Proskauer

newsletter

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in this issue

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A report to clients and friends of the firm

Edited by **Stacey C.S. Cerrone** and **Russell L. Hirschhorn**

Editor's Overview

Our first article this month addresses the treatment of the attorney-client privilege in employee benefits matters. Pursuant to the so-called "fiduciary exception," communications between an attorney and a plan fiduciary are not always shielded from disclosure to plan participants. While the fiduciary exception doctrine is well established, its application may differ depending on the particular facts and circumstances presented. This article highlights ten principles that generally are determinative of whether the exception will apply.

Our second article reviews decisions from the U.S. Supreme Court in 2013 and those to come in 2014 that are likely to have a significant impact in the world of pension and welfare employee benefits. The issues addressed, and to be addressed, by the Supreme Court are wide ranging. They include same sex marriage benefits, welfare plan reimbursement provisions, statute of limitations, class certification, ERISA stock-drop litigation, the "contraceptive mandate" under the Affordable Care Act, and whether the Federal Insurance Contributions Act tax applies to reduction in force related severance pay.

As always, please be sure to review the Section on Rulings, Filings, and Settlements. This month we address recent developments in healthcare reform, newly issued IRS regulations under Code Section 83 regarding substantial risk of forfeiture analysis, and privilege issues.

View From Proskauer: ERISA Plan Fiduciaries—Are Your Conversations With Counsel Privileged?*

By Russell L. Hirschhorn

It is generally understood that communications between clients and lawyers are privileged and that the substance of those conversations may not be divulged to third parties except in the rarest of circumstances. In the employee benefits world, however, plan sponsors and fiduciaries are often surprised to learn that this cardinal rule does not always apply. In fact, many communications between plan fiduciaries and plan counsel *must* be divulged to plan participants and beneficiaries.

The reason for different treatment of the attorney-client privilege in employee benefits matters is the so-called "fiduciary exception," pursuant to which communications between an attorney and a plan fiduciary are not shielded from disclosure to plan participants. There are two explanations for the exception: first, because the participants, rather than the plan fiduciaries, are viewed as the "real" clients of plan counsel; and second, because plan participants are entitled to disclosure of all information pertaining to the administration of their claims for benefits.

While the fiduciary exception doctrine is well established, its application may differ depending on the particular facts and circumstances presented. This article highlights ten principles that generally are determinative of whether the exception will apply.

Ten Factors in Determining Fiduciary Exception

Identify the Client. In order to evaluate whether the fiduciary exception is applicable, one must first identify the client with whom the attorney was communicating. There are several potential clients, including the plan, a plan fiduciary, a plan administrator or a plan sponsor, which in the multiemployer context could include a contributing employer or a union. The fiduciary exception applies—if at all—only in cases of attorney communications with plan fiduciaries.[1]

Nature and Purpose of the Communication. The reasoning behind the fiduciary exception, at least in part, is that plan fiduciaries have a duty to make information regarding the administration of a plan available to a plan's participants and beneficiaries. As part of this obligation, fiduciaries must make available upon request communications with plan counsel that are intended to assist in the *administration* of the plan. Whether a communication concerns

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1 *See, e.g.*, *U.S. v. Mett*, 178 F.3d 1058, 1063 [23 EBC 1081] (9th Cir. 1999) (26 BPR 1545, 6/7/99) ("As applied in the ERISA context, the fiduciary exception provides that 'an employer acting in the capacity of ERISA fiduciary is disabled from asserting the attorney-client privilege against plan beneficiaries on matters of plan administration.'") (citation omitted).

the administration of a plan is often a fact-intensive inquiry made by a court *in camera*.

