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QUALIFIED PLANS 2006-4

HIGHLIGHTS

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1. DOL Further Expands Voluntary Fiduciary Correction Program

The Department of Labor recently published an update to the Voluntary Fiduciary Correction Program ("VFC Program"). 71 Fed. Reg. 20261 (Apr. 19, 2006). In general, the VFC Program provides a means to avoid a lawsuit initiated by the DOL in connection with certain fiduciary breaches and relief from the imposition of a 20% civil penalty, imposed under section 502(l) of ERISA, on amounts recovered under any DOL lawsuit or settlement. The VFC Program now covers 19 specific transactions that could result in fiduciary breaches and prohibited transactions. The updated VFC Program is effective on May 19, 2006.

A companion prohibited transaction class exemption (PTE 2002-51) to the VFC Program provides relief from excise taxes (under Internal Revenue Code section 4975) that would otherwise be imposed in connection with certain transactions corrected under the Program. In addition to updating the VFC Program, DOL also finalized amendments to PTE 2002-51. 71 Fed. Reg. 20135 (Apr. 19, 2006). The amendments to PTE 2002-51 also are effective as of May 19, 2006.

Most of the changes to the VFC Program and to PTE 2002-51 were described by DOL in revisions to the program originally published in April 2005 (Qualified Plans 2005-4). Major changes in the 2005 revision included the adoption of a model application form, a reduction in the documentation required from filers, simplifying the calculations necessary to determine any lost earnings or profits to be restored to the plan, the introduction of an internet-based tool to calculate lost earnings or profits to be restored, and the addition of new transactions that may be corrected through the Program. These changes have been reflected in DOL's most recent update.

In addition, DOL's latest update includes the following notable changes to the VFC Program:

- The VFC Program now explicitly provides relief from civil penalties imposed under ERISA section 502(i). ERISA section 502(i) permits the DOL to assess a 5% civil penalty on

prohibited transactions in connection with welfare plans and nonqualified pension plans (plans not subject to the excise tax under Code section 4975).

- Additional covered transactions include:
  - the sale of an illiquid asset from a plan to a party in interest;
  - participant loans that violated IRS' level amortization requirements (Code sec. 72(p)), or were defaulted due to administrative or system errors, where correction is made under the IRS' forthcoming Employee Plans Compliance Resolution System ("EPCRS") program; and
  - payment by the plan of certain expenses that should have been paid by the plan sponsor (e.g., plan design consulting fees).
- The Program's on-line calculator has been revised to allow corrections involving multiple transactions with different time periods.
- The correction methods for a transaction that involves a plan's purchase of an asset from a party in interest has been expanded to allow a plan to retain the asset, and receive a settlement amount in cash for the correction of the transaction. Previously, the VFC Program required the plan to sell the asset in all cases.
- Changes have been made to narrow the definition of "under investigation" (for purposes of the exclusion from eligibility for those plans or applicants that are "under investigation" at the time of the application) to investigations involving the plan or an act or transaction involving the plan.

Final changes to PTE 2002-51 include the addition of two new transactions. PTE 2002-51 now covers six categories of VFC Program transactions, including the following new transactions:

- the plan's acquisition of an illiquid asset and subsequent sale to a party in interest; and
- the use of plan assets to pay for settlor, as opposed to plan, expenses.

On the negative side, in response to a request to expand the scope of PTE 2002-51 to cover transactions involving IRAs, the Preamble clarifies DOL's view that neither the VFC Program nor the exemption applies to IRAs not subject to ERISA. DOL explained that excise tax relief for transactions involving IRAs may only be obtained through DOL's individual administrative exemption process.

While all of the new changes to the VFC Program are positive, the addition of 502(i) penalty relief may be the most important. Advisors and their clients often overlook the fact that welfare plans are not subject to excise taxes under the Internal Revenue Code. Accordingly, the excise tax relief under the prior version of the VFC Program (which only covered the IRS excise tax and not the 502(i) penalty) was not helpful to welfare plan fiduciaries. Although the 502(i) penalty has rarely been imposed, relief from the penalty now provides welfare plan fiduciaries with a tangible benefit of correction through the VFC Program.

2. Seventh Circuit Finds "Implicit Exception" to ERISA 404(c) Compliance

The Seventh Circuit recently concluded that the trustee of a participant-directed plan could effectively delegate to plan participants responsibility for selecting among investment options chosen by the trustee – even though the plan failed to qualify under ERISA section 404(c). Jenkins v. Yager, 2006 WL 956944 (Apr. 14, 2006).

ERISA section 403(a) provides that the plan trustee shall have exclusive authority and control over plan investments with two explicit exceptions: (1) the plan provides that the trustee is subject to the direction of a "named fiduciary," and (2) authority to manage the plan assets has been delegated to an "investment manager" (as defined in section 3(38)). Jenkins, a plan participant whose account lost money in several consecutive years, alleged that Yager, the plan trustee, violated section 403 when he delegated investment responsibility to plan participants and failed to comply with the requirements of section 404(c).

