

FIDUCIARY RESPONSIBILITY AND PENSION PLAN ADMINISTRATION

Bill Ackerman, Esquire

Klausner, Kaufman, Jensen & Levinson

7080 Northwest 4th Street

Plantation, Florida 33317

NAPPA 2015 Legal Education Conference

INTRODUCTION

- Fiduciary considerations should be the guiding principle behind the actions of the Board of Trustees, both individually and collectively.
- The primary duty of a pension fund lawyer is to ensure that the trustees fulfill their fiduciary responsibilities and obligations to the members, retirees, and beneficiaries of the retirement system.

How Are Fiduciary Relationships Created/Defined?

- Law of Trusts – Restatement of Trusts (Third), 1992.
- By Contract (relationship of the parties).
- By statute
 - Federal Statutes – ERISA, 1974.
 - Uniform Prudent Investors Act (UPIA), 1994.
 - Uniform Management of Public Employees Retirement Systems Act (UMPERSA), 1997.
 - Retirement Plan enabling statutes.
 - State statutes, local ordinances.

Fiduciary Duties

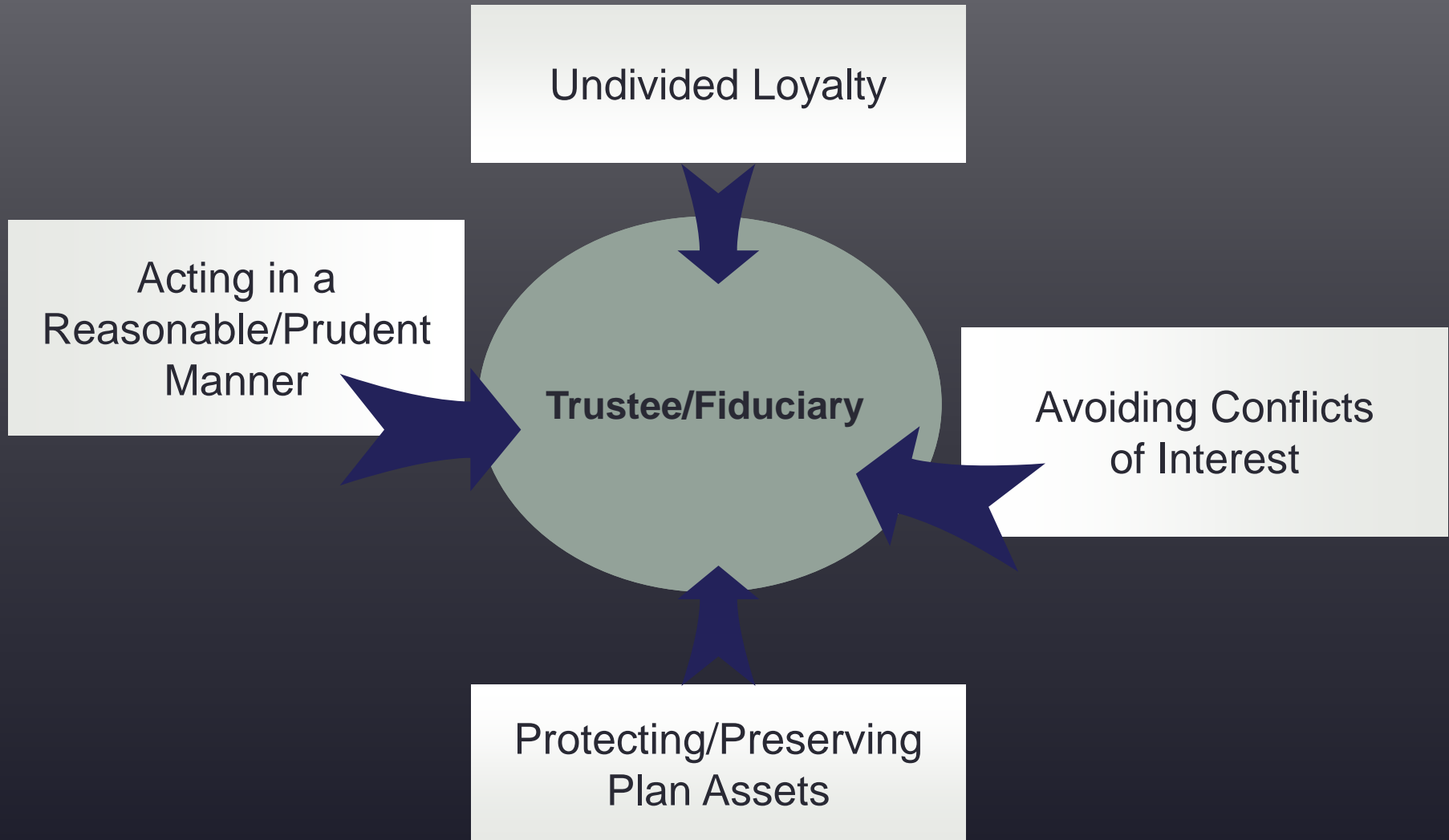
- Fiduciary duties fall into two broad categories – the duty of loyalty and the duty of care.
- The duty of loyalty requires trustees to act:
 - Solely in the best interests of the members, retirees, and beneficiaries of the retirement system
 - For the exclusive purpose of providing benefits
 - Impartially, avoiding conflicts of interest and self-dealing.

Fiduciary Duties

- The duty of care requires trustees to act:
- With the care, skill, and prudence exercised by similar fiduciaries in investment-related matters, including diversification of investments.
- To perform due diligence in matters related to investment of the system's assets.
- To incur only costs that are appropriate and reasonable
- To act in accordance with applicable statutes and regulations

