THREE KEY EMPLOYEE BENEFIT PLAN ISSUES FOR HEALTH SYSTEMS IN 2017

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April 2017

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January 27, 2017
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Summary

Health system employers should make sure they are familiar with three key employee benefit issues: (1) the new Department of Labor (DOL) fiduciary rule that currently becomes effective April 10, 2017 (but may be delayed in the near future under the new administration); (2) recent excessive fee litigation filed against universities (and now health care systems such as Essentia Health) maintaining Code Section 403(b) fee plans; and (3) new Code Section 457(f) regulations. Each of these issues present risks and opportunities for health systems in 2017.

In Depth

The start of a new year is a good time to take stock and prioritize key issues. Following is a summary of three key employee benefits issues that health system employers should become familiar with in 2017: (1) the new Department of Labor (DOL) fiduciary rule that currently becomes effective April 10, 2017 (but may be delayed in the near future under the new administration); (2) recent excessive fee litigation filed against universities maintaining Code Section 403(b) fee plans and, as of December 30, 2016, a health care system (Essentia Health); and (3) new Code Section 457(f) regulations, expected to become effective by December 31, 2017, that affect deferred compensation and severance plans of tax-exempt entities. Health system employers should understand each of these key issues in order to appropriately assess risks, exposure and new opportunities presented with respect to their employee benefits plans.

DOL Fiduciary Rule

The new DOL fiduciary rule expands the definition of who is considered a “fiduciary” with respect to an employee benefit plan covered by the Employee Retirement Income Security Act of 1974 (ERISA), clarifies what qualifies as “investment advice,” and establishes the standard that investment advice “must be in the client’s best interest.” More information on the DOL fiduciary rule can be found here.

An issue somewhat unique to tax-exempt organizations that has arisen with the new DOL fiduciary rule concerns the investment advisor service agreements for tax-exempts that maintain defined benefit pension plans. Many tax-exempt organizations retain investment advisors to work directly with the investment committee of the organization’s board to assist and counsel the committee on the best way to invest the organization’s own assets. However, it also is not unusual for the investment committee to piggyback off the due diligence conducted on the organization’s investments and, based on that information, make similar investments of pension plan assets. Although the investment committee may believe that the investment advisor is functioning as an ERISA 3(21) fiduciary with respect to the pension plan investments, the investment advisor often will not agree with that assumption, particularly if the investment recommendation was not specifically designed for the pension plan. Moreover, the pension plan is often not referenced in the investment advice service agreements.

If an ERISA fiduciary relationship does exist, the underlying investment advisor service agreement may need to be amended to clarify the investment advisor’s status. Note, however, that if the investment advisor receives any compensation based on providing advice related to pension plan assets, then the advisor would likely fall under the definition of an ERISA “fiduciary” under the new DOL fiduciary rule. This is true even if the underlying service agreement does not acknowledge fiduciary status, because a “verbal understanding” would still be sufficient to make the ERISA fiduciary connection.

Fiduciary breaches by investment committees can result in personal liability for the individual committee members. Most committees seek to demonstrate they are making prudent investment decisions by hiring expert advisers who will help them fulfill their fiduciary duties and share some degree of fiduciary liability. If you are part of an organization that fits the pension plan scenario described here, we recommend that you review your current investment advisor service agreement to identify whether the pension plan is included within its scope. If not, and further fiduciary protection is desired, then the underlying investment advice service agreement should be amended to make clear that the adviser is also serving in a fiduciary capacity with respect to the pension plan. Alternatively, a separate service agreement that pertains solely to the pension plan could be created that specifically references the pension plan, the investment advisor’s role in making investment recommendations, and the fiduciary nature of the relationship.

Code Section 403(b) Fee Litigation

During 2016, over ten large class action lawsuits were filed against prominent higher education institutions (*e.g.*, Duke, Vanderbilt, Cornell) claiming fiduciary breaches occurred under their Code Section 403(b) plans as a result of insufficient oversight of plan investments, which allegedly caused excessive fees to be paid by participants. This litigation mirrors similar Code Section 401(k) fee litigation over the past several years. The targets of the lawsuits originally were higher education institutions with plans with relatively large balances (in excess of $2 billion). However, the scope of these lawsuits recently was expanded to the health care industry when a similar lawsuit was filed on December 30, 2016 against Essentia Health.

The complaints generally assert one or more of the following claims, which plaintiffs argue led to fiduciary breaches:

- By providing too many investment options (one plan offered over 400 choices), the fiduciaries created duplicative offerings that charged higher fees and confused participants, preventing them from making educated choices;
- By utilizing multiple recordkeepers, the fiduciaries impeded the plan’s ability to consolidate management of plan investments, which negatively impacted the plan’s ability to secure more

favorable fee terms and to streamline the plan’s administration to effectively reduce costs;

- The fiduciaries chose to offer higher-cost share classes of mutual funds instead of lower-cost institutional share classes. In addition, when the higher-cost share class investments demonstrated poor performance, they were not effectively monitored and removed from the slate of investment options;
- Use of investment options that included revenue-sharing arrangements was not appropriate, because plan fiduciaries did not compare overall plan fees against a reasonable participant-based recordkeeping fee;
- The fiduciaries failed to conduct a Request for Proposal (RFP) to ascertain whether a better and less expense provider was available ; and
- The fiduciaries failed to capitalize on the size of the Code Section 403(b) plan to secure the best pricing for administrative and investment services.