Noting that neither of the explicit exceptions to the trustee's exclusive authority over plan assets applied to the situation at hand – apparently participants were not described as "named

fiduciaries" in the plan document – the court went on to recognize an "implicit exception" to ERISA's vesting of investment responsibility in the plan trustee. The court explained that, although section 404(c) and the regulations thereunder "create a safe harbor for a trustee, we see no evidence that these provisions necessarily are the only possible means by which a trustee can escape liability for participant-directed plans." It then went on to establish the "implicit exception," mostly by relying on the "intent" to permit participant direction expressed in section 404(c) and the Department's regulations.

Significantly, although the court stated that "the benefits of section 404(c)" would not be available to a plan relying on this "implicit exception," its analysis of Yager's duties in this case was identical to the analysis applicable to decisions of trustees who do "have the benefits" of section 404(c), i.e., the court looked at the process used by the trustee to select and monitor the investment options offered to participants under the plan. Moreover, the court specifically rejected Jenkins' argument that trustee Yeager violated his duties by not reviewing the investment directions of each participant during the year "to ensure that they were appropriate."

The very limited information and investment flexibility provided to participants also did not appear to concern the court. In most years, the plan permitted participants to change investments only once per year, and never more than every six months. In addition, annual performance information for a year was provided *after* the participant was permitted to change investments for the upcoming year. It is difficult to see how participants could effectively control their investments under these circumstances.

If the Seventh Circuit is correct – and it is not clear that its analysis would be adopted by other courts – a plan trustee can effectively delegate investment authority to plan participants without complying with section 404(c). Because compliance with the regulations thus will be undermined, we would not be surprised if DOL disagrees with the court's position that section 404(c) is only a "safe harbor" and not the exclusive means for avoiding fiduciary responsibility for participant investment decisions.

3. Split in Recent Cash Balance Plan Rulings

Recent rulings in the pending class action lawsuits against the FleetBoston and AT&T cash balance plans add to the growing number of decisions regarding age discrimination and other attacks on such plans. In Richards v. FleetBoston, D. Conn., No. 3:04-cv-1638 (JCH), 3/31/06, the U.S. District Court in Connecticut ruled that the basic cash balance benefit formula violates the age discrimination rules, making it the first court since the district court in the IBM case to come to such a conclusion. In Engers v. AT&T, D.N.J., No. 98-3660 (JLL), unpublished 3/31/06, the U.S. District Court in New Jersey dismissed a number of claims pending against the AT&T cash balance plan. While many of the most recent decisions, including the decision in AT&T discussed below, have come out in favor of the legality of cash balance plans (for example, the decision in favor of the PNC cash balance plan last fall (Qualified Plans 2005-11), the ruling against the FleetBoston Plan is a blow to plan sponsors.

A. FleetBoston Decision

In FleetBoston, the court considered a preliminary motion to dismiss claims involving a number of issues, the most significant being that the cash balance plan formula violates age discrimination rules. Other pending claims include allegations that Fleet failed to provide advance notice of plan changes as may be required by section 204(h) of ERISA, the plan's SPD was insufficient because it did not describe the age discriminatory impact of the cash balance formula and the possibility of "wear-away," and the wear-away period caused the benefit accrual pattern to violate the anti-backloading rules.

1. Age Discrimination

Like claims in many cash balance plan cases, the FleetBoston participants claim that the cash balance formula is age discriminatory because pay credits made to younger employees will have more time to grow with interest than similar credits made to an older employee's account. ERISA section 204(b)(1)(H) requires that the "rate of an employee's benefit accrual" under a defined benefit plan cannot be reduced because of the attainment of any age. The issue that courts must resolve is how to measure the rate of accrual. Plaintiffs claim that the rate of accrual must be measured by the change in the benefit expressed as an annual benefit commencing at normal retirement age – an analysis

which requires the inclusion of all future interest credits (to normal retirement age) with respect to a current pay credit made to the participant's account. Under this approach, the cash balance formula can be viewed as age discriminatory. Plan sponsors contend that the rate of accrual should be measured based on the change in the account balance from year to year – like a defined contribution plan. Under this approach, the cash balance formula is not age discriminatory.

The court in FleetBoston concluded that the statutory language "rate of benefit accrual" refers to the rate of change in the participant's "accrued benefit." In turn, the term "accrued benefit" is defined by ERISA as the participant's annual benefit commencing at normal retirement age. The court refused to consider that legislative history may not support this conclusion and that the U.S. Department of Treasury (the agency charged with interpreting this section of ERISA) has consistently indicated that the statute should not be read in this manner for cash balance plans.