Characteristics of Fiduciary Responsibility

6



Areas of Fiduciary Responsibility

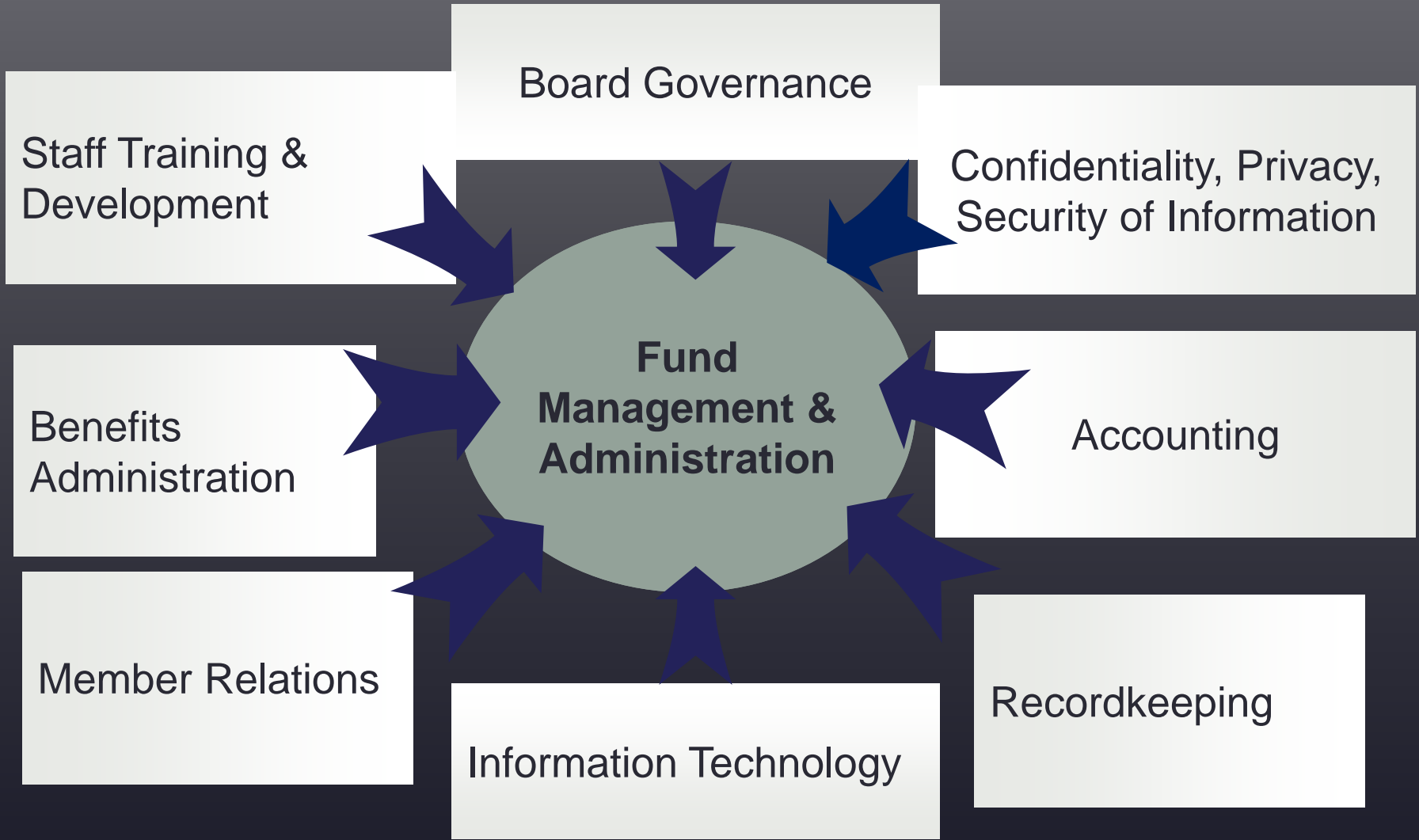
Fund Management and Administration

```
graph TD; A[Fund Management and Administration] --> B[Communications and Education]; B --> C[Investment-Related Activities]; C --> D[Selection of Consultants/Advisors];
```

Communications and Education

Investment-Related Activities

Selection of Consultants/Advisors



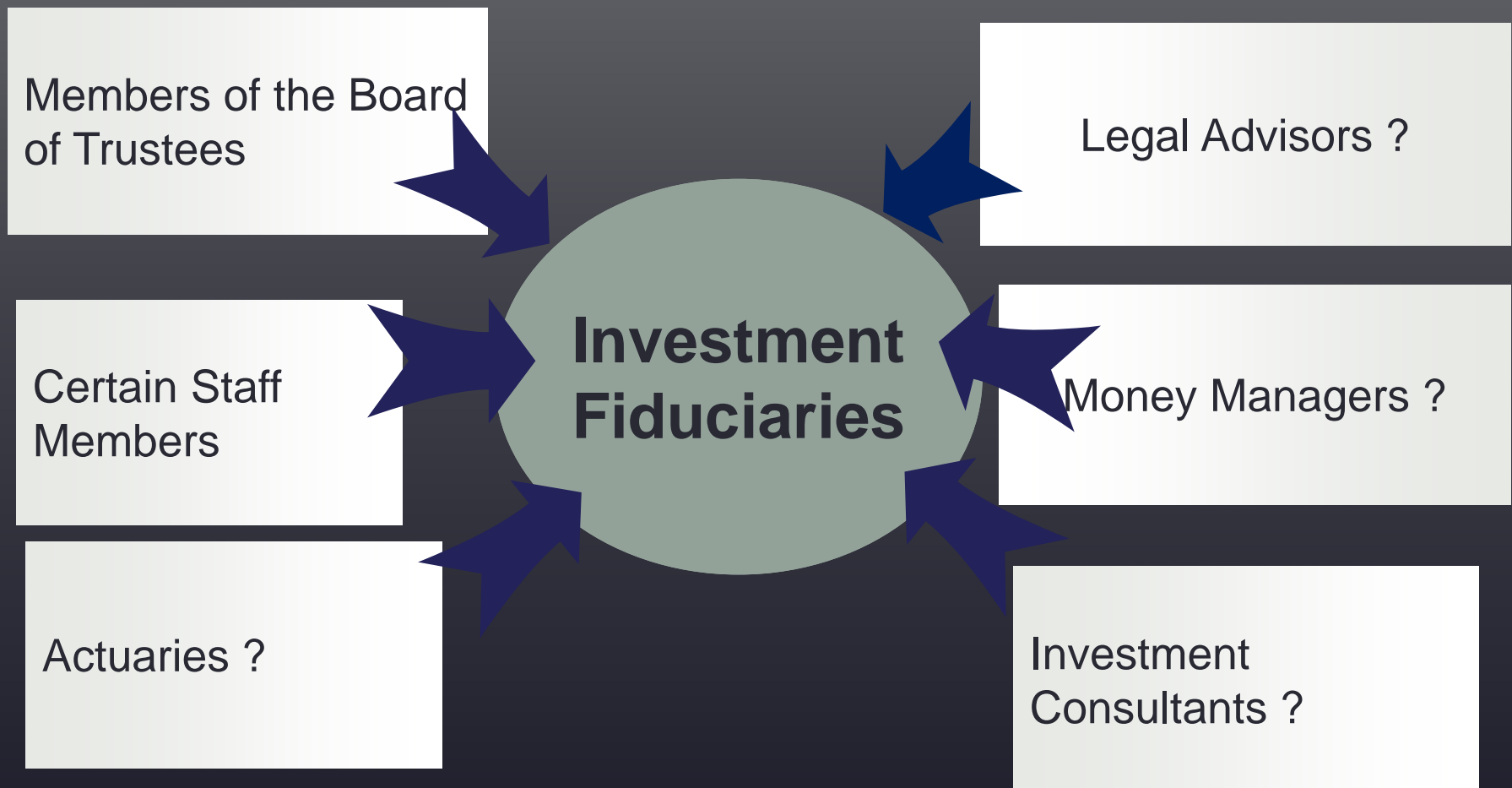
Communications & Education

- Handbooks & Pamphlets
- Periodic Newsletters
- Annual Report
- Annual Benefit Statements
- Annual Meeting
- Website
- Education Workshops
- Pre-Retirement Seminars

Investment-Related Activities

- Statement of Investment Policy and Objectives
- Selection of Investment Consultant
- Selection of Investment Managers
- Investment Management Agreements
- Monitoring of Investment Performance

Who Are Investment Fiduciaries?



