the lack of precision regarding the relationship between two sections of the claims procedure regulations: 29 C.F.R. Section 2560.503-1(g)(1)(iv) requires a benefit determination to include, among other things, "a description of the plan's review procedures and the time limits applicable to such procedures, including a statement of the claimant's rights to bring a civil action under Section 502(a) of the Act following an adverse benefit determination on review." Another section of those regulations, 29 C.F.R. 2560.503-1(j)(4), requires a benefit determination on review to include, among other things, "a statement describing any voluntary appeal procedure offered by the plan and the claimant's right to obtain the information about such procedures described in paragraph (c)(3)(iv) of this section, and a statement of the claimant's right to bring an action under Section 502(a) of the Act." Thus, as the district court stated in *Fontenot v. Intel Corp. Long Term Disability Plan,*[75] "irrespective of ERISA's other requirements, the governing regulation, 29 C.F.R. Section 2560. 503-1(j) plainly does not require plan administrators to state the contractual limitations period in final denial letters."[76]

As the Court of Appeals for the Eleventh Circuit explained in *Wilson v. Standard Ins. Co.,* DOL Regulation Section 2560.503-1(g)(1)(iv) "can also be reasonably read to mean that notice must be given of the time limits applicable to the plan's review procedures, and the letter must also inform the claimant of her right to bring a civil action without requiring notice of the time period for doing so."[77] *Michael C.D. and Michael D. v. United Health Care*[78] indicates why some courts believe that, "although providing time limits in denial letters for bringing a civil action under the ERISA statute may be a good idea and may be helpful to the claimant," a denial letter is not required under DOL regulations to disclose the contractual limitations period in the initial denial letter:

> As the last step in the administrative process, the final denial letters permit a claimant to pursue his or her claim in federal court for the first time. Therefore, the limits and procedures applicable to the claim in federal court are most relevant to the claimant at the time of receiving a final denial letter. But the regulations do not require time limits to be disclosed in final denial letters. Requiring time limits for federal court proceedings to be included in initial denial letters, where they are less relevant, but not in final denial letters, where they are the most relevant, is counterintuitive.

However, while it may not be required under DOL regulations, there would seem no good reason not to disclose to plan participants, if not in both the initial denial letter and the final denial letter. A summary plan description should also inform participants of a contractual statute of limitations.

CONCLUSION

Contractual limitation periods are a useful feature to include as part of plan administration, not so much from an adversarial perspective of eliminating meritorious participant claims but rather to require plan participants to address any issues that they may have in a timely manner, so that a resolution might be more easily accomplished. Plan sponsors have a great deal of flexibility in selecting a contractual limitations periods for all types of ERISA plans, and, except where there is a controlling statute to the contrary, determined after an ERISA preemption analysis, such internal statutes of limitation will withstand judicial challenge.

NOTES

1. *Gasperini v. Center for Humanities, Inc.*, 518 U.S. 415, 426 (1996).

2. Jennifer S. Hendricks, "In Defense of the Substance Procedure Dichotomy," 89 *Washington University Law Review* 103, 109 (2011).

3. *Winburn v. Progress Energy Carolinas, Inc.,* 2015 WL 505551 (D.S.C. February 6, 2015); *St. Alexius Medical Center v. Roofers Unions Welfare Trust Fund,* 2017 WL 3584212 (N.D. Ill. August 8, 2017); *Demopolous v. Anchor Tank Lines, LLC,* 2015 WL 4430699 (S.D.N.Y. 2015); *Mosdos Chofetz Chaim, Inc. v. RBS Citizens, N.A.,* 14 F. Supp. 3d. 191, 210 (S.D.N.Y. 2014); *Staehr v. Hartford Financial Services Group, Inc.,* 547 F. 3d 406, 425 (2d Cir. 2008), *cited in Guo v. IBM 401(k) Plus Plan,* 95 F. Supp. 3d 512 (S.D.N.Y. 2015).

4. *Heimeshoff v. Hartford Life and Accident Ins. Co.,* 134 S. Ct. 604, 610 (2013), quoted in *Center for Restorative Breast Surgery v. Blue Cross Blue Shield of Louisiana,* 2016 WL 7468165 (E.D. La. May 6, 2016).

5. *Wilson v. Garcia,* 471 U.S. 261, 271 (1985).

6. *Lozzano v. Montoya Alvarez,* 134 S. Ct. 1224, 1234 (2014).

7. *See, for example, Northlake Regional Medical Center v. Waffle House Sys. Employee Benefit Plan,* 160 F. 3d. 1301, 1303 (11th Cir. 1998); *Salisbury v. Hartford Life and Acc. Co.,* 583 F. 3d 1245, 1247 (10th Cir. 2009).

8. *Mazur v. Unum Insurance Company*, 2014 WL 5454836 (6th Cir. October 28, 2014); *Salisbury v. Hartford Life and Acc. Co., supra* n.7 ("choosing which state law to borrow is unnecessary … where the parties have agreed upon a limitations period.").

9. *Salisbury v. Hartford Life and Acc. Co., supra* n.7.

10. *Withrow v. Halsey,* 655 F. 3d. 1052, 1055 (9th Cir. 2011). *See also Armstrong v. Hartford Life and Accident Insurance Company,* 2014 WL 5514183 (E.D. Cal. October 30, 2014).

11. *Heimeshoff v. Hartford Life & Accident Insurance Company, supra* n.4 at 604.

12. *Order of United Commercial Travelers of America v. Wolfe*, 331 U.S. 586 (1947).

13. *Heimeshoff, supra* n.4 at 610.

14. The Supreme Court in *Heimeshoff* specifically distinguished ERISA Section 1113 (the breach of fiduciary duty section) from its holding that where the statute creating the cause of action is silent regarding a statute of limitations, the plan can provide a time limit. *Winburn v. Progress Energy Carolinas, Inc., supra* n.3.

15. *Heimeshoff, supra* n.4 at 611.

16. *Id.* at 615.

17. *Occidental Life Insurance Corp. of California v. EEOC,* 432 U.S. 355 (1977).

18. *Lamantia v. Voluntary Plan Administrators, Inc.,* 401 F. 3d. 114, 119 (9th Cir. 2005).

19. *Hughes v. Life Insurance Company of North America,* 2016 WL 5231811 (E.D. La. September 22, 2016).

20. *McArthur v. Unum Life Ins. Co.,* 2014 WL 4494241(N.D. Ala. September 4, 2014).

21. *Shealy v. Unum Life Ins. Co. of America,* 979 F. Supp. 395, 399–400 (D.S.C. 1997).

22. *Heimeshoff, supra* n.4 at 615. However, an an argument that a contractual limitations period should not be enforced because it was part of a contract of adhesion was rejected in *Tarallo-Brennan v. Smith Barney,* 1999 WL 294873 (S.D.N.Y. May 10, 1999).

23. *Tuminello v. Aetna Life Ins. Co.,* 2014 WL 572367 (S.D.N.Y. February 14, 2014).

24. *Wilson v. Standard Ins. Co.,* 2014 WL 358722 (N.D.Ala. January 31, 2014) Aff'd 613 Fed. App'x 841, 844 (11th Cir. 2015) (unpublished), cited in *McArthur v. Unum Life Ins. Co. of America,* 2014 WL 4494221 (N.D. Ala. September 4, 2014).

25. *Santana-Diaz v. Metropolitan Life Ins. Co,* 2015 WL 317194 (D.P.R. January 23, 2015).

26. *Jamison v. Aetna Life Insurance Company,* 2015 WL 6711081 (N.D. Ill. November 2, 2015). For a general discussion, *see* Barry Salkin, "Equitable Tolling in the ERISA Context," 22 *Benefits Law Journal* September 2009.

27. *Threadgill v. Moore U.S.A., Inc.,* 269 F. 3d 848 (7th Cir. 2001). For an illustration of an equitable tolling analysis, *see Guo v. IBM 401(k) Plus Plan*, *supra* n.3.

28. *Northlake Regional Medical Center v. Waffle House Sys. Employee Benefit Plan, supra* n.7 at 1301, 1304; *Webb v. Liberty Mutual Insurance Company,* 2017 WL 2297615 (11th Cir. 2017).