The FleetBoston decision is consistent with the widely publicized district court decision in the IBM cash balance plan (Qualified Plans 2003-8) – currently before the Seventh Circuit Court of Appeals. A decision on the IBM appeal could come at any time. Most other courts have concluded that cash balance plans (including the plans of PNC, CBS, ARINC, Southern California Gas and Onan Corporation) do not violate these age discrimination rules. Thus, regardless of how the IBM appeal turns out, this issue is likely to remain the subject of litigation for the foreseeable future unless a legislative solution is found. As noted in Qualified Plans 2006-2, the pending House and Senate pension bills include differing provisions in this area and it is unclear what compromise will emerge.

2. Other Issues in FleetBoston

The court refused to dismiss two other claims made against the FleetBoston plan: (1) that Fleet failed to provide a notice as required under ERISA section 204(h) before implementing the cash balance benefit, and (2) that the summary plan description ("SPD") did not describe the possibility that wear-away could occur and that the cash balance benefit could be age discriminatory. The court allowed the 204(h) notice claim to proceed because the facts regarding its content and the timing of its distribution were not yet established to the court's satisfaction. As for the SPD, the court held that the plaintiffs' allegations were sufficient to meet the "likely prejudice" standard for claims alleging that SPDs do not meet the requirements of ERISA. Both of these issues will require the court to review further the specific language of the 204(h) notice and the SPD, the relevant standard of disclosure for both items, and whether any failure to properly disclose may be cause for damages.

The court did dismiss, at least preliminarily, the plaintiffs' claim that the wear-away period that occurred following the cash balance conversion caused the plan to violate the anti-backloading requirements of ERISA. Citing ERISA section 204(b)(1)(B)(i) and the recent decision in Register v. PNC Financial Services, Civ. Act. No. 04-CV-6097 (E.D. Pa. Nov. 21, 2005), the court found that the back loading requirements are applied by considering the cash balance benefit formula on a stand-alone basis, without consideration of any wear-away caused by the transition from the old benefit formula. However, the court gave leave to the plaintiffs to brief this issue further if the plaintiffs so requested (and we understand the plaintiffs have made this request).

B. AT&T Decision

In the long-running class action suit against the AT&T cash balance plan (first filed in 1998), the federal district court in New Jersey recently granted partial summary judgment in favor of AT&T on claims involving the alleged failures (1) to provide a proper notice to participants under ERISA section 204(h), (2) to set forth the plan's "wear-away" rule in the written plan document, and (3) to disclose in the plan's SPD the "bad parts" of the cash balance conversion.

204(h) Notice – The court in AT&T reviewed the section 204(h) requirements and concluded that, although the statutory provision requires the notice where there is a significant reduction in the *rate* of future benefit accrual, the proper threshold determination under the controlling regulations was whether there had occurred a significant reduction in the *amount* of normal retirement benefits. Expert testimony was provided that none of the named plaintiffs would experience a reduction in the amount of benefits payable at normal retirement. In fact, each plaintiff's post-amendment accrued benefit was projected to be higher than under the pre-amendment plan. The court, therefore, determined that a 204(h) notice was not required.

Wear-Away – The plaintiffs claimed that the wear-away period (during which benefits may not accrue because the new cash balance benefit does not yet exceed the frozen prior benefit) was not

expressly set forth in the plan document in a timely manner. The court held that the claim involved the interpretation of the terms of the plan document to determine whether wear-away was, in fact, properly required. The court concluded that this determination must first be made under the plan's claims procedures. Because the plaintiffs had not followed the plan's claims procedures, this claim was dismissed (without prejudice) for failure by the plaintiffs to exhaust their administrative remedies.

Misleading SPD – The plaintiffs contended that the SPD for the AT&T plan was misleading in that it overemphasized the "best" features of the plan and deemphasized the "worst" features of the plan. In particular, the plaintiffs claimed that the SPD did not properly disclose that, among other things, benefits for older employees may be reduced, the factors used to determine the opening cash balance benefit were not the most valuable factors that had applied under the old plan, and that the new plan did not provide any early retirement subsidies. The court held that remedies would be available for a failure to comply with ERISA's reporting and disclosure requirements only if the plaintiff could demonstrate "extraordinary circumstances." AT&T may have put a favorable "spin" on the description of the benefits of the cash balance plan, but that did not rise to the level of "active concealment," which would be required to show extraordinary circumstances to support a claim for a substantive remedy.

4. DOL Finalizes Rules and Class Exemption for Abandoned 401(k) Plans

DOL recently issued final regulations and a class exemption (collectively, the "Program") that permit, but do not require, financial institutions to take responsibility for abandoned 401(k) and other defined contribution plans and distribute the plans' assets to participants and beneficiaries. 71 Fed. Reg. 20820 (Apr. 21, 2006). The final rules will be effective on May 21, 2006.

The Program consists of the following four parts.