Standard of Care for Investment-Related Activities

- Changes to the Restatement of Trusts in 1992 and the UPIA resulted in a shift from the “prudent person” standard to the “prudent investor” standard, reflecting a recognition that, in accordance with Modern Portfolio Theory, prudence should be measured on an overall portfolio basis, rather than by consideration of specific investments.
- Whether or not an investment-related decision is prudent is determined by the facts and circumstances when the decision is made, not based on the advantage of hindsight.

Fiduciary Responsibility in Selecting Investment Managers

- Evaluation/Selection Process
- Due Diligence
- Investment Management Agreement
- Performance Monitoring

Consultants & Advisors

Trustees and staff must exercise fiduciary responsibility in selecting the following consultants and advisors:

- Actuaries
- Auditors
- Custodian
- Outside Legal Counsel
- IT Consultants
- Medical Advisors

Problem Areas with Investment Managers and Consultants

- Indemnification language – Who is indemnifying who? What is the trigger – negligence, gross negligence, willful and wanton misconduct, criminal conduct?
- Limitation of liability language – In the event of loss, Investment Managers or Consultants may attempt to limit their liability to the amount of the annual fee.

Fiduciary Responsibility and Litigation

- The concept of Fiduciary Responsibility also serves a strategic purpose in litigation involving pension funds.
- When the interests or rights of a pension fund's members, retirees, or beneficiaries are threatened, the trustees have a fiduciary obligation to take whatever action is necessary to protect the interests/rights of its members, retirees, and beneficiaries, including litigation. In this respect, the fiduciary responsibility of the trustees is the basis for pursuing an offensive strategy.
- In recent years, public employee pension funds have initiated litigation against plan sponsors, investment managers, and advisors/consultants.

Fiduciary Responsibility and Litigation

- When the trustees of a pension fund are sued for “Breach of Fiduciary Duty” by a member, retiree, or beneficiary, the concept of Fiduciary Responsibility serves a defensive purpose, as the trustees defend the fund against the claim.

Breach of Fiduciary Duty

- In order to maintain a claim for breach of fiduciary duty, a plaintiff must establish the following:
 - Existence of a fiduciary relationship
 - Breach of the fiduciary duty
 - Causation
 - Harm (*i.e.* damages)
- A breach of fiduciary duty claim can be filed against individual trustees, as well as the Board itself.
- Vast difference in standards of care for negligence and breach of fiduciary duty claims.

Best Fiduciary Practices

- Thorough knowledge of your state's statutes and applicable local ordinances/regulations pertaining to fiduciary duties of your retirement system's trustees.
- Adopt Board Governance Policy, including Conflict of Interest guidelines
- Written statement of investment policy and objectives
- Annual financial and management audits
- Periodic review of administrative policies/procedures
- Criminal records check of prospective employees
- Establish trustee education program
- Staff education and training

Best Fiduciary Practices

- Ensure that accurate information is provided to retirees, spouses, and beneficiaries
- Adhere to your system's rules, regulations, policies, and procedures
- Establish administrative appeal procedure
- Exercise due diligence in selecting investment managers and professional consultants
- Monitor investment manager performance
- Conduct legal review of consultant and investment management agreements
- Consider Fiduciary Liability Insurance

For questions or comments, please contact:

Bill Ackerman

(949) 680-8920

bill@robertdklausner.com



Benefits Basics for Governmental Defined Benefit Plans

NAPPA Legal Education Conference, New Attorney Session
Brian J. Goodman, VRS
June 23, 2015

Five Points For New Practitioners



1. More than the Plan Document:
Federal Laws Affecting Governmental Plans
2. More than the Plan Document:
State Laws Affecting Benefits Administration
3. Governmental Plans:
Exemption from many Federal Law Requirements
4. Common Issues in Calculating Retirement Allowances
in a Traditional DB Plan
5. Dealing with Errors in Administration of Benefits

1. More than the Plan Document: Federal Laws Affecting Governmental Plans



- U.S. Constitution Art. I, § 10: “No State shall pass any... Law impairing the Obligations of Contracts”
- Internal Revenue Code (IRC)
- Uniformed Services Employment and Reemployment Rights Act (USERRA)
- Title II of Employee Retirement Income Security Act of 1974 (ERISA)
- Age Discrimination in Employment Act (ADEA), Americans with Disabilities Act (ADA) and others

2. More than the Plan Document: State Laws Affecting Benefits Administration



- **Banking Issues:** stale checks, stop payments, EFT issues
- **Valid Execution of Forms:** notaries, forgery, fraud
- **Guardianships and Powers of Attorney:**
 - Determine governing law
 - Will typically include recognition of out-of-state orders/POAs if validly executed under laws of that jurisdiction
 - Develop review process
 - Smaller fund may use counsel to review
 - Larger fund may develop POA checklist to send for legal review (out-of-state, springing powers, successor agents, designations of beneficiary/gifting issues)

3. Governmental Plans:

Exemption from many Federal Law Requirements



- A governmental plan (defined at ERISA § 3(32)/29 U.S.C. § 1002(32)) is exempt from ERISA Title I (fiduciary duties, reporting and disclosure requirements) and Title IV (plan termination insurance).
See ERISA § 4(b)(1)/29 U.S.C. § 1003(b)(1) and ERISA § 4021(b)(2)/29 U.S.C. § 1321(b)(2).
 - ***Example:*** Qualified Domestic Relations Orders (QDROs) under ERISA § 206(d)(3)/29 U.S.C. § 1056(d)(3)
- Many IRC 401(a) provisions do not apply to a governmental plan (defined under IRC/26 U.S.C. § 414(d))
 - ***Example:*** Anti-Alienation IRC 401(a)(13)

4. Common Issues in Calculating Retirement Allowances in a DB Plan



- Traditional DB formula for the Allowance =
 - **AFC \times months/years of service \times a “factor/multiplier”**
 - **AFC/AFS** = Average final compensation is typically an average of 3/5 highest, recent, consecutive years of salary
 - What salary is included? Pay for normal job duties, but there are variations by individual fund (*See 91 A.L.R. 5th 225*)
 - Salary spiking
 - **Service credit**
(*See 60A Am. Jur. 2d Pensions & Retirement Funds 1192*)
 - Part-time, school year vs. calendar year, two jobs
 - Service interruptions: FMLA, military, employer-approved leaves
 - Service purchases, credit for unused leave
 - Portability