29. A contractual limitations period begins to run as defined by the plan's terms" [*Koblentz v. UPS Flexible Employee Benefit Plan,* 2013 WL 4525432 (S.D. Cal. August 23, 2013), appeal dismissed February 23, 2014)] and would begin, at the latest, upon an insurance company's or plan administrator's final denial of benefits [*Johnson v. Unum Provident,* 363 Fed. Appx. 1, 3 (11th Cir. 2009), cited in *McArthur v. Unum Life Ins. Co. of America, supra* n.24.

30. *Id. See also Mazur v. Unum Insurance Co., supra* n.8.

31. *Hughes v. Life Insurance Company of North America, supra* n.19.

32. *Cigna Corp. v. Amara,* 563 U.S. 421 (2011).

33. *St. Alexius Medical Center v. Roofers Unions Welfare Trust Fund*, *supra* n.3.

34. *Bell v. Xerox Corp.,* 2014 WL 4955372 (W.D.N.Y. October 2, 2014).

35. *Sandefur v. Iron Workers St. Louis District Council Pension Fund*, 2015 WL 4232490 (S.D. Ind. July 13, 2015).

36. *Perris Valley Community Hospital, LLC v. Southern California Pipe Trades*, 2014 WL 12558843 (C.D. Cal. February 21, 2014).

37. *Mogck v. Unum Life Insurance Company of America*, 292 F. 3d 1025, 1029 (9th Cir. 2002).

38. *Nelson v. Standard Insurance Company*, 2014 WL 4244048 (S.D. Cal. August 26, 2014).

39. *Almont Ambulatory Surgery Center, LLC v. United Health Group, Inc.,* 2015 WL 160899 (C.D. Cal. April 10, 2015).

40. *Jevelkides v. Lincoln National Corporation,* 2015 WL 3849312 (N.D.N.Y. June 22, 2015); *Hoover v. Metropolitan Life Ins. Co.,* 2016 WL 4076418 (E.D. Pa. August 1, 2016).

41. *Lonogan v. UNUM Life Ins. Co.,* 2017 WL 569521 (E.D. Pa. February 10, 2017).

42. *Dye v. Associates First Capital Long Term Disability Plan 504,* 243 Fed. Appx. 808, 810 (5th Cir. 2007), cited in *Center for Restorative Breast Surgery, LLC v. Blue Cross Blue Shield of Louisiana, supra* n.4.

43. *Abena v. Metropolitan Life Ins. Co.,* 544 F. 3d 880, 884 (7th Cir,. 2008), citing *Doe v. Blue Cross Blue Shield United of Wisconsin,* 112 F. 3d 869, 887 (7th Cir. 1997); *Center for Restorative Breast Surgery v. Blue Cross Blue Shield of Louisiana, supra* n.4 (a contractual limitations period that expires before the issuance of a final denial of benefits is unreasonable); *Nelson v. Standard Insurance Company,* 2014 WL 4244048 (S.D. Cal. August 26, 2014) ("Defendant cites no legal authority holding that a period of approximately 100 days constitutes a reasonable period to file suit in a case such as this one, where the plan administrator has not issued a final decision prior to the expiration of the limitation period.").

44. *Hansen v. Aetna Health and Life Ins. Co.,* 1999 WL 1074048 (D. Ore. November 4 1999).

45. *Northlake Regional Medical Center v. Waffle House Sys. Employee Benefit Plan, supra* n.7.

46. *Rotondi v. Hartford Life and Accident Group,* 2010 WL 3720830, n.2 (S.D.N.Y. September 22, 2010); *DeMarco v. Hartford Life and Accident Ins. Co.,* 2014 WL 3490481 (E.D.N.Y. July 11, 2014); *Hyatt v. Prudential Ins. Co.,* 2014 WL 5530130 (W.D.N.C. October 31, 2014); *Jerves v. Hartford Life and Accident Ins. Co.,* 2016 WL 5887601 (E.D. Tex. October 7, 2016) (three-year limitation period running from proof of loss is reasonable); *Barrilleaux v. Hartford Life & Accident Ins. Co.,* 2014 WL 3778696 (E.D. La. July 29, 2014) (3 years after time written proof of loss required to be provided is reasonable); *Barriero v. NJ BAC Health Fund,* 2013 WL 6843478 (D.N.J. December 27, 2013) (3 years from the end of the year in which medical services provided is reasonable); *Schulte v. Boston Mutual Life Ins. Co.,* 2015 WL 7273148, fn.30 (D. Md. November

18, 2015) (limitation period " materially identical" to *Heimeshoff* is reasonable); *Thomas v. Prudential Insurance Company of America,* 2015 WL 2406036 (M.D. La. May 9, 2015) (3 years after proof of claim required is reasonable); *Haas v. Metropolitan Life Ins. Co.,* 2016 WL 4076418 (E.D. Pa. August 1, 2016) (3 years after proof of disability must be filed is reasonable); *Soich v. Aetna Life Ins. Co.,* 2017 WL 449171 (D. Ohio February 2, 2017) (three years from the deadline for filing a claim is reasonable). *Cf. Jacobs v. Prudential Ins. Co. of America,* 2014 WL 2807537 (E.D. La. June 19, 2014) (6-year period is reasonable).

47. *Hoover v. Harvard Pilgrim Health,* 2016 WL 2636236 (D.N.H. May 5, 2016) (2-year limitation period is reasonable); *Freeman v. American Airlines LTD Plan,* 2014 WL 690207 (C.D. Cal. February 20, 2014) (2-year internal statute of limitations period not unreasonable); *Arkin v. Unum Group et al.,* 2017 WL 4084050 (S.D.N.Y. September 14, 2017) (more than 30 months within which to file a claim is reasonable); *Medical Mutual of Ohio v. K. Amalia Enters., Inc.,* 548 F. 3d 383, 391 (6th Cir. 2008) (2- or 3-year period within which to bring a claim is reasonable); *Dahmen v. Liberty Mutual,* 2016 WL 3072256 (E.D. Wash. May 31, 2016) (1 year after the time that proof of claim is required is reasonable); *Doe v. Blue Cross Blue Shield of Wisconsin, supra* n.43 (17 months following completion of internal appeals is reasonable), discussed in *Summer v. Hartford Life & Accident Ins. Co.,* 2014 WL 107002 (E.D. Wisc. January 9, 2014); *Dunn v. The Building Trades United Pension Trust Fund,* 2015 WL 7432846 (E.D. Wis. November 23, 2015) (14 months after completion of administrative appeals is reasonable); *Abena v. Metropolitan Life Ins. Co., supra* n.43 (seven months following the completion of internal appeals is reasonable); *Russell v. Catholic Health Care Partners Employee Long Term Disability Plan,* 2014 WL 3953722 (6th Cir. August 14, 2014) (over six months remaining to file a legal action is reasonable); *Horton v. Hilton Retirement Plan,* 2017 WL 5992096 (E.D. La. December 4, 2017) (180-day period is reasonable, where there is prompt notification of decision on appeal, and the period does not begin to run until the exhaustion of internal claim procedures); *Sheckly v. Lincoln National Corp. Employees Retirement Plan,* 366 F. Supp. 2d 140, 145–148 (D. Me. 2005) (enforcing a plan provision that suit must be filed within six months of final denial); *Dye v. Associates First Capital Corp. Long Term Disability Plan 504, supra* n.42 (120-day limitation period in context of disability benefit was not unreasonable); *Center for Restorative Breast Surgery v. Blue Cross Blue Shield of Louisiana, supra* n.4 ("A contractual limitations period that results in the claimant having at least 90 days to file suit from the date the plan issues a decision on final appeal is presumptively reasonable"); *White v. Worthington Industries, Inc. LTD Plan,* 266 F.R.D. 178, 185 (S.D. Ohio 2010) (71 days); *Delosky v. Penn State Geiger Health Plan,* 2002 US Dist. LEXIS 17188 (M.D. Pa. Apr. 23, 2002) (enforcing 60 days to file suit from a final decision by a state department of insurance); *Davidson v. Walmart Associates Health and Welfare Plan,* 305 F. Supp. 2d. 1059, 1069–1075 (S.D. Ia. 2004) (requiring plaintiff to file suit within 45 days after denial of favorable appeal is reasonable). For an excellent discussion of the pre-*Heimeshoff* cases cited herein, see J.S. Christie and Jessica L. Jones, "After Heimeshoff: Applying an ERISA Plan's Contractual Limitation of Action Provision" (May 23, 2014) (*https://www.bradley.com/insights/publications/2014/04/after-iheimeshoffi-applying-an-erisa-plans-contr__*).