- The Abandoned Plan Regulation, 29 C.F.R. 2578.1 (the "QTA Regulation"), provides standards for determining when a plan is abandoned and establishes a process for winding up the affairs of the plan by a qualified termination administrator ("QTA") and distributing benefits to participants and beneficiaries.
- The Safe Harbor for Distributions from Terminated Individual Account Plans, 29 C.F.R. 2550.404a-3 ("the Safe Harbor Regulation"), is a fiduciary safe harbor for use in making distributions of benefits from terminated plans on behalf of participants and beneficiaries who fail to make a distribution election ("missing participants"), the selection of an individual retirement plan or other account provider, and the investment of funds in connection with such distributions.
- The Terminal Report for Abandoned Plans Regulation, 29 C.F.R. 2520.103-13 (the "Reporting Regulation"), imposes reporting requirements on the QTAs in connection with plan terminations.
- Prohibited Transaction Class Exemption ("PTE") 2006-06, 71 Fed. Reg. 20856 (Apr. 21, 2006), provides relief from prohibited transaction rules under ERISA for QTAs that select and pay themselves for services rendered prior to becoming a QTA, for providing services in connection with terminating and winding up abandoned plans, and for distributions from abandoned plans to IRAs or other accounts maintained by the QTA resulting from a participant's failure to provide direction.

The final Program maintains the same basic structure and most of the substance of the proposed Program. Key changes from the proposal and other significant points in the final Program are highlighted below.

QTA and Additional Relief For Non-QTAs. Although DOL received requests to expand the definition of the QTA to include recordkeepers, third-party contract administrators and other service providers, DOL limited the QTA status to those entities that are eligible to serve as trustees or issuers of IRAs. Also, DOL clarified that it intended that there would be only one QTA per plan. Because parties other than a QTA may be holding assets of an abandoned plan, DOL added a new provision that makes it clear that a person holding assets of an abandoned plan will not violate section 404(a) of ERISA to the extent that person

cooperates with and follows the direction of the QTA. In order to benefit from this provision, the non-QTA holding the assets must confirm that the person representing to be the QTA is the QTA recognized by DOL either by contacting DOL or by checking the DOL's web site dedicated to abandoned plans, where DOL intends to list plans deemed terminated under the Program and to identify associated QTAs.

QTA Fees. DOL clarified that the QTA does not need to charge its lowest or discount rate for services to abandoned plans, as long as the fees charged are not in the excess of rates "ordinarily" charged by the QTA for same or similar services to similarly situated customers.

Plans Holding Assets With No Readily Ascertainable Market Value. DOL noted that plans with significant holdings of hard-to-value or illiquid assets (e.g., limited partnership interests, employer securities, participant loans, defaulted mortgages) may not be suitable for termination under this Program.

IRS "Blessing." DOL confirmed with the IRS that the IRS generally will not challenge the qualified status of any plan terminated under the Program or take any adverse action (including penalties assessment) against the QTA, the plan, or any participant or beneficiary of the plan as a result of such termination, provided three specified conditions are met (the QTA determines whether the survivor annuity rules apply, participants/beneficiaries are vested in their account balances, and Code sections 402(f) notices are provided). The Preamble (pages 20827-28) contains a rather detailed discussion of these issues, including DOL's summary of IRS' views on a number of important issues, such as the need to determine whether a partial termination had occurred, situations where the survivor annuity rules may not permit a direct rollover, and plan amendment responsibilities.

De Minimis Account Balances. Several commenters requested guidance on how to handle account balances that amount to less than the administrative cost of processing and distributing the account ("de minimis accounts"). In response to these comments, the QTA Regulation provides that a QTA shall not have failed to use reasonable care in calculating benefits payable if it treats as forfeited such de minimis account balances and uses them to defray plan expenses or allocates them to other plan participant or beneficiary accounts on a per capita basis.

Alternative Investment Option for Small Accounts of Missing Participants. The proposal conditioned the relief for distributions on behalf of missing participants on rolling account balances to individual retirement accounts or annuities. For account balances that are $1,000 or less – or below the minimum amount required to be invested in an individual retirement plan product offered by the QTA to the public at the time of distribution – the final rule permits a distribution to be made to an interest-bearing federally-insured bank account in the name of the participant or beneficiary, or to the unclaimed property fund of the state in which the participant's or beneficiary's last known address is located, or to an individual retirement plan offered by a financial institution other than the QTA.

Class Exemption. An important change from the proposed exemption is that DOL expanded the scope of the final exemption with respect to QTA fees. The final exemption covers two new scenarios involving payments of fees. First, the exemption permits the payment for services provided pursuant to a written contract previously entered into with the plan sponsor or other independent fiduciary. Second, the exemption also permits payments for services that were rendered in connection with a determination of whether the plan is abandoned, which generally would be rendered prior to the service provider becoming a QTA. DOL expressly rejected proposals to eliminate the fee "cap" that limits fees and expenses (with the exception of establishment charges) to the income earned by the IRA or other account, and to expand the definition of "Eligible Investment Product" to permit investments in lifestyle, retirement date and other balanced fund options.