5. Dealing with Errors in Administration of Benefits



- **Does Plan document address error correction?**
 - “if, because of an error, a participant receives a benefit that differs from the benefit he is entitled to receive, the plan shall correct the error...”
- **Governmental Exception to Estoppel**
 - *Office of Personnel Management v. Richmond*, 496 U.S. 414 (1990) (estoppel does not lie against the government as it lies against private litigants – courts must observe the conditions defined by law for charging the public treasury).
- **Employee Plans Compliance Resolution System (ECPRS) – Internal Revenue Service (Rev. Proc. 2013-12)**

NATIONAL ASSOCIATION OF PUBLIC PENSION ATTORNEYS
2015 LEGAL EDUCATION CONFERENCE
NEW MEMBER AND ASSOCIATE COUNSEL SESSION

BENEFITS BASICS
FOR GOVERNMENTAL DEFINED BENEFIT PLANS

JUNE 24, 2014

Brian J. Goodman, Legal Affairs and Compliance Coordinator¹
Virginia Retirement System

I. LAWS GOVERNING OR IMPACTING GOVERNMENTAL PLAN BENEFITS

- A. **“Plan Document”** - State statutes (or local ordinances) establishing the defined benefit plan are generally considered to be the “Plan document.” Regulations or administrative materials may amplify and assist in interpretation of the plan. In some jurisdictions, legislation authorizes the board to adopt the plan language. The plan document generally covers the benefits offered by the Plan, how the Plan is funded, how the Plan is governed, and how the assets are managed.
- B. **Contract Clause** – Article I § 10 clause 1 of the United States Constitution states “No State shall pass any . . . Law impairing the Obligations of Contracts.” (“Contract clause”) Most states, but not all, have general contract clauses that are analogous to the federal Contract Clause. The majority approach is that pension benefits are contractual in nature.
- C. **Internal Revenue Code** - If the Plan intends to be a “qualified plan” under Section 401(a) of the Internal Revenue Code (“IRC”), in order to enjoy tax-exempt status under IRC § 501(a), the Plan must meet many IRC requirements. However, governmental plans are also exempt from many of the IRC requirements that apply to non-governmental plans.
- D. **ERISA** - Governmental plans² are exempt from most key provisions of the Employee Retirement Income Security Act of 1974 (“ERISA”): (1) Title I of ERISA³ which deals with mandatory requirements for pension plans, (2) Title IV of ERISA⁴ dealing with plan termination insurance, and (3) certain tax provisions in Title II that were made inapplicable to governmental plans.

¹ Thanks to Rachel Cohen of the Maryland State Retirement & Pension System for her excellent work in developing this outline.

² “Governmental plan” is defined in ERISA § 3(32); 29 USC § 1002(32); and in IRC § 414(d) (26 U.S.C. § 414(d)).

³ ERISA § 4(b)(1); 29 U.S.C. § 1003(b)(1).

⁴ ERISA § 4021(b)(2); 29 U.S.C. § 1301(b)(2).

Title II of ERISA amended the IRC and includes certain Plan qualification requirements that do apply to governmental plans. Although governmental plans are not subject to certain portions of ERISA, the majority of states have enacted fiduciary standards that are almost identical to the ERISA standard. ERISA is administered by the Department of Labor.

- E. **ADEA, ADA, and USERRA** - Governmental plans are subject to many other provisions of federal law, including but not limited to the Age Discrimination in Employment Act (“ADEA”), the Americans with Disabilities Act (“ADA”), the Uniformed Services Employment and Reemployment Rights Act (“USERRA”), the Civil Rights Act, and the Family and Medical Leave Act (“FMLA”).

Sovereign Immunity

Note that *state*-sponsored plans may have sovereign immunity from a private cause of action under a federal law such as the ADEA (where the legislation was not enacted by Congress under the 14th amendment). *Kimel v. Florida Bd. of Regents*, 120 S. Ct. 631, 650 (2000). Sovereign immunity is not available from an EEOC enforcement action under the ADEA.

II. DEFINED BENEFIT PLANS vs. DEFINED CONTRIBUTION PLANS

A. Defined Benefit Plan (“DB Plan”)

1. The employee receives a specific amount of money at retirement, and the Plan describes how that amount (the “defined benefit”) is calculated. The amount is based on a formula, typically a percentage of final average salary multiplied by years of service. The amount of the benefit is NOT determined by the dollars contributed by the employee, the employer, or the investment return.
2. Advantages
 - Permit employees to project monthly retirement income with certainty
 - Benefits paid at least for life of the retiree
 - Substantial payments possible for early death or disability due to pooling of assets
 - Economical – a dollar of benefits can be delivered to a retiree under a defined benefit plan at roughly half the cost of a defined contribution plan. (Source: National Institute on Retirement Security: “A Better Bang for the Buck” 2008)
 - Retains employees with seniority

3. Disadvantages

- Employer bears the risk and the responsibility for the adequacy of trust assets.
- Lack of portability
- Provides little benefits for short-term employees.

B. Defined Contribution Plan (“DC Plan”)

1. An employee has an individual account into which employer and/or employee contributions are deposited. The Plan describes the contribution to be made by the employer or employee, or both, to the employee’s account, as opposed to the benefit, e.g. 6% of pay (the “defined contribution”) When the employee retires, the amount of the benefit is determined by the amount of contributions and the investment earnings in the account.

2. Advantages

- The employer does not bear the responsibility for adequacy of trust assets – the risk is transferred to the employee
- Easy to understand
- Compounding investment returns allows savings to grow
- Very portable

3. Disadvantages

- Few individuals save enough money for retirement
- Few individuals have sufficient expertise to choose their investment options well/plan may offer limited investment options
- Because monies are held in individual accounts, the plan cannot provide effectively for early disability or death

C. **Hybrid plan** – e.g., a Cash balance plan. A hybrid combines defined benefit and defined contribution elements in a single plan.

III. BENEFITS 101: WHAT IS (OR IS NOT) IN YOUR PLAN DOCUMENT?

A. **Membership** – The plan document should describe who is entitled or required to participate in the Plan, and may also provide specific exclusions or exemptions from membership. In a multiemployer plan, the plan document will also discuss who is an eligible employer. The plan may exclude part-time, temporary or contractual employees, and may provide optional membership for elected or appointed officials. The IRS position is that only employees of a governmental employer may be members of a governmental plan.

B. Service credit – The Plan should describe how employment time accrues in the Plan. Issues may include how part-time service is calculated, the counting of service for school year employees, dual employment, employment interruptions including FMLA leave or military leave, unused sick leave.