Limits to the Fiduciary Exception. Courts have recognized that there are circumstances where the fiduciary exception is inapplicable. For instance, it has no application where the advice relates to a settlor function, *e.g.*, issues pertaining to adoption, amendment and termination of a plan amendment.[2] Similarly, where the goal of the advice is to advise the fiduciary of his or her potential personal liability, the fiduciary exception does not apply.[3]

Joint Representation. A plan fiduciary cannot preclude the application of the fiduciary exception to the attorney-client privilege where it is otherwise applicable merely by retaining the same counsel that advises the plan sponsor. In other words, if a lawyer is retained to advise an employer to provide advice in his capacities as both a nonfiduciary and as a plan fiduciary, consultation on the nonfiduciary matters will not prevent disclosure of privileged communications on the fiduciary matters.[4]

Participant Claims and Appeals. Although a participant's administrative claim or appeal is necessarily adversarial in nature, *i.e.*, a participant generally demands benefits or additional benefits that she believes she is entitled to under the terms of the plan, courts have concluded that the fiduciary exception applies to communications between plan fiduciaries and counsel concerning such claims and appeals provided that the communications occur *prior* to the time the administrative process is fully exhausted.[5] One rationale for this conclusion is that under Department of Labor regulations, a claimant who has had her claim denied must be allowed access to all documents and information "relevant" to the claim. Post-decisional communications, where a plan seeks legal advice after the decision to deny an appeal, are no longer relevant to the decision-making process and constitute evidence that the interests of the beneficiary and the plan fiduciary have diverged.[6]

Good Cause Requirement. Early in the development of the fiduciary exception, some courts required a participant to demonstrate good cause before applying the fiduciary exception.[7] The requirement derives from the showing that a shareholder must make in a derivative action to obtain discovery from management. The few courts that have required a showing of good cause in the

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[2] *See, e.g.*, *Bland v. Fiatallis North America*, 401 F.3d 779, 787-88 [34 EBC 1875] (7th Cir. 2005) (51 PBD, 3/17/05; 32 BPR 681, 3/22/05).

[3] *See, e.g.*, *U.S. v. Mett*, 178 F.3d at 1065 (holding that the fiduciary exception did not apply to legal memoranda advising defendants, as plan trustees, about their personal, civil and criminal exposure).

[4] *See, e.g.*, *In re Long Island Lighting Co.*, 129 F.3d 268, 272 [21 EBC 2025] (2d Cir. 1997).

[5] *See, e.g.*, *Gunderson v. MetLife Ins. Co.*, No. 10-CV-50, 2011 WL 487755, at *10-11 (D. Utah Feb. 7, 2011).

[6] *See*, *e.g.*, *Neathery v. Chevron Texaco Corp. Group Acc. Policy No. OK826458*, No. 05 Civ. 1883, 2006 WL 4690828, at *2 (S.D. Cal. July 11, 2006).

[7] *See In re Occidental*, 217 F.3d 293, 297 (5th Cir. 2000); *Donovan v. Fitzsimmons*, 90 F.R.D. 583, 586-87 (N.D. Ill. 1981) (144 PBD, 7/26/00; 27 BPR 1828, 8/1/00).

Employee Retirement Income Security Act context appear to be seeking a balance between the fiduciary's interest in confidentiality and the participant's need for the information in question. Most courts have either expressly rejected the need to show good cause, or simply have not addressed the issue.

Application to DOL Proceedings. Where the DOL commences an investigation or a lawsuit on behalf of participants and beneficiaries, courts have concluded that the agency steps into the shoes of the participants and beneficiaries and may invoke the fiduciary exception.[8]

Application to Insurance Companies. There is a split of authorities regarding the application of the fiduciary exception to insurance companies. The Third Circuit concluded that the fiduciary exception does not apply to a health plan insurer because the plan beneficiaries were not the "real" clients obtaining legal representation.[9] The court reached this conclusion because: (i) legal title to the assets remained with the insurer; (ii) a conflict of interest exists when an insurance company determines eligibility for benefits and pays those benefits from its own funds; (iii) insurers have interests larger and distinct from any one plan's beneficiaries insofar as they handle multiple ERISA benefit plans at once; and (iv) insurers paid for legal advice using their own assets, not those of their beneficiaries. The Ninth Circuit, on the other hand, found that the fiduciary exception is applicable to insurers.[10] The court reasoned that the fiduciary exception applied equally to both trustees who serve as fiduciaries of a plan and insurers acting in the role of fiduciaries, since both maintain the same legal duties as fiduciaries under ERISA and there is no meaningful distinction between them.