48. *Dahmen v. Liberty Mutual Group, supra* n.47.

49. *Baptist Memorial Hospital, DeSoto, Inc. v. Crain Auto, Inc.,* 392 Fed. Appx. 288, 294 (5th Cir. 2010) (per curiam), cited in *Center for Restorative Breast Surgery v. Blue Cross Blue Shield of Louisiana, supra* n.4.

50. *Heimeshoff, supra* n.4 at 61, cited in *Mulholland v. MasterCard Worldwide,* 2014 WL 6977805 (E.D.Mo. December 9, 2014), rev'd on other grounds, 2015 WL 6161462 (8th Cir. October 21, 2015).

51. *Caldwell v. Standard Insurance Company,* 2015 WL 4727378 (S.D. W. Va. August 10, 2015).

52. *Mulholland v. MasterCard Worldwide, supra* n.50.

53. *Mulholland v. MasterCard Worldwide,* 2014 WL 6977805 (E.D. Mo. December 9, 2014).

54. *See also Harris v. The Epoch Group, L.C.,* 357 F. 3d. 822, 824–826 (8th Cir. 2002), in which an ERISA plan contained almost the identical contractual language and the court held that Missouri's 10-year statute of limitations was applicable.

55. *Halpern v. Blue Cross Blue Shield of New York,* 2014 WL 4385759 (W.D.N.Y. September 9, 2014).

56. *Carey v. United of Omaha Life Ins. Co.,* 2017 WL 1045077 (C.D. Cal. January 31, 2017). *See also Wetzel v. Lou Ehler Cadillac Group Long Term Disability Plan,* 222 F. 3d 643, 650–651 (9th Cir. 2000) (en banc) (remanding action to district court to determine whether plaintiff's action was barred by the plan's limitation period in light of California law, particularly California Insurance Code § 10350.7). *cf. Stephan v. Unum Life Ins. Co. of America,* 697 F. 3d 917, 927 (9th Cir. 2012) (California statutory law is read into an insurance policy and becomes part of the contract).

57. *Johnson v. State Mutual Life Assurance Company of America,* 942 F. 2d. 1260 (8th Cir. 1991) (en banc).

58. *Citing Doe v. Blue Cross Blue Shield United of Wisconsin, supra* n.43.

59. *Harris v. The Epoch Group, LC,* 357 F. 3d. 822, 825 (8th Cir. 2004).

60. *Prudential Ins. Co. of America v. Doe,* 140 F. 3d. 785, 791 (8th Cir. 1998).

61. *See, for example, Estaban Jeanette Dodge v. Hartford Life & Accident Ins. Co.,* 2017 WL 412633 (E.D. Ark. January 30, 2017) (An Arkansas prohibition against shortening the limitations period for filing suit on a life insurance policy did not apply to a group disability plan); *McArthur v. Unum Life Insurance Company of America, supra* n.24 (Georgia Statute 33-29-3(b)(7) not a controlling statute to the contrary, because it applies to individual disability policies, not group disability policies).

62. *Jerves v. Hartford Life & Accident Ins. Co., supra* n.46.

63. *Schulte v. Boston Mutual Life Ins. Co., supra* n.46.

64. *Grunley Walsh USA, LLC v. Raap,* 386 Fed. Appx. 455, 459 (4th Cir. 2010).

65. *Chicago Building Design, P.C. v. Mongolian Houses, Inc.,* 770 F. 3d. 610, 615 (7th Cir. 2014), cited in *Dunn v. The Building Trades United Pension Trust Fund, supra* n.47. *See also supra* n.4.

66. *Tregenza v. Great American Communications, Co.,* 12 F. 3d 717, 719 (7th Cir. 1993), cited in *Dunn v. The Building Trades United Pension Trust Fund, supra* n.47. *See also Harris v. City of New York,* 186 F. 3d 243, 250 (2d Cir. 1999) (dismissing a complaint on statute of limitations grounds at the complaint level "is appropriate only if a complaint clearly shows the claim is out of time."); *Mosdos Chofetz Chaim, Inc. v. RBS Citizens, N.A., supra* n.3 (a pre-answer motion to dismiss on statute of limitations grounds should be granted "only if it is clear on the face of the complaint that the statute of limitations has run"); *Staehr v. Hartford Fin. Serv. Group Inc., supra* n.3, cited in *Guo v. IBM 401(k) Plus Plan, supra* n.3 (a statute of limitations defense may be raised in a pre-answer 12(b)(6) motion if the defense appears on the face of the complaint); *La Chapelle v. Berkshire Life Ins. Co.,* 142 F. 3d 507, 509 (1st Cir. 1998), cited in

Hoover v. Harvard Pilgrim Healthcare,Inc., supra n.47 ("Granting a motion to dismiss based on a limitations defense is entirely appropriate when the plaintiff's allegations leave no doubt that an asserted claim is time-barred"); *Trans Spec Trucking Serv. v. Caterpillar, Inc.,* 524 F. 3d 315, 320 (1st Cir. 2008) ("Where the dates included in the complaint show that the limitations period has been exceeded and the complaint fails to sketch a factual predicate that would warrant the application of either a different statute of limitations or equitable estoppel, dismissal is appropriate.").

67. *Witt v. Metropolitan Life,* 772 F. 3d 1269 (11th Cir. 2014). *See also Russell v. Catholic Healthcare Partners Employee Long Term Disability Plan, supra* n.47; *Munro-Kienstra v. Carpenters' Health and Welfare Trust Fund of St. Louis,* 2015 WL 3756712 (8th Cir. June 17, 2015).

68. In *Novick v. Metropolitan Life Ins. Co.* 764 F. Supp. 2d 653, 661 (S.D.N.Y. 2011), the district court held that the disclosure of the applicable time limit was required, while in *Soares v. United of Omaha Life Ins. Co.,* 2016 WL 158495 (D. Conn. January 13, 2016), the court concluded that it was not required.. While most courts in the Ninth Circuit have held that disclosure is not required, the district court in *Solien v. Raytheon*, 2008 WL 2323915 (D. Ariz. 2008) reached a contrary conclusion.

69. *Santana-Diaz v. Metropolitan Life Ins. Co.,* 816 F. 3d 172 (1st Cir. 2016); *Candelaria v. Orthobiologics,* 661 F. 3d 675 (1st Cir. 2011).

70. *Mirza v. Insurance Administrator of America, Inc.,* 800 F. 3d 129 (3rd Cir. 2015).

71. *Moyer v. Metropolitan Life Ins. Co.,* 762 F. 3d 503 (6th Cir. 2014).

72. *Scharff v. Raytheon Co. Short Term Disability Plan,* 581 F. 3d 899, 907–908 (9th Cir. 2009) (declining to supplement ERISA's comprehensive scheme for regulating disclosures to participants with a California law requiring the express disclosure of a statute of limitations).

73. *Young v. United Parcel Services,* 416 F. App'x 734, 740 (10th Cir. 2011) (unpublished) (concluding that requiring a notification of the time limit for filing suit "conflates the internal appeals process, and its associated deadlines, with the filing of a legal action after the process has been fully exhausted.").

74. *Wilson v. Standard Ins. Co., supra* n.24.

75. *Fontenot v. Intel Corp. Long Term Disability Plan,* 2014 WL 2871371 (D. Ore. June 24, 2014).

76. *Id.* at *p7.

77. *Wilson v. Standard Ins. Co., supra* n.74.

78. *Michael C.D. and Michael D. v. United Health Care*, 2016 WL 2888984 (D. Utah 2016).

Has the Qualified Transportation Benefit Offering Crashed?

Karen R. McLeese

This column reviews the effect of the Tax Cuts and Jobs Act (TCJA; Pub. L. No. 115-97)[1] on employer-provided transportation benefits.

Background

For several years, tax-favored status has been available to the employer and employee for a qualified transportation program offered in accordance with Code Section 132(f).[2] A qualified transportation program is a program that can be funded through direct employer contribution, reimbursement, or salary reduction.