1. **Purchases of Service Credit** – Public plans may allow employees to purchase additional years of service credit. The service credit may represent certain years of service the employee had with the current employer or a previous government employer. Credit can often be purchased for the following employment: Federal government, military service, out-of-state or in-state counties or municipalities, out-of-state teaching. IRC limits (26 U.S.C. § 415(n)) apply to purchases of service.
2. **Military Service Credit** - USERRA (38 U.S.C. § 4318 and 20 C.F.R. § 1002.259) requires that on reemployment following an absence due to service in the uniformed services, the employee is treated as not having a break in service for purposes of participation, vesting and accrual of benefits. Reemployment rights under USERRA typically apply to cumulative periods of military service of up to 5 years. If public plan terms differ from USERRA, the Plan must apply whichever provision is more generous in the given situation.

C. Salary – The plan document should describe the compensation that is used to calculate pension benefits. May be limited to an employees' base salary for working the normal time in the member's position, excluding compensation in the form of: bonuses, overtime, honoraria, stipends, and pay for coaching extra-curricular or summer activities. See 91 A.L.R.5th 225 – *What Constitutes "Salary, "Wages," "Pay," or the Like, with Pension Law Basing Benefits Thereon*. Typically, a Plan will pay benefits based on an "average final salary" taking into account a specified period of time (typically 3 or 5 years), either consecutive or non-consecutive, in which salary was highest.

- **Salary spiking**: the manipulation of final salary in final years of employment to enhance pension benefits in retirement. Salary spiking activities may include the payment of extraordinary salary increases, conversion of employer paid benefits into cash, adoption of "early notification programs" (e.g., a 10% add on to salary for notifying employer of retirement date). Some plans place caps on salary increases that will count towards average final salary (e.g., 10k or 10%), limit end of career add-ons.

D. Vesting – Many plans permit vesting prior to full retirement eligibility. A vested employee is entitled to receive a future benefit based on length of service. A vested allowance is not paid at the time of separation from service, but deferred

until a later date. In most DB plans, individuals are not vested until they have worked a minimum number of years, e.g., 5 or 10 years. The benefit will typically commence upon attainment of normal retirement age.

E. Normal Service Retirement - Eligibility for normal retirement benefits can be based on age, years of service, or age and years of service combined (e.g., Rule of 92 – the participant’s age combined with years of service equals 92). Early service may be provided, typically with a reduction. Service retirement benefits typically commence upon attainment of normal retirement eligibility and separation from employment. Plans should consider the IRC’s requirements regarding normal retirement age. New guidance was issued in April, 2012 regarding the normal retirement age regulations.

F. Calculation of Retirement Benefit - Based on a formula:

$$\frac{\text{Average Final Salary}}{\text{(average of the highest years of earnings)}} \times \frac{\text{Months/Years of Service}}{\text{(service credit earned)}} \times \frac{\text{Multiplier}}{\text{(a specific percentage adopted by the plan sponsor)}}$$

1. Average Final Salary – Generally based on a set number of years, depending on the Plan provisions, e.g., 3 or 5 highest years of earnings.
2. Months of Service – Service credit is earned for each month the individual meets the employer’s requirements for days/hours worked. A cap may apply.
3. The multiplier may vary from system to system and within the same system for different periods of time, depending on the Plan provisions.

G. Retirement Benefit Options - Choices at Retirement

1. Single life annuity – Benefits are paid over the life of the retiree; when the retiree dies, the payments cease. There is no benefit reduction to support a single life annuity. This is also referred to as a “straight life annuity.”
2. Dual life annuity – A benefit is paid over the life of the retiree, and, upon the retiree’s death, a continuing monthly benefit is paid for the life of the surviving beneficiary (e.g. spouse). The continuing monthly benefit due to the survivor is usually 50% or 100% of the annuity provided to the retiree. This is also referred to a “joint and survivor annuity.”
3. For a dual life annuity, generally, the benefit paid over the life of the retiree is reduced in order to “pay” for the survivor annuity that begins on the death of the retiree. Some plan provisions, often police plans, are designed to subsidize an

annuity for a retiree's spouse, meaning that there is no reduction in the benefit paid to the retiree to "pay" for the survivor benefit.

4. Alternate options may be available, including lump sum distributions to surviving beneficiaries.

H. Reemployment after retirement – A Plan may provide for suspension of retirement benefits, an earnings limit (reduction in retirement benefits if the retiree earns a salary that exceeds a specified limit), and/or prohibition against future benefit accruals. State statutory provisions may be designed to ensure bona fide separation from employment before commencement of retirement (e.g., prohibition against return to work within a specified time period).

I. Other benefits – A Plan may provide employee death benefits, line of duty death benefits, disability retirement, return of accumulated contributions, cost-of-living adjustments (COLA).

J. Deferred Retirement Option Plan ("DROP")

1. A DROP is an arrangement under which an employee who is eligible to retire can receive deferred benefits while continuing to work.
2. The DROP member "retires" but continues to work. The retirement benefit is based on years of service and salary before entry into DROP. Salary increases and years of service while in DROP are not taken into account.
3. While the DROP member continues to work, the monthly retirement benefit is paid into the individual's DROP account maintained by the Plan, rather than being paid to the participant; DROP funds accumulate and earn interest
4. The length of DROP participation is usually limited to several years. Once DROP participation ends, the funds accumulated in the member's DROP account are distributed to the member, and member separates from employment.
5. Some have raised ADEA concerns with respect to DROPs. In *Lerman v. City of Fort Lauderdale*, No. 02-60967-CIV, 2008 WL 5378127 (S.D. Fla. Dec. 23, 2008)(unpublished), *aff'd*, 346 Fed. Appx. 500 (11th Cir. 2009), *cert. denied*, 130 S. Ct. 1543 (2010), certain veteran police officers challenged a DROP under the ADEA, alleging it discriminated on the basis of age. *Id.*, 2008 WL 5378127, at *4-5. Citing the "safe harbor" for voluntary early retirement incentive plans (29 U.S.C. § 623(f)(2)(B)), the court determined that DROP conformed to the ADEA because the program was "completely voluntary" and "fit[] within the purpose of the ADEA" by creating an incentive for officers to retire early. *Id.*, at *13.