Waiver. The attorney-client privilege can be waived if the communication occurs in the presence of a third party. In the employee benefits world, meetings about plan issues often address a multitude of issues, such as plan investments, ongoing compliance and benefit claims and appeals. These meetings are often attended by various service providers, including the plan fiduciaries, counsel, investment consultants, actuaries and accountants. Careful consideration should be given to whether the presence of service providers is necessary to the discussion at hand. If it is not, any privilege that may have existed concerning a conversation between the plan fiduciaries and counsel could be deemed to have been waived.[11]

Attorney Work Product. The work product doctrine protects attorney communications, thought processes and other activities conducted in anticipation of litigation. Courts have concluded that the fiduciary exception generally has no

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[8] *See*, *e.g.*, *Solis v. The Food Employers Labor Relations Assoc.,* 644 F.3d 221, 229-31 [50 EBC 2697] (4th Cir. 2011) (88 PBD, 5/6/11; 38 BPR 910, 5/10/11) ("there was no principled basis on which to distinguish between enforcement actions and investigations in the application of the fiduciary exception").

[9] *Wachtel v. Healthnet, Inc.*, 482 F.3d 225 [40 EBC 1545] (3d Cir. 2007) (63 PBD, 4/3/07; 34 BPR 856, 4/10/07).

[10] *Stephan v. Unum Insurance Co. of Amer.*, 697 F.3d 917 [54 EBC 1887] (9th Cir. 2012) (177 PBD, 9/13/12; 39 BPR 1767, 9/18/12).

[11] *See*, *e.g.*, *Hill v. State Street Corp*., 2013 U.S. Dist. LEXIS 181168, at 17-19 (D. Mass. Dec. 30, 2013).

application to the work product doctrine because the work product belongs exclusively to the attorney.[12] However, courts have ruled that communications between plan fiduciaries and the plan's attorney during the administrative process are not shielded from disclosure under the fiduciary exception, even if they may appear to be made in anticipation of litigation.

Proskauer's Perspective

While ethical issues arise across all disciplines, they are particularly prevalent in the employee benefits practice because of the multiple parties involved and the multiple "hats" that individuals may wear. The fiduciary exception to the attorney-client privilege adds yet another layer of complication. Plan fiduciaries should be mindful of the principles outlined above when engaged in communications with their attorneys, so that they avoid being surprised—and potentially disadvantaged—if these communications one day become the subject of litigation.

High Court Employee Benefits Cases: A Review and Look Ahead[*]

By Russell Hirschhorn

Having settled into the new year, we reflect on decisions from the U.S. Supreme Court in 2013 that are likely to have a significant impact in the world of pension and welfare employee benefits and, in some cases, already have had such an impact. The issues addressed by the Supreme Court are wide ranging and are both substantive and procedural.

They include same sex marriage benefits, welfare plan reimbursement provisions, statute of limitations and class certification. Looking ahead into 2014, we see that the Supreme Court has already agreed to decide several significant benefits issues, including issues pertaining to Employee Retirement Income Security Act stock-drop litigation, the so-called "contraceptive mandate" under the Affordable Care Act and whether the Federal Insurance Contributions Act tax applies to reduction in force related severance pay.

2013 Supreme Court Decisions

Section 3 of DOMA Unconstitutional

By now, it is well known that the Supreme Court ruled unconstitutional the section of the Defense of Marriage Act that defined marriage and spouse as excluding same-sex partners on the ground that it violated the Equal Protection

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[12] *See, e.g.*, *Wildbur v. Arco Chemical*, 974 F.2d 631, 646 [16 EBC 1235] (5th Cir. 1992) ("Because the attorney work product doctrine fosters interests different from the attorney-client privilege, it may be successfully invoked against a pension plan beneficiary even though the attorney-client privilege is unavailable.").