Because the 403(b) plan fee litigation derives from 401(k) plan fee litigation, some of the claims do not take into account the nuances of a Code Section 403(b) plan. For example, many 403(b) plan investment procedures were modified following the recent issuance of regulations that require written plan documents to account for all Code Section 403(b) assets. However, some organizations were unable to fully consolidate because of the requirements of the applicable vendors, or because old service agreements created an impediment to consolidation. As a result, some of the litigation does not take into account specific characteristics of prior Code Section 403(b) arrangements that have existed since the arrangements were originally entered into in the 1970s and 1980s.

Fiduciaries of Code Section 403(b) plans should take steps to ensure compliance and the ability to demonstrate best practices in case their organization becomes subject to a lawsuit. Following are some of our recommendations:

- **Identify Plan Fiduciaries and Train Them.** We recommend that fiduciary training occur for investment committee members frequently. Many organizations do this annually, or every 2–3 years. New committee members should be trained separately as soon as possible to ensure fiduciary obligations and duties are understood by all committee members.
- **Have and Use a Written Investment Policy.** Fiduciaries should document how investment decisions are made for the plan by adopting a written investment policy. Investment policies typically include a description of the types of investment funds to be offered, as well as benchmarks to compare the performance of the investment options against. The investment committee should review the investment policy at least annually to ensure that it continues to reflect the current objectives and meets the needs of the plan's participants.
- **Keep Proper Plan Minutes.** Process is the key to demonstrating fiduciary prudence. It is important to maintain a written record of the process undertaken in reviewing investments and making decisions. That does not mean creating an overly detailed transcript of the investment committee discussions, but committees should prepare a written record sufficient to demonstrate a thoughtful and deliberative process.
- **Periodically Evaluate Plan Fees for Reasonableness.** Although the claims in the class action litigation allege that securing the lowest fees is the only factor in

determining whether investment options are prudent, the standard for reasonableness allows fiduciaries to collectively evaluate both cost and value. That is why documentation of the steps taken for such evaluation is important, as it will create the foundation for proving a thoughtful and deliberative process.

- **Periodically Conduct RFPs.** Although RFPs can be time consuming when many human resource departments are already stretched to the limit, conducting an RFP signals to the current provider that the organization is willing to make a change and solicit more competitive pricing. Even if an organization remains with the same provider, the organization often can negotiate a reduction in fees based on the "market data" it collected from the other submitted proposals. The DOL has indicated that it believes that plan fiduciaries should undertake a formal RFP process every three years. While that view may be subject to debate, it nevertheless signals that the DOL will have a negative opinion of fiduciaries who have not engaged in an RFP for many years.
- **Consider Retaining an Investment Advisor to Advise on Plan Investments.** If an organization has not yet hired an independent investment advisor to conduct a fee analysis and assist in monitoring, selecting and, in some instances, reducing investment options, now may be the time. The expertise and additional fiduciary protection provided by independent investment advisers can add significant protection for the organization and the committee, while also helping make the review process more effective and streamlined.

Proposed Code Section 457(f) Regulations

The proposed 457(f) regulations offer some new design possibilities for nonqualified deferred compensation arrangements offered by tax-exempt entities. There are four key opportunities presented by the proposed 457(f) regulations that tax-exempt employers may wish to evaluate:

1. The new ability for executives to make voluntary elective deferrals of their own pay;
2. The ability to delay the Code Section 457(f) taxation event until the actual payment date, if the payment arrangement qualifies under the Code Section 457(f) short-term deferral exception;
3. The ability to incorporate a rolling risk of forfeiture as the plan's substantial risk of forfeiture; and
4. The ability to utilize a noncompete as the plan's substantial risk of forfeiture.

See here for more information on the proposed regulations.

Whether any of these features is desirable from an organizational standpoint depends on the organization's objectives under the nonqualified deferred compensation plan and whether inclusion of the features further assists the organization in attaining those objectives from an executive pay perspective. Additionally, implementation of any of these features has specific requirements which must be met. Confirming that the organization can coordinate those requirements with its executive pay objectives is crucial before implementing any changes.

Additionally, the proposed 457(f) regulations outline some new restrictions on certain common arrangements that organizations should review more closely in 2017:

- **Vacation pay policies that allow significant accruals and carryovers may be reclassified as nonqualified deferred compensation**. The proposed 457(f) regulations imply that if paid time off (PTO) accrual policies permit a significant accrual of PTO hours such that those hours are extremely unlikely to be used “in the normal course” by the employee (resulting in a large payment of cash to the employee to settle or reduce the accumulated PTO hours), then the arrangement should be characterized as a deferred compensation plan rather than an exempt “bona fide sick or vacation leave” plan.
- **The elimination of flexible allowance plans because of the potential non-taxation of certain deferrals**. In these types of arrangements, the deferrals contributed to the plan are “exchanged” and used to purchase additional benefits under the nonqualified plan such as life insurance, death benefits for surviving spouses, long-term disability coverage, long-term care coverage or conversion to an auto allowance, etc. In these situations, the executive achieves a tax deferral on the compensation or contribution while converting it into a benefit that ultimately might not be taxable or includable in income. The proposed regulations now provide that the purchase of these welfare benefits essentially make the deferral amounts “available” to the executive, thereby triggering taxation at the time of purchase under the plan.

Conclusion

Health system employers should evaluate the impact of the new DOL fiduciary rule, excessive fee litigation filed against Code Section 403(b) fee plans and the proposed 457(f) regulations on their organizations and their employee benefit plans. The implementation of best practices and necessary changes may help minimize risks and exposure and provide new opportunities for employee benefits.