IV. LIENS/ANTI-ALIENATION

- A. **Anti-Alienation Generally** – Governmental plans are not subject to IRC § 401(a)(13), requiring that plan benefits may not be assigned, attached, garnished or alienated. 26 CFR § 1.401(a)-13(a). Nonetheless, governmental plans generally contain provisions to limit or prohibit the attachment, garnishment, execution or seizure of any current or future benefit. If the plan itself or relevant statutes do not contain anti-alienation provisions, state spendthrift laws may also apply to protect the participants' benefits.
- B. **Private Garnishment.** Typically, a plan will prohibit garnishment or attachment of pension benefits by a private party. However, U.S. tax liens are exempted from any anti-alienation provisions (IRC § 2631), and state tax liens are often exempted as well.
- C. **Child Support Orders** – Typically, a plan will permit garnishment of benefits to satisfy an order of child support. Note the provisions of Federal Consumer Credit, Protection Act which prevent garnishment of more than 50-65% of retiree's benefit for child support (% cap depends on whether retiree is supporting a current spouse/child and whether there are any arrearages to be recovered). See 15 U.S.C. § 1673; 29 CFR § 870.11.
- D. **Domestic Relations Orders (“DRO”) other than Child Support**
1. As defined by federal tax law (IRC § 414(p)(1)(B)), a domestic relations order is a court order (not an agreement) made pursuant to state domestic relations law that provides marital property rights, alimony, or child support to a participant's spouse, former spouse, child or other dependent.
 2. Governmental plans are not required to recognize a Qualified Domestic Relations Order (QDRO) under ERISA, because ERISA's requirements regarding QDROs (ERISA § 206(d)(3)) do not apply to governmental plans. However, if a plan makes distributions under a DRO that meets the IRC's definition of a qualified domestic relations order under IRC § 414(p), tax consequences are determined by federal tax law.
 3. Many states require governmental plans to recognize a DRO. Even where state law does not provide for recognition of a DRO by a Plan, some courts have held that the division of pension benefits in a divorce is not an alienation or assignment of a retirement plan benefit and should be honored by a governmental plan.

4. To prevent confusion, most governmental plans do not use the phrase QDRO. Governmental plans have their own terminology, e.g., “Approved Domestic Relations Order” (“ADRO”) or “Eligible Domestic Relations Order” (“EDRO”), and establish their own processing rules.
5. Typical state and local governmental plan provisions may provide that an ADRO is a court order that:
 - a. Assigns to the alternate payee a right to receive all or a portion of the participant’s benefit.
 - b. Specifies a fixed or determinable amount due to the alternate payee. May be a flat percentage, flat dollar amount, percentage of a marital share fraction (numerator is months of marriage during which participant accumulated benefits/denominator is months of service credit)
 - c. In Maryland, specifies that benefits may be paid to alternate payee only “if, as and when” a benefit is paid to the member. The alternate payee does not have the option to receive distributions at a different time or designate a beneficiary.
 - d. Does not require the plan to pay an amount that exceeds participant’s benefit
 - e. Does not require the plan to provide any type or form of benefit, or any option, not otherwise provided under the plan.
 - f. Does not require the payment of benefits to an alternate payee which are required to be paid to another alternate payee under a previous order.
6. The DRO should address all potential plan benefits that may become payable to the participant:
 - a. Monthly Allowance
 - b. Pre-retirement death benefits
 - c. Post-retirement survivor benefits
 - d. Cost-of-living adjustments
 - e. Return of accumulated contributions
7. Model Domestic Relations Orders – Many governmental plans find it convenient to provide a model order to avoid the time and expense of rejecting defective court orders. The model should explicitly state that it should not be taken as legal advice, and is presented for informational purposes for use by counsel, only to assist in the submission of a DRO that may be found acceptable to the plan administrator.

V. DEALING WITH ERROR CORRECTIONS

- A. Under the IRC, a qualified plan is required to be administered in accordance with the written plan document.

- B. Many plans have a provision requiring correction of errors: “If, because of an error in the records, a retiree or beneficiary receives a benefit that differs from the benefit the retiree or beneficiary is entitled to receive, the plan shall correct the error.”
- C. Estoppel – a participant may argue that the error should not be corrected based on principles of estoppel: The participant may argue that the error resulted from (a) the plan employee providing information that the plan knew or should have known was incorrect; (b) the information was reasonably relied upon by the member; (c) the member changed his/her position based on the information.
- D. Governmental Exception to Estoppel: The government cannot be forced to do that which it has no authority to do.
1. *Office of Personnel Management v. Richmond*, 496 U.S. 414, 416, 110 S. Ct. 2465, 2467 (1990). The claimant in *Richmond*, a Navy welder, received erroneous advice regarding a statutory limit on earnings that would disqualify him from a disability annuity, and lost six months of benefits. The claimant argued that the bad advice should give rise to equitable estoppel against the government, and should entitle him to payment of the benefits in accordance with the advice he received, contrary to the statutory terms. The U.S. Supreme Court recognized that estoppel does not lie against the government as it lies against private litigants, and explained that not even the temptations of a hard case will provide any basis for ordering a recovery contrary to the terms of a statute. *Id.* at 420, 110 S. Ct. at 2469. To do so, said the Court, would disregard “the duty for all courts to observe the conditions defined by Congress for charging the public treasury.” *Id.*, quoting *Federal Crop. Ins. Corp. v. Merrill*, 332 U.S. 380, 68 S. Ct. 1 (1947). The Court stated that:

Extended to its logical conclusion, operation of estoppel against the Government in the context of payment of money from the Treasury could in fact render the Appropriations Clause a nullity. If agents of the Executive were able, by their unauthorized oral or written statements to citizens, to obligate the Treasury for the payment of funds, the control over public funds that the Clause reposes in Congress in effect could be transferred to the Executive.

496 U.S. at 428, 110 S. Ct. at 2473.

2. Governmental exception to estoppel is often recognized by state courts, and there are state law precedents with respect to governmental pension plans. *E.g.*, *Employees’ Retirement System v. Melton*, 294 Ga. App. 634 (2008); *Strong v.*

State ex rel. Oklahoma Police Pension and Retirement Board, 115 P.3d 889 (Okla. 2005). However, members may have a tort claim for consequential damages even if the Plan must correct the error.

- E. Certain factors will affect the likelihood of a court upholding a plan's decision to correct. A court may not uphold a decision to correct if the statute is ambiguous and susceptible to interpretation in favor of the member's position.
- F. **ECPRS** - With regard to correction by a plan of IRC compliance errors (which does contemplate errors on an individual participant's benefit), IRS has issued Revenue Procedure 2013-12 (find it at <http://www.irs.gov/pub/irs-drop/rp-13-12.pdf>) introducing the Employee Plans Compliance Resolution System ("ECPRS") that provides a comprehensive system of correction programs for sponsors of qualified plans under IRC §§ 401(a), 403(a), 408(k) or 408(p), but that have not met the relevant requirements for a period of time. The three programs comprising ECPRS are, in increasing level of complexity and cost, the Self-Correction Program (which should cover the vast majority of individual participant benefit errors), the Voluntary Correction Program, and the Audit Closing Agreement Program.