Finally, to harmonize the exemption with the Safe Harbor Regulation, DOL modified the final exemption to provide relief for a QTA (or its affiliate) that is a provider of certain bank accounts that would receive small distributions of $1,000 or less, in connection with the QTA's selection of itself (or its affiliate) to receive these distributions and fees on such accounts.

5. DOL Eliminates 3-Day Limit for "Incidental Loans"

DOL recently adopted a helpful amendment to Prohibited Transaction Exemption 80-26. 71 Fed. Reg. 17917 (Apr. 7, 2006). PTE 80-26 provides relief from the provisions of section 406(a)(1)(B) and (D) and 406(b)(2) of ERISA for a loan by a "party in interest" (such as the sponsoring employer or a

service provider) to a plan if, among other conditions, no interest or fee is charged to the plan in connection with the loan.

Under the prior version of PTE 80-26, a distinction was made between loans for "ordinary operating expenses" (including benefit payments), which were permitted to be of unlimited duration, and loans made for a purpose "incidental to the ordinary operation of the plan," which could be no longer than 3 days. The final amendment eliminates the duration limitation for "incidental" loans, providing exemptive relief for both types of loans regardless of the duration, if the other conditions of the exemption are met. This is, of course, a welcome change and will increase the opportunities for beneficial no-interest loans to plans, but it does not come without a "cost."

Under the prior version of the amendment, a loan made for operating expenses did not require a written agreement. A plan sponsor might advance to its plan expenses or benefit payments, employing a quarterly or even annual reconciliation and reimbursement process. Under the amended exemption – initially proposed in December 2004 (Qualified Plans 2004-12) – an employer may advance plan benefits or expenses only if it executes a written agreement with the plan (with all material terms), if PTE 80-26 is to be relied upon for any loan with a term of 60 days or longer. Because this new requirement applies to "operating expense" loans (effective April 7, 2006) as well as "incidental" loans (effective December 15, 2004), it could have an impact on the cash flow practices of plan sponsors and providers. In this regard, the Preamble contains a discussion of the common practice by employers of paying plan expenses and then seeking reimbursement from plan assets. The "written loan agreement" condition in the final exemption seems to have been driven in part by DOL's desire to discourage employers from paying plan expenses from their general assets and then, years after the fact, "recharacterizing" these expenses as reimbursable plan expenses.

In addition, PTE 80-26 has occasionally been used to "solve" inadvertent loans by employers/service providers and plans. Now, if the loan is not discovered and documented within 60 days, the exemption will not be available for this type of "fix" because the required written loan agreement will not exist.

Notwithstanding the limitations of these new conditions, the final amendment clearly broadens the scope of the exemption in many ways that should be helpful. For example, where the lender is willing to forego interest, the following loans or advances may be covered by PTE 80-26 –

- a "book up" or "book in" or "market value adjustment" (where a service provider advances funds to a new client plan to cover termination charges imposed by a prior provider and recovers the advance over time);
- an investment-related loan to the plan, such as a liquidity facility to better manage plan investments;
- overdraft protection provided by a trustee or custodian in processing plan investment transactions.

The final amendment of PTE 80-26 states that PTE 80-26 does not cover a loan to an ESOP to the extent that the loan relates to the acquisition by the ESOP of employer securities. It is unclear whether this condition would be applied to affect the availability of the exemption for a no-interest liquidity facility provided by an employer or a plan service provider to an employer stock fund characterized as an ESOP. Typically, these funds "borrow" to make redemptions and effect exchanges and not to "acquire" additional securities.

6. DOL Guidance on Allocation of Market Timing/Late Trading Settlements

On April 19, the U.S. Department of Labor (DOL) released Field Assistance Bulletin (FAB) 2006-1, which addresses a variety of issues in connection with distributions from settlement funds established to remedy late trading and market timing in mutual funds. The FAB provides detailed and helpful guidance to plan fiduciaries on how to allocate amounts received from the settlement funds among plan participants. However, as explained below, the guidance affecting banks, brokers, insurance companies, and other entities ("intermediaries") that receive mutual fund settlement proceeds for the benefit of ERISA-covered plans is troubling in that DOL takes the position that such an intermediary will be a "fiduciary" for ERISA purposes, even if the intermediary does not otherwise have a fiduciary role to ERISA-covered plans.

As noted elsewhere in this memorandum's discussion of the pending mutual fund litigation, the

law continues to develop in the market-timing and late trading area and further settlements can be expected.