The types of transportation expenses available include van pooling, mass transit fares, and qualified parking.[3] The qualified bicycle commuter benefit[4] is only available if it is funded with employer dollars, as more fully described below. The limitations on transportation expenses under a qualified transportation program are subject to indexing; the monthly indexed limits for 2018[5] for commuter highway vehicle (van pooling), any transit pass, and any qualified parking are $260.

Qualified transportation programs can be sponsored by both private sector and government employers.[6] Participants in the program must be employees; therefore, self-employed individuals, including partners and over-2-percent shareholders of an S-corporation, are ineligible to participate in this type of plan.[7]

A qualified transportation program can be designed in a manner similar to a Code Section 125 (cafeteria) plan in that it can be a salary reduction program; however, it cannot be part of a Code Section 125 plan. To date, there has been no regulatory guidance issued on how to design a qualified transportation program. A conservative approach would be to design a qualified transportation program with requirements similar to a Code Section 125 plan, such as having

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a written plan document in place, requiring advanced irrevocable elections to participate in the plan, and establishing a written substantiation process for reconciling the expense. Like a Code Section 125 plan, the election under a qualified transportation program must be made prior to compensation becoming readily available, and the election is irrevocable.[8] Unlike a Code Section 125 plan in which the election must be made for 12 months, the election for a qualified transportation program can be for a shorter period. It is common for a qualified transportation program to allow elections to be changed monthly.

Effect of the Tax Cuts and Jobs Act

The TCJA changed the tax status of qualified transportation benefits, effective January 1, 2018, as follows:

- The employer deduction for van pooling, mass transit fares, and qualified parking is lost; however, the tax exclusion available to individuals is retained.[9] For tax exempt organizations offering qualified transportation benefits, the unrelated business income tax is imposed on the benefit, but the tax exclusion available to individuals is retained.[10]

- IRS Publication 15-B, *Employer's Tax Guide to Fringe Benefits,* issued after the enactment of the TCJA, affirms that the employer deduction is no longer available for reimbursement amounts, including salary reduction amounts. While this publication does not specifically address the imposition of the unrelated business income tax on salary reduction amounts permitted by tax exempt organizations, informal IRS guidance suggests that it would be imposed.

- In accordance with the TCJA, for tax years beginning after December 31, 2017, and before January 1, 2026, the exclusion from gross income and wages for qualified bicycle commuting reimbursements is suspended.[11] The effect of this change in the law is that the tax deduction for the employer is still available; however, the tax exclusion for the employee is lost. Under prior law, if an employer sponsors a qualified bicycle fringe benefit plan, a participating employee who uses a bicycle for traveling between his or her home and place of employment was entitled to receive a reimbursement of up to $20 per month ($240 annually) on a tax-favored basis for qualified bicycle expenses. Reimbursement for such

bicycle expenses cannot be made through a salary reduction methodology.

Local Jurisdiction Commuter and Transit Laws

As of the date of this writing, the following local jurisdictions have ordinances or laws in place that require certain commuter benefits for employees.

San Francisco Bay Area Commuter Benefits Program

All public, private, and nonprofit Bay Area employers with 50 or more full-time employees within the nine-county San Francisco Bay Area are required to register and offer commuter benefits to any of their eligible W-2 employees.[12] An employer can select one or more commuter benefit options to offer its employees:

- Allow employees to exclude their transit or vanpooling costs from taxable income, to the maximum allowed by federal law ($260 per month for 2018);

- Provide a transit or vanpool subsidy to cover or reduce employees' monthly transit/vanpool costs (up to $75 per month);

- Provide a low-cost or free shuttle, vanpool, or bus service, operated by or for the employer; or

- Provide an alternative commuter benefit that would be as effective as one of the other options in reducing drive-alone commuter trips (and/or vehicle emissions).

Berkeley and Richmond, California

The cities of Berkeley and Richmond, California, have nearly identical commuter benefit program ordinances in place[13] that require employers with 10 or more employees to provide a commuter program to encourage employees to use public transit, vanpools, or bicycles. In determining the number of persons performing work for an employer during a given week, all persons performing work for compensation on a full-time, part-time, or temporary basis are counted, including those who perform work outside of the geographic boundaries of the relevant city, and those who work through the services of a temporary services

or staffing agency. These employers must offer one or more of the following options:

- A pre-tax election. A program, consistent with Code Section 132(f), that permits employees to elect to exclude employee commuting costs incurred for transit passes or vanpool charges from taxable wages and compensation, up to maximum level allowed by federal tax law (currently $260) per month for transit and qualified vanpools, and $20 per month for bicycles (however, as noted above, the bicycle benefit tax exclusion is suspended);

- Employer-paid benefit. A program whereby the employer supplies an annual, monthly, or other form of transit pass, or reimbursement for equivalent vanpool expenses at least equal in value to the purchase of the appropriate benefit, which does not exceed the cost of an adult monthly AC Transit regular pass, for the public transit system requested by each employee or to reimburse qualified vanpool charges; and/or

- Employer-provided transit. Transportation furnished by the employer at no cost to the employee in a vanpool, bus, or similar multipassenger vehicle operated by or for the employer.

Both Berkeley and Richmond are located in counties covered by the San Francisco Ordinance, as described above, and the commuter benefits must be coordinated.

District of Columbia Commuter Benefits Law

Under this law,[14] covered employers are required to offer commuter benefits in one or more of the following ways to employees:

- Employee-paid, pre-tax contribution. Allow employees to set aside income on a pre-tax basis to cover the cost of commuting by mass transit or vanpools (up to $260 per month, indexed for 2018).

- Employer-paid, direct benefit. Offer a tax-free subsidy for transit up to $260 per month (indexed for 2018), or up to $20 per month for bicycle expenses (however, as noted above, the bicycle benefit tax exclusion is suspended).

- Employer-provided transportation. Provide shuttle or vanpool services at no cost to employees.

For purposes of this law:

- A covered employer is any individual, partnership, general contractor, subcontractor, association, corporation, business trust, or any person or group of persons employing 20 or more full-time and/or part-time employees.

- An eligible employee is one employed by the covered employer who performs 50 percent or more of his or her work in the District of Columbia. Individuals who are based in D.C. and perform a substantial amount of their work in D.C., but less than 50 percent in any other state, are also eligible for the benefit. Employees become eligible for benefits under the program after 90 days of employment.

New York City Mass Transit (Commuter) Benefit Law

This law[15] requires for-profit and nonprofit employers with 20 or more full-time nonunion employees who work in New York City to offer their full-time employees the opportunity to use pre-tax income to pay for their commute.

The employer's number of full-time employees is determined by calculating the average number of full-time employees for the most recent consecutive 3-month period. A full-time employee is one who works an average of 30 hours or more per week in the most recent 4 weeks, any portion of which was in New York City. Accordingly, even if a full-time employee works only occasionally in New York City, the employee would be eligible.

Employees may use their pretax income to pay for transit passes that can be used on public or privately owned mass transit, commuter vans with a seating capacity of six or more passengers, or ferry services and water taxis taken into and within New York City. Employees may use their benefits to pay for more than one mode of transit in their commutes.

Conclusion

In closing, whether the changes in the tax status in qualified transportation benefits imposed by the TCJA will cause employers to modify their commitment to sponsor transportation programs remains to be seen. Some employers might consider changing their program to an after-tax program, in effect, providing taxable compensation that can be used for transportation expenses at the employee's discretion. This would allow the employer the take the Code Section 162

deduction available on compensation as a business expense. Many employers will continue to offer a transportation program, particularly those with employees in local jurisdictions as described above that require the offering of a salary reduction transportation program.

Notes

1. Tax Cuts and Jobs Act (TCJA), Pub. L. No. 115-97 (enacted December 22, 2017).

2. Reference citations: 26 U.S. Code § 132 (f) Qualified transportation fringe; 26 CFR 1.132-9—Qualified transportation fringes.