VI. ACTIONS BY GUARDIANS AND AGENTS UNDER A POWER OF ATTORNEY

- A. **Powers of Attorney** – A power of attorney is a basic financial planning tool through which a person can authorize another individual to take certain actions with respect to property and assets on their behalf during their lifetime. The POA establishes a fiduciary relationship between a principal (the participant) and an agent (sometimes referred to as the "attorney-in-fact"). Many financial institutions and agencies review such documents on a daily basis.
 - 1. State law governs whether a plan administrator may or must permit the actions of an agent under a power of attorney.
 - 2. Scope of authority of a power of attorney is typically controlled by the language of the power of attorney.
 - 3. The agent is a fiduciary with duties of care and loyalty. Unless power of attorney expressly permits agent to make beneficiary designation, under state law, a plan administrator should consider whether to decline a beneficiary designation made by an agent under a POA. A beneficiary designation is a form of gifting of the assets of the principal, and under state law, may be required to be explicitly authorized. A plan administrator may also wish to consider whether a POA should explicitly authorize self-designations by an agent.

4. A plan administrator should develop best practices with legal counsel for the review and approval of actions by an agent under a POA.
5. Best practices might include: (a) a checklist or other screening tool for staff to use to review POAs and approve basic transactions performed by an Agent; (b) training selected staff to review POAs; (c) a process to identify potential problem POAs and forward to legal counsel for review.
6. POAs that require special attention may include: (a) out of state POAs (many state laws require that POA satisfy the execution formalities of home jurisdiction); (b) Designations of beneficiary by a POA; (c) springing POAs; (d) POAs submitted by dual agents; (e) non-durable POAs; (f) limited POAs.

B. Guardianship Orders – A guardian is an individual appointed by the court for the benefit of a minor or disabled person (person who has been determined to be unable to manage his or her affairs). A guardian serves in a fiduciary capacity, under the court’s supervision, and must account for his actions with the court.

1. Plan administrators should look to state law and the terms of the guardianship order to determine whether a particular action requested by a guardian is authorized.
2. In many jurisdictions, a guardianship order typically does not include authority to change beneficiary designations. Court approval would be needed.
3. Plan administrators should develop best practices with legal counsel for the review and approval of actions requested by a guardian.
4. Best practices may include: (a) requiring true-test copy of guardianship order; (b) checking docket to ensure order is still in effect; (c) determining whether all requirements have been met by guardian (e.g., did guardian furnish bond, submit any required accounting to court).

ARE YOU QUALIFIED?
Protecting the System's Qualified Status
and Providing the Best Tax Treatment for
Member's Benefits

June 23, 2015

Presented by:
Lisa Erb Harrison, Of Counsel



Role of the System Counsel or Compliance Officer

- **Type of Plan**
 - Most Governmental Retirement Systems established and maintained as qualified governmental plans under IRC §§ 401(a) and 414(d)
- **Sources of Requirements for a Qualified Plan**
 - The Internal Revenue Code as amended by Congress
 - Treasury Regulations
 - Revenue Rulings
 - Revenue Procedures
 - Private Letter Rulings (PLRs)
 - Notices
 - Other— Announcements, Newsletters, Court Decisions (*United States v. Windsor*)

Why is Qualification So Important?

- **Taxation**
 - Employer contributions are not taxable to members
 - Earnings/income are not taxed to the trust or members
 - Favorable tax treatments may be available to members upon plan distributions
 - Employers/members do not pay employment taxes when employer contributions are made or benefits are paid
 - Tax recapture available for qualified plans in tax treaty countries

Why is it So Important to be a Governmental Plan?

- **Exemption**

- Governmental plans are exempt from the Employee Retirement Income Security Act of 1974 ("ERISA")
- Governmental plans are exempt from Pension Benefit Guaranty Corporation ("PBGC") premium payments
- Governmental Plans are exempt from many Code requirements

Why is it So Important to be a Governmental Plan? (cont.)

- **Special Favorable Code Provisions**
 - Employee contributions may be "picked-up" and treated as pre-tax
 - State/local government plans have favorable grandfathering and transitional rules under IRS guidance
 - Governmental plans have favorable special limits on benefits
 - Special service purchase opportunities exist for governmental plans

How Does Counsel Know For Sure that Its Plans are Qualified?

- **IRS issues "determination letters" which confirm the qualified status of a retirement plan.**
 - Form 5300 is the IRS application form
- **IRS gave sponsors of individually designed governmental plans option of electing to use:**
 - Cycle C (Feb. 1, 2013 – Jan. 31, 2014) or
 - Cycle E (Feb. 1, 2015 – Jan. 31, 2016)
- **Possible changes to determination letter program?**

Definitions – "Pension Plan"

- **What is a Pension Plan?**
 - Plan must be established and maintained by an employer(s) for employees
 - Plan's assets must be held in trust as determined under state law
 - Trustees must exercise fiduciary duties
 - Plan must be established to provide systematically for the payment of definitely determinable benefits
 - Payment from the plan must be made to employees over a period of years, usually for life, after retirement

What Type of Qualified Plan is it?

- A defined contribution plan
- A defined benefit plan
- A hybrid defined benefit plan

Who Can be a Member?

- **To maintain qualified governmental status:**
 - Only employees of governmental employers may be members of the plan (IRS position)
 - Only contributions from these employers and their employees may be made to the plan
 - Advanced Notice of Proposed Rulemaking (ANPRM) –REG-157714-06 (government plans, generally) & REG-133223-08 (Indian tribal government plans)
- **Governmental plan status: Areas of Inquiry**
 - Privatization
 - Coverage of non-governmental entities/employees
 - Contracting Out and In
 - Charter Schools – Notice 2015-7
 - Utility Districts
 - Volunteer Fire Companies
 - Indian Tribal Governments

Pension Plan: Areas of Inquiry

- In-service distributions, including refunds of contributions during employment
 - PPA permits certain in-service distributions if the plan so provides
 - IRS issued final regulations on normal retirement age – governmental plans have delayed effective dates, Notice 2012-29

- Statement of actuarial assumptions

- Medical benefits -- Compliance with 401(h) requirements
 - Only means of paying medical benefits from pension plan
 - Limited to retiree, spouse, and dependents

Mandatory vs. Optional Membership

- **If the plan provides for optional participation, the option must be:**
 - A one-time irrevocable election (401(k) regulations) or
 - A grandfather cash or deferred arrangement
- **Membership Options: Areas of Inquiry**
 - Optional participation
 - Ongoing or revocable elections
 - Transfers to another plan maintained by the employer
 - "Special Pay" plans

Exclusive Benefit Rule– 401(a)(2)

- **Code Requirements**
 - Plan must be established and operated for the exclusive benefits of employees and their beneficiaries
 - Plan must make it impossible, at any time prior to the satisfaction of all liabilities with respect to employees and their beneficiaries... for any of the corpus or income to be... used for, or diverted to, purposes other than for the exclusive benefit of employees or their beneficiaries