Background – In connection with enforcement actions involving mutual fund late trading and market timing in the past few years, the Securities and Exchange Commission (SEC) has entered into settlement orders with ten or more mutual fund advisers and others involved in such activities. The settlement orders typically require the establishment of settlement funds to compensate mutual fund investors (both plan and non-plan) for losses resulting from late trading and/or market timing activities. Generally, an independent distribution consultant ("IDC") is appointed to administer the settlement fund and distribute the settlement proceeds to injured fund shareholders. In some cases, the IDC will be able to distribute settlement proceeds directly to the trustee of plans investing in the affected mutual funds. However, in many cases, plans hold their investments in mutual funds through so-called "omnibus" accounts with the mutual fund maintained by a bank, broker, insurance company or other intermediary. In these cases, IDCs may distribute a single lump sum to the intermediary and require the intermediary to further allocate the proceeds among its clients, including 401(k) and other plan clients. These allocations potentially give rise to ERISA fiduciary issues.

Overview – The FAB addresses the responsibilities of IDCs, intermediaries and plan administrators in connection with the distribution of proceeds of mutual fund settlement funds. DOL takes the view that proceeds distributed from a settlement fund for the benefit of an ERISA covered plan are "plan assets" that must be held in trust, administered and invested in accordance with ERISA's fiduciary responsibility rules. DOL further states that methodologies for allocating the proceeds must be consistent with ERISA's prudence requirement and may not violate the "solely in the interest" requirements under ERISA section 404. Based on this approach, the FAB discusses a number of issues arising in connection with the holding and administration of mutual fund settlement proceeds.

Role of Independent Distribution Consultants (IDCs) – Because the proceeds of these settlements become plan assets only upon distribution from the settlement fund, IDCs are generally not ERISA fiduciaries. This is true even if the IDC conditions a payment from the settlement fund on the recipient's use of a particular method to allocate the proceeds among plan participants or requires reports from intermediaries on how the proceeds are allocated.

Issues for Intermediaries – Because the settlement proceeds will be considered plan assets once distributed from a settlement fund, an intermediary that receives settlement proceeds on behalf of plan clients will generally be assuming fiduciary responsibilities with respect to the administration, management and control of the settlement proceeds, even if the intermediary is not otherwise a plan fiduciary. DOL notes that it would generally not be a fiduciary decision to decline the proceeds, unless the plan will be harmed. For example, if the intermediary declines to accept settlement proceeds and, as a result, the plan will not receive its share of the distribution, the intermediary's actions will be viewed as a fiduciary "exercise of discretion or control" over plan assets.

The FAB next addresses issues that intermediaries may face in their role as plan fiduciaries in connection with the settlement proceeds.

- Intermediaries are required to hold settlement proceeds in trust and manage the proceeds in accordance with ERISA's fiduciary responsibility rules pending distribution to clients.

- As an enforcement matter, DOL will consider intermediaries to have met their fiduciary duty to prudently select a distribution method if they follow the method compelled or made available by the IDC in a distribution plan approved by the SEC.

- If the IDC's distribution plan does not specify a method for distributing the settlement proceeds among the intermediary's omnibus account clients, then the intermediary will have to develop a "reasonable" method of distribution in accordance with ERISA's prudence and exclusive benefit rules. Intermediaries should, where possible, allocate proceeds among clients (including plans) in relation to how the late trading and market timing activities may have affected the individual clients.

- In identifying a prudent distribution methodology, a fiduciary may weigh the costs and benefits of the various

alternatives. For example, if the cost of allocating a share of the settlement proceeds to a plan would exceed the projected amount payable to the plan, an intermediary could allocate the plan's share among other clients, so long as plans and other clients are treated similarly. Also, where it would be more cost-effective to do so, an intermediary could allocate the settlement proceeds among clients in an omnibus account according to the average share or dollar balance of the clients' mutual fund investments during the relevant period rather than based on actual transactions.

- Where services provided by an intermediary in allocating settlement proceeds are not included in its service contract with clients, the intermediary may charge plans for its "direct expenses" incurred but not for its usual and customary fees for these services, unless specifically approved by the plans.

Avoiding Fiduciary Status – Importantly, DOL notes that intermediaries might be able to avoid fiduciary status and related self-dealing issues if the receipt, allocation and distribution services are carried out in accordance with the direction and approval of appropriate plan fiduciaries. In this regard, DOL refers to a 2001 advisory opinion issued to our firm in connection with an insurance company demutualization. In that opinion, DOL agreed that where an insurance company provided advance notice to a plan fiduciary policyholder of options for allocating demutualization proceeds among plan participants and gave a reasonable period of time (at least 60 days) to select an option, the insurance company would not be a fiduciary by implementing the "default" option described by the insurer and "negatively elected" by the policyholder. DOL Advisory Opinion 2001-02A (Feb. 15, 2001).

Plan Administrators – DOL's guidance to plan administrators with respect to the allocation of settlement proceeds among plan participants is similar to the guidance provided to intermediaries. First, if the distribution plan provides a specific methodology for allocating proceeds among participants (on either a mandatory or suggested basis), DOL will view the plan fiduciary's application of this methodology as satisfying ERISA requirements.