3. Code § 132(f)(1).

4. Code § 132(f)(1)(5)(F).

5. Code § 132(f)(6); IRS Rev. Proc. 2017-58 provides inflationary adjustments for 2018 tax year.

6. Code § 3401(d); Treas. Reg. § 31.3401(d)-1.

7. Treas. Reg. § 1.132-9, Q&As 5 and 24.

8. Treas. Reg. § 1.132-9, Q&As 11-15.

9. Code § 274(a)(4) as amended by TCJA § 13304(c)(1)(B).

10. Code § 512(a)(7), as amended by TCJA § 13703(a).

11. Code § 274(l)(2) as amended by TCJA; codified as Code § 132(f)(1)(5)(F)(8).

12. The Bay Area Commuter Benefits Program is authorized under California Government Code § 65081; and the Bay Area Air Quality Management District, Regulation 14, §§ 14-1-100 to 14-1-501, Mobile Source Emissions Reduction Measures. The law applies to the following counties: Alameda, Contra Costa, Napa, Solano, Sonoma, Marin, Santa Clara, San Mateo, and the City and County of San Francisco. The Bay Area Commuter Program is also coordinated with certain local Transportation Management Association programs established in other counties in California.

13. City of Berkeley Municipal Code Chapter 9.88, Tax Relief Action to Cut Commuter Carbon; City of Richmond Municipal Code, Chapter 9.62, Commuter Benefit Program.

14. Sustainable DC Omnibus Act of 2014, D.C. Act 20-385 §§ 301 to 303 (L. 2014); codified as District of Columbia Official Code, Division V. Local Business Affairs, Title 32. Labor, Chapter 1B. Reducing Single Occupancy Vehicle Use by Encouraging Transit Benefits, Sections 32-151 to 32-153.

15. NYC Transit Ordinance, Local Law 53; N.Y.C., NY Administrative Code, Tit. 20, Chap. 9, § 20-926.

Inaugural Season of Pay Ratio Disclosures Highlights Shortcomings of Requirements

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The pay ratio rules[2] adopted by the Securities and Exchange Commission (SEC) under the Congressional mandates of the Dodd-Frank Wall Street Reform and Consumer Protection Act[3] generally compelled disclosure of the ratio between a public corporation's chief executive officer and its median employee for the first time in proxy statements filed this year. Since the passage of the Dodd-Frank Act in July 2010, there has been substantial doubt as to the value to investors of the pay ratio information prescribed by these rules and persistent anguish by companies and practitioners over the costs of compliance, as well as considerable political and regulatory uncertainty as to whether the rules would survive without repeal, delay, or other limitation. Although the deliberations over the pay ratio rules provided a good deal of anticipation and agitation for practitioners, the pay ratio disclosures themselves, predictably, did little to challenge the notion that the costs of compliance imposed on public companies far exceed the value, if any, of the disclosures to investors and their assessment of executive compensation. This column reviews the historical development of the pay ratio requirements through the initial year of proxy disclosures, and questions the effect they have or may have in the future on executive compensation program design, employee relations, and shareholder engagement.

Historical Background

Dodd Frank Act and SEC Rulemaking

Congress introduced the pay ratio requirements as one of many executive compensation provisions of the Dodd-Frank Act. These provisions

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include requirements that are by now well established as a matter of public company executive compensation practice, such as nonbinding shareholder "say on pay" votes on named executive officer compensation[4] and enhanced independence requirements for members of compensation committees and their advisers.[5] (In contrast, other Dodd-Frank executive compensation rules, including those in respect of incentive compensation clawback policies[6] and "pay versus performance" disclosure requirements,[7] have remained in proposed form for several years, with the completion of final rules and effectiveness uncertain.[8])

In Section 953(b) of the Dodd-Frank Act, Congress directed the SEC to amend the executive compensation disclosure rules under Item 402 of Regulation S-K to require public company disclosure of the median annual total compensation of its employees (other than its CEO), the annual total compensation of its CEO, and the ratio of such amounts.[9] Section 953(b) specified that, for this purpose, annual total compensation would be determined in accordance with rules for determining the total compensation of each of the company's named executive officers in its summary compensation table.[10] Outside of these parameters, the Dodd-Frank Act otherwise left pay ratio rulemaking to the SEC. Although Item 402 of Regulation S-K has long imposed detailed individual compensation disclosure requirements with respect to each of the named executive officers and nonemployee directors of a public company, and financial statements often include aggregate compensation cost disclosures, information with respect to compensation paid to an individual nonexecutive officer employee generally had not been previously required.[11]

The SEC released proposed rules to implement the pay ratio provisions of the Dodd-Frank Act in September 2013,[12] generating a great deal of public response. By the time the final rules were released in August 2015, the SEC had received more than 287,400 comment letters.[13] The SEC reported that more than 99.4 percent of the comment letters on the proposed rules were in one of 12 "form letters" expressing support of pay ratio requirements generally, on purported grounds ranging from informing shareholders and increasing transparency to improving employee morale and productivity to discouraging pay practices that contributed to the 2008 financial crisis (although without pointing to any specific ways that pay ratio disclosures might have prevented or lessened the "great recession"). Although many of the commenters (including the American Bar Association) were highly critical of the proposed rules, the vast majority of the approximately 1,500 individualized letters also supported the pay ratio rules, whether conceptually or as actually proposed by the SEC. Backed by such overwhelming showing of public support, the final rules released in August 2015 largely followed their proposed form, but with more flexibility in respect to the methodologies used for the identification of median employees as compared to the proposed rules.[14]

As adopted, the final rules apply to all public companies other than smaller reporting companies, emerging growth companies, foreign private issuers, Multijurisdictional Disclosure System (MJDS) filers, and registered investment companies.[15] New Regulation S-K Item 402(u) compels disclosure of the pay ratio amounts in proxy statements, registration statements, and annual reports requiring executive compensation disclosure for fiscal years beginning on or after January 1, 2017.[16] Item 402(u) requires, in addition to the quantitative pay disclosures, a brief description of the methodology used to identify the median employee, including any material assumptions and adjustments made, but no specific information about the median employee other than his or her total annual compensation.[17] Supplemental narrative discussion and additional "alternative" pay ratios are permitted if clearly identified, not misleading, and not more prominent than the required ratio.[18]

The final rules provide companies with broad flexibility to use reasonable estimates to identify their median employees. Specifically, a company may select from its entire employee population or a subset of its employees, using statistical sampling or another consistently applied compensation measure, such as information from tax or payroll records, with exclusions of non-U.S. employees permitted under certain limited circumstances.[19] The final rules also provide flexibility in how compensation is defined and when it is calculated for median employee identification purposes. Companies generally may annualize the pay of full- and part-time employees, make cost-of-living adjustments for employees in jurisdictions different from its CEO, and include the value of perquisites and broad-based benefits that would otherwise have been excluded from total compensation as calculated for purposes of the summary compensation table.[20] Under the final rules, the total compensation of the CEO and median employee, and the ratio between them, must be recalculated every year in accordance with the summary compensation table requirements; however, a company may identify its median employee only once every three years in the absence of changes to its workforce, its pay structure, or its median employee's circumstances that would be expected to result in a significant change to the disclosure.[21]

The SEC explained in the preamble to the final rules that the flexibility provided in the final rule was intended to reduce the costs and burdens of compliance on companies while still fulfilling its obligation under Dodd-Frank Section 953(b) to enhance "the transparency of compensation."[22] Even with some latitude, the SEC estimated that, on average, the total initial compliance costs for the 2018 proxy season would be over $1.3 billion or approximately $368,159 per company subject to the pay ratio requirements, and for each year thereafter, $526 million, or $58,800 per company.[23] Although data is

not yet widely available, many practitioners expected that the actual direct and indirect costs incurred by companies in satisfying the pay ratio requirements for the 2018 proxy season would be far in excess of the SEC's estimates. The preamble acknowledged that higher costs of compliance could be expected for a company with global operations, the degree of which being dependent upon its size, business, and degree of integration of its payroll and benefits programs, and conceded that the disclosures could have indirect costs, such as public relations costs, damage to brand, and competitive disadvantages for certain types of companies.[24]