Exclusive Benefit Rule & Areas of Inquiry

- Payments other than to the members and their survivors
- Investments that do not meet fiduciary standards
- Diversion of assets
- Return of contributions to employer
- QDROs
- Garnishment

Prohibited Transactions – 503(b)

- Plan may not engage in "prohibited transactions."
- Areas of Inquiry
 - Self-dealing in investments
 - Loans

Vesting – 401(a)(7)

- **Code Requirement**
 - Governmental plans are subject to pre-ERISA vesting rules
 - Plan must provide 100% vesting if:
 - There is partial or complete termination of the plan or
 - Complete discontinuance of contributions
 - Pre-ERISA vesting would also require 100% vesting of accrued benefit at normal retirement age

Limits on Contributions – 415(c)

- **Code Requirements**

- All annual additions to a defined contribution plan and post-tax employee contributions to a defined benefit plan are capped in the limit on "annual additions"
 - Lesser of 100% of compensation or \$40,000 (adjusted for inflation by the IRS) - \$53,000 by 2015

Limits on Contributions – 415(c) (cont.)

- **Contribution Limits: Areas of Inquiry**
 - Final 415 regulations

 - Definition of Compensation

 - Picked-up Contributions – Rev. Rul. 2006-43
 - Employer paying contributions in lieu of employee
 - Employee has no option of receiving picked-up amounts
 - Official action
 - Timing of pick-up
 - Irrevocable elections

Limits on Benefits – 415(b)

- **Code Requirements**

- Benefits from a defined benefit plan are subject to the "dollar limit" - \$160,000 (adjusted for inflation by the IRS) -- \$210,000 for 2015
- Benefit tested as the straight life annuity.

Limits on Benefits - 415(b) (cont.)

- **Benefit Limits: Areas of Inquiry**
 - Final 415 regulations
 - Service retirement with fewer than 10 years of service
 - Early retirement before age 62
 - Special limits for public safety employees
 - Post-retirement adjustments
 - Establishment of Qualified Excess Benefit Arrangement to handle excess benefits

Limits on Service Purchases- 415(n)

- **Code Requirements**
 - After-tax employer contributions for permissive service credit
 - Modified 415(c) limit
 - or
 - Modified 415(b) limit
- **Areas of Inquiry**
 - Qualified vs. nonqualified service

Limits on Compensation – 401(a)(17)

- **Code Requirements**

- Plan must limit the compensation that may be considered to \$200,000 in determining benefits (as adjusted for inflation) -- \$265,000 for 2015
 - For employee contribution calculation (generally not for employer contribution purposes for a defined benefit plan)
 - For benefit calculation
- Certain employees are grandfathered

- **Compensation Limits: Areas of Inquiry**

- Plan Year vs. Calendar Year
- Year-by-year application

Required Benefit Payments – 401(a)(9)

- **Code Requirements**
 - Plan must set forth IRC's distribution requirements and contain statements that the plan will comply with those requirements
 - Benefit must be distributed or begin to be distributed by the required beginning date (RBD)
 - April 1 of the calendar year that follows the calendar year in which the participant attains 70½ or separates from service, whichever is later
 - Benefits must be distributed
 - Over the period of life of the employee
 - Over the lives of such employee and a designated beneficiary or
 - Over a period not extending beyond life expectancy(ies)
 - IRS has issued final regulations under 401(a)(9) for defined contribution and defined benefit plans

Required Benefit Payments– 401(a)(9)

- **Required Benefit Payments: Areas of Inquiry**
 - Assuring that benefits begin by the requested beginning date (RBD)
 - Assuring that the required minimum distribution (RMD) is made
 - Tracking down participants and beneficiaries – dormant accounts
 - Testing survivor benefits under the incidental benefit rules
 - Grandfathered provisions and/or good faith, reasonable compliance

Rollovers – 401(a)(31)

- **Code Requirements**
 - Plan provide rollovers by employees and spouses and give the appropriate notices
 - Following *United States v. Windsor*, reference to spouse changed to include same-sex spouses (not applicable to domestic partners)
 - Rollovers are permitted out of and into:
 - Qualified plans
 - 403(b) plans
 - Governmental 457(b) plans
 - IRAs

Rollovers – 401(a)(31)

- **Rollovers: Areas of Inquiry**
 - Identifying eligible rollover distributions
 - Identifying eligible retirement plans
 - Using rollovers for service purchases
 - Maintaining limitations on in-service distributions
 - Compliance with notice requirements
 - After-tax dollars
 - Implementing non-spouse beneficiary rollover
 - Implementing Roth Rollovers
 - Implementing rollovers of lump-sum distributions from defined contribution plans to a defined benefit plans where amounts are converted to immediate annuities

Taxation of Benefits

- **Plan must follow Code and IRS guidance for tax withholding/reporting procedures**
 - 1099-R
 - 1042-S

- **Numerous Code provisions including Section 72, 101(h), 104 and 402**
 - Code Section 72(t) – 10-Percent Additional Tax on Early Distributions from Qualified Retirement Plans and exceptions

 - Code Section 101(h) – Survivor Benefits Attributable to Service by a Public Safety Officer Who is Killed in Line of Duty

 - Code Section 104(a) – Line of Duty Disability Benefits

Thank You

Questions

PUBLIC PENSION PLAN INVESTMENTS

NAPPA

**2015
LEGAL
EDUCATION
CONFERENCE**

AUSTIN, TEXAS

NEW MEMBER AND ASSOCIATE COUNSEL SESSION

- **Types of Investments**
 - **Public Markets Investments**
 - **Alternative Investments**
 - Hedge Funds
 - Private Equity/Venture Capital
 - Real Estate
 - Real Assets
 - **Derivatives**

LEGAL ISSUES IN INVESTMENTS

- **Gating Items:**
 - Sovereign Immunity/Governmental Immunity
 - Indemnification Limits
 - Public Disclosure Laws & Fund Level Information
 - Placement Agent Policies & Pay to Play Matters
 - Prohibited Investments
 - Tax Matters
 - Jurisdiction for Disputes & Governing Law
- **How are gating items addressed: Side Letters**

NON-STATUS LEGAL ISSUES IN INVESTMENT DOCUMENTATION

- **Fiduciary Duties of Investment Managers**
 - To the Investor
 - To the Investment Vehicle
- **Standard of Care**
- **Transfer Rights**
- **Excuse/Exclusion & Withdrawal**
- **Debt & Confirmation Letters**
- **Power of Attorney**
- **Confidentiality**

BUSINESS ISSUES IN INVESTMENTS

- How is the Investment Manager being compensated:
 - Management Fees
 - Performance Allocation/Carried Interest
- Alignment of Interest
- Governance
- Reporting