If the distribution plan does not contain a method for allocating the proceeds among participants, then the plan administrator must determine a method for allocating the proceeds that relates to the impact of the market timing and late trading activities on individual participant accounts. Plan administrators are permitted to weigh the costs to the plan and participant accounts and the ultimate benefit to participants when trying to determine how to allocate settlement proceeds, taking into account matters such as the availability of plan records and the costs of different allocation methodologies.

For example, the FAB suggests that it may be permissible to allocate the proceeds to current participants (rather than participants who may have been in the plan at the time of the alleged activity) in some circumstances. In addition, if amounts are truly de minimis, the plan administrator might conclude that allocations are not cost-effective and use the amounts to pay plan expenses. Finally, plan fiduciaries should document the plan's receipt and use of the settlement proceeds.

IRS Issues – Unlike DOL, the IRS has not provided guidance on the plethora of plan qualification and distribution issues raised by the allocation and distribution of settlement proceeds. Issues in this area include –

- the need for nondiscriminatory allocations of earnings,
- whether the allocations involve "annual additions" under Code section 415,
- the application of participant and spousal consent and rollover notice requirements when the proceeds are distributed (e.g., to terminated participants).

IRS has addressed a handful of these issues in private letter rulings on settlements and insurance company demutualizations, but there is no comprehensive authority in this evolving area.

7. Fiduciary Claims in In-House Mutual Fund Market Timing and Late Trading Litigation

A federal district court recently denied motions to dismiss in five similar cases brought by 401(k) plan participants alleging damages resulting from market timing and late trading in mutual funds offered as plan investment options. This litigation,

consolidated in federal district court in Maryland, is particularly interesting because the court relies heavily on still-developing legal analysis applied in recent employer "stock-drop" cases in deciding whether these cases may proceed.

The court's conclusions on the motions to dismiss are based on its analysis and decisions in In re Mutual Funds Investment Litigation, 403 F. Supp. 2d (D. Md. 2005), which addresses claims brought by a former employee of Strong Capital Management in connection with alleged losses incurred in his individual account in the Strong Capital Management, Inc. Profit Sharing and 401(k) Plan. Memos to counsel addressing similar issues were issued on February 27, 2006 in the following cases – Walsh v. Marsh & McLennan Cos., Inc. (relating to the Marsh & McLennan Companies Stock Investment Plan); Corbett v. Marsh & McLennan Cos., Inc., (plan maintained by Putnam Investments, with three individuals serving as directed trustees); Walker v. Massachusetts Financial Services Co. (plan sponsored by MFS); Zarate v. Bank One Corp., (plan sponsored by Bank One Corp., with Bank One Trust as trustee); and Calderone v. Amvescap PLC (directed trustee is Amvestcap National Trust Co. and Investco is a participating employer of plan).

The cases contain similar fact patterns. Each is brought in connection with a 401(k) plan maintained for its employees by a financial institution sponsor or affiliate of mutual funds implicated in late trading and market timing transactions. Generally, the plaintiff participants claim that the value of their 401(k) plan accounts was adversely affected by market timing and/or late trading in mutual funds offered as investment options under their 401(k) plan. In some instances, claims were also brought in connection with employer stock investments under these plans. The plaintiffs further allege that certain plan fiduciaries (e.g., the financial institution plan sponsor, certain officers or employees of the plan sponsor, and/or a plan trustee) should be liable for the losses because the fiduciaries knew or should have known that the mutual funds (and, in some cases, the employer stock) were not prudent plan investments due to the market timing and/or late trading activities.

The decisions address several legal issues.

Standing – Former plan participants who received a lump-sum payment of plan benefits have standing to bring claims against plan fiduciaries under ERISA section 502(a)(2) on the basis that the participants did not receive the full amount of benefits due.

Fiduciary Status of Defendants – To the extent that the court concluded that any defendant was not a plan fiduciary with responsibility for the addition, deletion or monitoring of plan investment options, claims against the defendant were dismissed. The court concluded that –

- claims could proceed against a committee or other person identified as plan administrator or other "named fiduciary" under plan terms and against other persons, such as committee members or other individuals, where these persons actually perform discretionary functions with respect to the plan's management, assets or plan administration;

- corporate officers are not plan fiduciaries merely because they hold a position of authority in a corporate plan sponsor, such as chairman of the board, or because they sign documents filed with the Securities and Exchange Commission;

- plan sponsorship, by itself, does not confer fiduciary status on the corporate plan sponsor or its parent, and

- providing services to an underlying mutual fund does not make a person a fiduciary for any retirement plan that simply invests in the fund.

Directed Trustee Defendants – In several of the cases, defendants include "directed trustees" affiliated to the plan sponsor. These directed trustees argued that claims against them should be dismissed because they were not fiduciaries under the circumstances. However, the court concluded, based on DOL Field Assistance Bulletin ("FAB") 2004-03 (Dec. 17, 2004) (see Qualified Plans 2005-2), that claims against these directed trustees should not be dismissed.