Given the significant expense and complications of compliance, the value of the required pay ratio disclosures to shareholders and other constituencies in any cost–benefit analysis has been called into question since the enactment of the Dodd-Frank Act. Noting that neither the Dodd-Frank Act pay ratio provisions nor the legislative history specify any purpose, objectives, or intent of the pay ratio rules, the SEC explained in the preamble that it intended for the final rules simply to implement Congress' command to give investors additional data that they did not otherwise have, consistent with the general purpose of the executive compensation sections of the Dodd-Frank Act to "facilitate shareholder engagement with executive compensation."[25] It declined to take a position on the merits of the pay ratio rules and, instead, merely acknowledged questions by commenters—as well as the minority in the Senate report accompanying the Dodd-Frank Act—that the pay ratio number may not be material to investors or provide any value in assessing compensation.[26] The SEC posited that the pay ratio information could provide new information not previously required and might assist shareholders in their say-on-pay voting determinations[27] but, tellingly, declined to quantify any potential benefit of having the required pay ratio disclosure.[28] Instead, the SEC stated that the pay ratio is just one of the many data points by which to potentially assess executive compensation in the context of a say-on-pay vote, is not tied to any immediate economic transaction (e.g., the purchase or sale of stock), and that, especially given that any such say-on-pay vote is advisory only and not binding on the company, any link between disclosure to changes in executive compensation or other economic outcomes would be highly speculative.[29]

Implementation and Uncertainty

Merits notwithstanding, the 2015 final rules would, by their terms, first require pay ratio disclosures in proxy statements, registration statements, and annual reports filed in 2018. In contrast to the proposed rules, which would have required disclosure in filings on or

after the effective date, the final rules provided enough of a time lag to give companies and practitioners some remote hope that Congress or the SEC might take action to repeal or delay the effectiveness of the final pay ratio rules in the interim. In the aftermath of the November 2016 U.S. presidential election, however, those hoping that pay ratio would be nixed became much more optimistic. Shortly after being sworn in to office, President Trump issued an executive order in February 2017 directing the Department of the Treasury, in consultation with other federal agencies including the SEC, to review laws and regulations that inhibit the effective oversight of the U.S. financial system consistent with certain "core principles" he set forth.[30] Although the executive order did not specifically mention the Dodd-Frank Act, President Trump's administration's intent to review and rollback the Dodd-Frank Act was well publicized.[31] A few days later, the SEC's then-Acting Chairman Michael Piwowar released a public statement seeking further public comment on the pay ratio rules and any "unexpected challenges" faced by companies while preparing to comply, in order to help the SEC staff reconsider pay ratio implementation and additional relief.[32] Finally, in June 2017, the U.S. House of Representatives passed the Financial CHOICE Act of 2017 that would, if approved by the Senate, rollback key parts of the Dodd-Frank Act, including the complete repeal of the pay ratio rules.[33]

Despite the mounting political excitement and uncertainty, the pay ratio rules survived the summer of 2017 unscathed from the terms of the final rules. With the end of the first fiscal year for which pay ratio disclosures would be required coming to a close, preparations for making the principal determinations and calculations became necessary. In addition to engaging outside accountants, compensation consultants, and legal counsel, companies enlisted their human resources, technology, payroll, finance, accounting, legal, and internal and external communications teams to tackle their pay ratio dictates on a coordinated, multidisciplinary basis. In September 2017, with most companies' pay ratio processes well underway, the SEC released welcomed guidance regarding pay ratio disclosure under Item 402(u) of Regulation S-K to facilitate the identification of median employees, including assistance and clarification on the use of internal records and statistical sampling and other methodologies.[34] Notably, the SEC stated that it would not pursue enforcement actions against companies that use reasonable estimates, assumptions, or methodologies, unless the related disclosures were made without a reasonable basis or provided other than in good faith. In doing so, the SEC not only reiterated the flexibility that it sought to bestow upon companies to comply with the pay ratio rules, but also provided reassurance that from a regulatory perspective, reasonable and good faith compliance

with the final rules would be adequate. Over the final months of 2017, proxy advisory firms ISS and Glass Lewis each announced updates to its proxy voting policy guidelines which confirmed that, while the pay ratio data would be presented in research reports, no specific policy had been developed with respect to the use or application of the data or disclosure in formulating voting recommendations.[35]

By November 2017, the potential for an 11th-hour legislative or regulatory reprieve from pay ratio was all but eliminated as the attention of lawmakers, companies, interest groups, and practitioners alike shifted to U.S. tax reform under the Tax Cuts and Jobs Act and its precursors. With the SEC having announced that reasonable, good faith compliance would not trigger an enforcement action, and the foremost proxy advisory firms having announced that initial disclosures would not affect voting recommendations, the legal-governance stakes presented by the pay ratio rules were meaningfully reduced.

By then, with pay ratio disclosure requirements a near-certainty and the underlying compensation data becoming available, companies could test various median employee identification methodologies and employee identification dates to explore the effect that a particular approach would have on the pay ratio calculation. With the identity of the chief executive and his or her compensation generally static, the only avenue available to influence the resulting pay ratio data was through the identification of the median employee to whom the CEO's compensation would be compared. Many (including the SEC) initially seemed to assume that companies would seek to identify a methodology and approach that would yield the lowest possible pay ratio, so as to limit the extent of any perceived disparity in CEO income relative to that of the average employee.[36] However, it became clear that workforce perception to not merely the CEO pay ratio, but also the median employee compensation information needed to be carefully considered and managed. By definition, half of the employees in a given company would be expected to fall below the median employee compensation level and thus, might consider themselves to be underpaid compared to the company's "average" worker. This potential negative impact on a below-average employee's morale would be exacerbated to the extent that the employee more closely compared to the median employee by title, position, location, status, or other information disclosed: the more similar the employment relationship, the more likely the perceived unfairness. The expectation that employees would, upon seeing the proxy disclosure, instinctively compare their own compensation to that of the median employee presented corporate counsel and human resources professionals with an additional challenge in managing employee relations and internal communications.[37]

2018 Proxy Season

Despite so much anticipation and tension from the politics surrounding the very subsistence of the pay ratio rules, the first proxy season of required pay ratio proxy disclosures turned out to be rather inconsequential in substance. As expected, the enormous variation of corporate structures, strategies, and compensation programs, coupled with the flexibility permitted in identifying median employees, resulted in a wide range of disclosed ratios. Although some pay ratios made headlines in national and local newspapers,[38] there has been little in the way of publicized reports or even anecdotal evidence of any immediate employee relations nightmares or shareholder outcry resulting from 2018 pay rate disclosures.

Without any consistency in the methodologies used to calculate the pay ratio, the use of pay ratios to compare one company to another may be misleading, even among companies within a particular industry or sector, or in a specific geographic location. In this regard, the SEC took great care in the preamble to the final rules to caution against the use of pay ratios to compare companies, noting that doing so "may be inappropriate to the extent that registrants employ workers in different countries that have unique compensation practices, use different methodologies to calculate the median employee, employ workers with different skill levels, and have different corporate structures."[39] It discussed the strategic determination of whether to outsource certain tasks that might otherwise be performed by employees among the examples of the way that variety incorporate strategies and business structures could diminish the value of pay ratio as a comparative executive compensation measure.[40]

Despite the warning, various overall correlations have already begun to be identified, such as (not surprisingly) higher ratios in companies with higher revenues, and higher ratios in the retail section as compared to the financial services sector.[41] Generally, pay ratios for companies that stood out in their particular industries or sectors were attributable to specific factual circumstances unique to the companies' workforces or to their CEOs' compensation: large international workforces; more than one CEO during the relevant fiscal year; one-off awards, such as new hire grants or special retention awards; or changes in the timing of awards, resulting in no awards—or multiple awards—in the fiscal year.

The disclosures have provided practitioners with an understanding of what methodologies, adjustments, and exclusions were applied to identify median employees, and how companies approached their pay ratio disclosures, including with respect to the placement of the disclosure within the proxy statement, the use of supplemental disclosures and alternative pay ratios, and the inclusion of statements affirming the reasonableness of the assumptions or cautioning against limited

comparability of the data. Aside from these technical takeaways (interesting mainly to practitioners and corporate counsel to consider for their pay ratio calculations and disclosures in the 2019 proxy season), there would seem to be very little actionable value to shareholders from the pay ratios and related narratives disclosed to date.

The pay ratio disclosures limitations are especially pronounced with only a single year of data available. Unless and until a company has made available several years of pay ratio data, there is no sense of how a particular company's pay ratio, or the median employee compensation on which it is determined, has changed over time, whether on an absolute basis or relative to competitors or other companies within its industry, geographic market, or stock index. Future proxy seasons will provide more data and precedent to mitigate some of these limitations, but any material changes in the company's chief executive or general employee compensation programs, employee workforce, or corporate structure over time would directly limit the comparability of pay ratio data from one year to the next at a particular company, making the pay ratio data potentially misleading as a measure of internal pay equity considerations. As a result, unless a company has relative consistency in both its CEO pay structure and its workforce and compensation program generally, reviewing changes in its pay ratios over time may be meaningless, inappropriate, or even misleading. Similarly, unless the company and its competitors and peer group maintain relative consistency from year-to-year in not only compensation and workforce but also overall business strategy, comparing trends over time across competitors or within industries is of dubious value and reliability for assessing executive compensation.

Future Outlook

Of course, it is too soon to tell whether the pay ratio disclosures will have any measurable impact on, for example, say-on-pay advisory votes, compensation-related shareholder proposals (such as approval of an equity compensation plan), or even election of compensation committee members and directors generally; over the course of the next several years of pay ratio disclosures, however, the link between pay ratio and shareholder voting, if any, will become more measurable. It is also far too early to tell whether the availability of median employee compensation data will have any effect on the competitive labor market; however, on the fringes, the availability of the pay ratio disclosures could make some employees more apt to look for new opportunities with another company that they perceive pays more on average. As a result, public companies with higher median employee compensation could have a competitive advantage in terms of attracting new talent

over public companies with lower median employee compensation, while companies with lower median employee compensation might become more susceptible to having their workforce poached by competitors within both their sector as well as their geographic market. This includes private companies that get the benefit of additional data and information on which to compete with their public counterparts for talent.

Where this potential influence on competition might exist, a disadvantaged company might consider ways to get ahead of news of the pay ratio disclosures being discussed in media outlets and around water coolers, for example, by providing supplemental and/or alternative disclosures in their proxies and proactively training managers to be able to engage with employees and communicate key messages to mitigate potential that the pay ratio information might mislead employees and damage morale and retention. Where this is not enough, or where there is reluctance to disclose information that might provide sensitive information and projections, pay ratio could, indirectly, force some companies to consider implementing special retention programs, making changes to their salary-wage structures, or even outsourcing business functions historically performed in house where they might not have in the absence of the pay ratio rules.

Although seemingly unlikely that pay ratio outcomes would trigger actual investor backlash or public relations crisis standing alone, the SEC did express worry about the risk of corporations making pay determinations intended to skew their pay ratio results. The preamble to the final rules noted various ways in which a company might "alter their pay structure or workforce structure in ways that are different from their efficient labor market decisions,"[42] including by refraining from expanding business into lower-cost regions outsourcing work that otherwise could be done in-house by employees, or modifying wage structures in ways that increase median employee compensation while reducing the pay of employees below the median, although these examples presume that companies would do so in order to generate lower pay ratios.[43]

For most companies who find their pay ratio to be within acceptable ranges of their competitors and compensation peers, pay ratio would not be expected to have any direct effect on compensation program design and structure. Nonetheless, even a company with no discernable pay ratio concerns might consider pay ratio in making annual merit raises, projecting into account the effect that changes in base compensation might have on the resulting pay ratio. With most executive compensation arrangements providing for three key components to annual compensation—a base salary, an annual bonus opportunity, and a long-term incentive award—changes to compensation

levels should be considered holistically in the context of a company's overall compensation program. On the surface, increasing salary levels by a higher percentage at lower-paid positions than percentage increases in salary for the CEO might be expected to reduce the pay ratio, but only if the focus on pay ratio rules was limited to base salary. In practice, any increase in salaries would also proportionately increase any annual bonus, long-term incentive opportunities, and elements of "total annual compensation" expressed as a percentage of annual salary or other base compensation. In general, where compensation opportunities are expressed in terms of a specified percentage or multiple of salary, the applicable percentage or multiple for chief executive pay universally tends to be higher than that of the average employee. As a result, a fixed percentage increase in salaries across-the-board for all employees would (and even a higher percentage increase in salary for lower-paid employees *could*) widen the gap between the total annual compensation levels reported for CEO compensation and median employee.

Even though the limited usefulness of the pay ratio disclosures made during the 2018 proxy season might not justify, in any economic cost–benefit analysis, or other demonstrable way, the compliance challenges and costs that the rules impose on public companies, in large part, the resulting disclosures achieved exactly what the SEC intended the pay ratio rules to do: implement the mandates of Congress under Section 953(b) of the Dodd-Frank Act in a way that provides companies flexibility in how they comply.[44] While it remains possible that legislative or regulatory action or guidance could modify or supplement the pay ratio rules, a rollback of the pay ratio rules is unlikely now that disclosures have finally been required, pending further understanding of their value, if any. Moreover, the addition of new disclosure requirements would seem to be unlikely to come from the SEC given the concerns it expressed throughout the preamble to the final rules as to "unnecessary costs and complexities that might result from mandating additional disclosures."[45]

Of course, the true effect of pay ratio on executive compensation and shareholder engagement on pay matters will depend on what voting policies and recommendations the key institutional shareholders and proxy advisory firms might adopt and refine. These might include calls for additional shareholder engagement and additional disclosure, particularly as more data becomes available over the next several years and pay ratio measures can be quantified and compared on an absolute basis over time, or on a relative basis against a peer group or industry index. Shareholder activists might seek to use the pay ratio to push social governance and sustainability initiatives, particularly those relating to internal pay equality; however, for the reasons described above, any resulting influence would be expected to be more likely to

affect employees at or below the median employee level rather than those in the C-suite.

As a result, the value to shareholders of pay ratio disclosures to the assessment of named executive officer compensation programs and/or corporate governance practices will continue to be called into question and potentially misunderstood or misapplied. With the assistance of compensation consultants and outside counsel, companies should be aware of how other similarly situated companies in their sector or geographic market have approached their pay ratio determinations and disclosures, while staying abreast of policy pronouncements and voting guidelines released by their largest institutional shareholders and proxy advisor firms, and being well prepared and coordinated internally as to how, if at all, to respond to and mitigate any potential concerns or criticisms expressed by employees, investors, competitors, or the media. Ultimately, the best thing that public companies can do is to seek to make compensation decisions in the reasonable exercise of their business judgment, taking into account market data, advice of outside advisers, and feedback from engagement with shareholders, to fulfill their retention, incentive, and new-hire needs. By doing so, the pay ratio disclosures hopefully will portray their executive compensation programs in a positive and transparent way, but not drive their structures and designs.

Notes

1. This column is not, is not intended to be, and shall not be construed to be, either the provision of legal advice or an offer to provide legal services, and it does not necessarily reflect the opinions of Proskauer Rose LLP (*Proskauer*) or its lawyers or its clients. No client–lawyer relationship with Proskauer is or may be created by your access to or use of this column or any information contained in it. Rather, the content is intended as a general overview of the subject matter covered. Proskauer is not obligated to provide updates on the information presented herein. Those reviewing this column are encouraged to seek direct counsel on legal questions.

2. Pay Ratio Disclosure, Securities Act Release No. 33-9877, Exchange Act Release No. 34-75610 (2015) (codified at 17 CFR parts 229 & 249) available at *https://www.sec.gov/rules/final/2015/33-9877.pdf* (hereinafter, the "preamble," and the specific statutory pronouncements, the "final rules").

3. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 953(b), 124 Stat. 1376, 1904 (2010) (hereinafter, the "Dodd-Frank Act"). Sec. 102(a)(3) of the Jumpstart Our Business Startups Act amended Section 953(b) of the Dodd-Frank Act to exempt emerging growth companies as defined in Sec. 3(a) of the Exchange Act. 15 U.S.C. 78c(a).

4. Final say-on-pay rules were approved on January 25, 2011. See Shareholder Approval of Executive Compensation and Golden Parachute Compensation, Securities Act Release No. 33-9178, Exchange Act Release No. 34-63768 (2011) (codified at 17

CFR parts 229, 240 & 249), available at *https://www.sec.gov/rules/final/2011/33-9178.pdf*.

5. Final compensation committee and advisor independence rules were adopted by the SEC on June 20, 2012. *See* Listing Standards for Compensation Committees, Securities Act Release 33-9330, Exchange Act Release 34-67220 (2012) (codified at 17 CFR parts 229 & 240), available at *https://www.sec.gov/rules/final/2012/33-9330.pdf*. On January 11, 2013, the SEC released orders approving exchange rules submitted by NYSE and Nasdaq. *See* Nasdaq Listing Rule 5605(d) and IM 5605-6 and NYSE Listed Company Manual Section 303A.02(a)(ii).