Specifically, the court notes that FAB 2004-03 provides that directed trustees will rarely have the obligation to question the prudence of a direction to purchase publicly traded securities at market price, but this limitation is only available under circumstances in which the directed trustee does not possess non-public information about the securities being purchased. Noting that the plaintiffs have

claimed that these directed trustees were aware of late trading or market timing activity that was concealed from the public, the court held that that the facts alleged could support a finding that the directed trustees were fiduciaries against whom the plaintiffs could recover damages and permitted the cases against the directed trustees to proceed.

Presumption of Prudence – The defendants argued, based on the reasoning of Moench v. Robertson, 62 F.3d 553 (3d Cir. 1995), that they should be entitled to a presumption of prudence in maintaining the plans' mutual fund (as well as employer stock) investments. In Moench, the 3rd Circuit concluded that plan fiduciaries are entitled to a "presumption of prudence" with respect to plan investments in employer stock, where plan terms mandated that the plan must invest in the employer stock; some other courts have adopted this approach in employer stock cases (see Qualified Plans 2004-5). However, the court was skeptical of these arguments, noting that the Moench reasoning only addresses employee stock ownership plans, not mutual fund investment options. In addition, the court concluded that, even if Moench might apply, it would not apply the Moench presumption at the motion to dismiss phase of a case.

8. Pension Improvement on Verge of Bankruptcy Ruled Fraudulent

Within a month of filing for Chapter XI relief, the Board of Directors of the Fruehauf Trailer Corp. approved an amendment to the company's defined benefit plan that lifted a freeze imposed 5 years earlier on benefits for vested participants, and granted a cash-balance type benefit to those employed or laid off about 6 months later. The Third Circuit recently affirmed a lower court ruling that found this amendment improving qualified pension benefits was a fraudulent transfer that could be avoided in bankruptcy. In re Fruehauf Trailer Corp., 2006 WL 933404 (Apr. 12, 2006). Key facts before the court included –

- the amendment benefited two members of the Administrative Committee that recommended it to the Board,
- the amendment was presented to the Board as an "administrative change,"
- the pension plan had a surplus primarily attributable to favorable experience on union-represented workers,
- the amendment "cost" $2.4 million (and later grew to over $4.4 million) and provided pension increases of 200% to 500% for some employees.

In light of these facts, the court made the following rulings –

- the plan sponsor's "right" to pension surplus was "property" subject to the "fraudulent transfer" restrictions under federal bankruptcy law,
- the amendment to the plan was a "transfer" under these restrictions, and
- because the participant-defendants could not show that the retention value to the Company supported the cost of the amendment, it was "avoidable."

The court recognized that accrued pension benefits could not be cut back under ERISA, but did not tackle the knotty question of how the increased benefits could now be "avoided" consistent with ERISA rules. We would not be surprised to see a future decision on that point.

It is worth noting also that last year's bankruptcy overhaul legislation – applicable to filings made after October 17, 2005 – made several changes affecting situations like the one in Fruehauf. For example, the 2005 Act extends the "lookback" period on fraudulent transfers from one year to two years, and contains several new restrictions on payments to "insiders." This suggests that "troubled companies" need to be more careful than ever that last-minute pension sweeteners may not hold up to scrutiny.

9. Sample Plan Amendment for Roth 401(k) Contributions

The IRS recently issued a sample amendment that can be used by both individually-designed plans and pre-approved plans to add a Roth contribution feature to a 401(k) plan. Notice 2006-44 (May 15 IRS Bulletin). The IRS points out that plan sponsors are not required to adopt the amendment verbatim and, in fact, might have to modify the sample amendment to reflect plan administration. For example, the sample amendment does not address the extent to which a terminated participant may elect that a distribution be made from a Roth account before any other plan account. A plan sponsor can tailor the sample amendment to address the manner in which the plan will administer

Roth distributions. Of course, the sample also would have to be modified to fit a 403(b) plan.

The IRS guidance makes the following points:

- the Roth amendment is a discretionary amendment that must be adopted by the end of the plan year during which the Roth feature is first added to the plan;

- a plan that utilizes a pre-approved plan document can adopt either the sample Roth amendment or an individualized Roth amendment without causing the plan to become an individually-designed plan; and

- a plan that adopts the sample Roth amendment or an individualized Roth amendment may continue to rely on a favorable opinion, advisory, or determination letter, as applicable.

The sample amendment reflects the treatment of a Roth account as a separate plan in applying certain of the direct rollover rules. For example, it provides that the $200 limit on eligible rollover distributions applies separately to the Roth account. It also includes language to the effect that the Roth account and all other accounts are aggregated for the purpose of determining whether the account balance exceeds $1,000 and is subject to the mandatory rollover rules under Code section 401(a)(31)(B). We understand that several organizations intend to submit comment letters in which they will request that the IRS streamline these rules. Therefore, it might be desirable to delay adopting Roth amendments until later in the year when final rules are likely to be published.