6. The clawback rules would prohibit the listing of any company that fails to develop and implement incentive-based compensation recoupment policies to recover certain "excess" incentive compensation upon an accounting restatement required as a result of a material failure to comply with applicable financial reporting requirements. *See* Listing Standards for Recovery of Erroneously Awarded Compensation, Securities Act Release No. 33-9861, Exchange Act Release No. 34-75342 (proposed July 1, 2015) (to be codified at 17 C.F.R. parts 229, 240, 249 & 274) (2015), available at *http://www.sec.gov/rules/proposed/2015/33-9861.pdf*. *See* Miller, Joshua M., "Proposed Rules to Implement Dodd-Frank Clawback Rules: Overview, Issues and Implications for Executive Compensation," Bloomberg BNA *Tax Management Compensation Planning Journal* (October 7, 2016).

7. The "pay for performance" rules would require disclosure in a prescribed table and a narrative description or graphic presentation of the relationship between named executive officer compensation and shareholder return over a 5-year period. See Pay Versus Performance, Exchange Act Release No. 34-74835 (proposed April 29, 2015) (to be codified at 17 CFR parts 229, 240 & 249), available at *https://www.sec.gov/rules/proposed/2015/34-74835.pdf*.

8. Updates on the status of Dodd-Frank Act rulemaking generally are provided on the SEC's website at *https://www.sec.gov/spotlight/dodd-frank.shtml*.

9. Dodd-Frank Act, § 953(b).

10. *Id.*

11. For purposes of Item 402, a company's "named executive officers" include its chief executive officer, its chief financial officer, its three most highly compensated executive officers (other than the CFO and CEO) who were serving as of the end of the last completed fiscal year, and up to two additional individuals with respect to whom disclosure would have been required but for the fact that the individuals were not serving as executive officers as of the end of the last completed fiscal year. Item 402(a)(3) of Regulation S-K.

12. Pay Ratio Disclosure, Securities Act Release No. 33-9452, Exchange Act Release No. 34-70443 (2013), available at *https://www.sec.gov/rules/proposed/2013/33-9452.pdf* (hereinafter, the "proposed rules").

13. *See* preamble at 19–23.

14. *See* preamble at 113–124.

15. Preamble at 43.

16. Preamble at 1 and 157.

17. Instruction 11 to Item 402(u) of Regulation S-K.

18. Instruction 9 to Item 402(u) of Regulation S-K.

19. All employees worldwide must be included in the median employee analysis, subject to two limited exceptions that may be available (use of which will trigger additional disclosure obligations). First, companies may exclude employees in foreign jurisdictions where, due to applicable data privacy laws or regulations, companies are unable, after reasonable efforts, to obtain or process the necessary information to conduct the analysis, provided that the companies seek relief or exemption from the applicable rules and obtain and file a legal opinion from local counsel as to the applicable legal or regulatory limitations and efforts to obtain relief. Second, a company may exclude employees in foreign jurisdictions under certain circumstances, including all non-U.S. employees where the total number of non-U.S. employees is less than 5 percent of the company's total employees, or all employees in any particular countries jurisdictions, if the total number of non-U.S. employees excluded is less than 5 percent of the company's total employees. Although there have been no reported uses of the data privacy exception, many companies did take advantage of the *de minimis* exception in their 2018 pay ratio disclosures. For employees with large, international workforces, the *de minimis* exception is of limited value, if any.

20. *See* Instructions 2–5 to Item 402(u).

21. Instruction 5 to Item 402(u).

22. Preamble at 10.

23. Preamble at 269–272.

24. Preamble at 205–2017.

25. Preamble at 9–10.

26. Preamble at 180, citing S. Rep. No. 111-176 (2010) ("Although provisions like this appeal to popular notions that chief executive officer salaries are too high, they do not provide material information to investors who are trying to make a reasoned assessment of how executive compensation levels are set. Existing SEC disclosures already do this.").

27. *See* preamble at 175.

28. *See* preamble at 176.

29. Preamble at 176. It would be interesting to see whether, if presented with the opportunity to vote (whether on a binding or nonbinding, advisory basis) and a description or estimate of the anticipated financial, administrative, and human resources expense, shareholders would actually approve the company's investment in determining and disclosing the applicable pay ratio information in the absence of the pay ratio rules. Ironically, under the general goal of the Dodd-Frank executive compensation disclosure reforms to enhance public company engagement with shareholders in executive compensation matters, Congress did not give shareholders that opportunity.

30. *See* President Trump, "Presidential Executive Order on Core Principles for Regulating the United States Financial System," February 3, 2017, available at *https://www.whitehouse.gov/presidential-actions/presidential-executive-order-core-principles-regulating-united-states-financial-system/*.

31. *See, for example,* Antoine Gara, "With a Stroke of the Pen, Donald Trump Aims to Wave Goodbye to the Dodd-Frank Act", *Forbes*, February 3, 2017, available at *https://www.forbes.com/sites/antoinegara/2017/02/03/with-a-stroke-of-the-pen-donald-trump-will-wave-goodbye-to-the-dodd-frank-act/#134853c51148*;

and Damian Paletta, "Trump administration calls for scaling back post-crisis financial regulations," *The Washington Post,* June 12, 2017, available at *https://www.washingtonpost.com/news/wonk/wp/2017/06/12/treasury-calls-for-scaling-back-banking-rules-citing-need-for-growth/?noredirect=on&utm_term=.5b91f16abef6*.

32. Public Statement by SEC Acting Commissioner Michael S. Piwowar, "Reconsideration of Pay Ratio Rule Implementation," February 6, 2017, available at *https://www.sec.gov/news/statement/reconsideration-of-pay-ratio-rule-implementation.html*. Mr. Piwowar announced in May 2018 that he intended to resign by July 2018. *See* Statement of Commissioner Michael S. Piwowar, May 7, 2018, available at *https://www.sec.gov/news/public-statement/piwowar-statement-letter-050718*.

33. Financial CHOICE Act of 2017, H.R. 10–115th Congress (2017–2018) (passed House amended June 8, 2017), available at *https://www.congress.gov/bill/115th-congress/house-bill/10*.

34. Commission Guidance on Pay Ratio Disclosure. Available at *https://www.sec.gov/rules/interp/2017/33-10415.pdf*

35. *Accord., see* Institutional Shareholder Services, *U.S. Equity Compensation Plans—Frequently Asked Questions* (updated Dec. 14, 2017), Q&A 69, available at *https://www.issgovernance.com/file/policy/active/americas/US-Compensation-Policies-FAQ.pdf*; and Glass, Lewis & Co., *Proxy Paper Guidelines—2018 Proxy Season—United States*, pgs. 2, 33, available at *http://www.glasslewis.com/wp-content/uploads/2017/11/US_Guidelines_2018.pdf*.

36. *See, for example,* preamble at 207–208.

37. This concern might explain why a company would be reluctant to provide information on the median employee, which it is not required to do under Instruction 11 to Item 402(u) of Regulation S-K.

38. *See*, Jena McGregor, "Looking for a bigger salary? These are the companies with the highest median pay," The Washington Post, May 31, 2018, available at *https://www.washingtonpost.com/news/on-leadership/wp/2018/04/26/looking-for-a-bigger-salary-these-are-the-companies-with-the-highest-median-pay/?noredirect=on&utm_term=.7d9fb3979a60*.

39. Preamble at 181.

40. Preamble at 178–179.

41. *Accord., see* Equilar, "Survey Results Show a Median CEO Pay Ratio of 140:1," February 2018, available at *http://www.equilar.com/press-releases/94-equilar-ceo-pay-ratio-survey-results.html*; and Deloitte Consulting LLP, "CEO Pay Ratio Overview," April 18, 2018, available at *https://www.compensationstandards.com/member/Memos/Firms/Deloitte/04_18_pay.pdf*.

42. Preamble at 207.

43. Preamble at 208.

44. Preamble at 13 (despite "the disagreement among commenters on the value of the pay ratio disclosure, in adopting the final rule we have sought to implement Congress's apparent determination that the pay ratio disclosure would be useful to shareholders").

45. Preamble at 15.

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