[*] Originally published by *Law360*. Reprinted with permission.

Clause of the U.S. Constitution in United States v. Windsor, 133 S. Ct. 2675 (2013).

As a result, same-sex marriages will be recognized for purposes of federal laws, protections and obligations. Since the court's ruling, the Internal Revenue Service and U.S. Department of Labor have both adopted a "place of celebration" rule, meaning that same-sex couple legally married in any jurisdiction will be recognized as spouses for federal tax purposes even if the couple resides in a jurisdiction that does not recognize the validity of their marriage. This rule is welcome news for plan sponsors who may now administer their benefit plans in a uniform manner with regard to covered same- and opposite-sex married couples.

Welfare Plan Reimbursement Clauses

For years, health plan sponsors and administrators had grappled with confusing and inconsistent rulings regarding their right to enforce plan reimbursement provisions in the face of common and state law equitable defenses. The reimbursement provisions typically are designed to enable a plan to recover previously paid medical benefits when the participant receives a recovery from another source, such as a person responsible for a participant's injury or illness.

In *US Airways Inc. v. McCutchen*, 133 S.Ct. 1537 (2013), the Supreme Court resolved much of this confusion by ruling that the terms of a plan's reimbursement provision, if clearly written, will trump competing equitable defenses. The court left room for application of equitable defenses, however, as a means to interpret ambiguous plan reimbursement provisions. As a result of the court's ruling, a properly drafted a reimbursement clause should allow a plan to recover the full amount of the medical costs it paid without qualification.

Statute of Limitations

In another case involving an employee welfare plan, the Supreme Court held that a contractual limitations clause that governs the length of the limitations period as well as when it begins is enforceable as long as the limitations period is reasonable and there is no controlling statute to the contrary. *Heimeshoff v. Hartford Life & Accident Insurance Co.*, 134 S.Ct. 604 (2013).

As a result of the court's ruling, employers should consider including in their plans reasonably crafted limitations periods for bringing claims, as well as rules concerning the accrual of claims, and then publishing such provisions in benefit statements and summary plan descriptions. These provisions may prove particularly effective for limiting exposure to claims for pension benefits, which are frequently brought long after participants retire, by which time relevant evidence may no longer be readily retrievable.

Class Certification

The Supreme Court ruled in *Comcast Corp. v. Behrend*, 133 S.Ct. 1426 (2013) that, in order to obtain class certification, plaintiffs carry the burden of establishing not only that they have proof of classwide liability, but also that their potential damages are tied to their theory of liability and are capable of classwide proof.

Although Comcast was an antitrust lawsuit, it is likely to have an impact on class certification proceedings across all disciplines, including claims under ERISA. At a minimum, the Supreme Court's ruling should make considerations of damages a component of the class certification analysis. This alone represents a considerable departure from the approaches of many lower courts, which have tended to focus exclusively on liability issues when addressing a class certification motion.

Supreme Court Decisions Expected by June 2014

Presumption of Prudence in Employer Stock Litigation

Over the past two decades, participants in 401(k) plans and employee stock ownership plans ("ESOPs") have increased the frequency in which they have mounted challenges to plan fiduciaries' decisions to continue allowing investment in an employer stock fund.

The complaints in these cases generally contain two principle claims: (1) a claim that the plan fiduciaries breached their fiduciary duties by maintaining an employer stock fund when was imprudent to do so, and (2) making misrepresentations and/or failing to disclose material information about the risks associated with investment in an employer stock fund.

With respect to the first claim, all circuit courts to have considered the issue, have applied a presumption of prudence with respect to the decision to continue allowing investment in an employer stock fund. The circuit courts are not, however, in agreement as to the types of allegations needed to rebut the presumption and whether the presumption should be applied at the motion to dismiss stage. The Supreme Court recently agreed to address the latter issue, and it is expected that, in so doing, it will conduct a more fulsome evaluation of the presumption itself. *Fifth Third Bancorp v. Dudenhoeffer* (U.S. No. 12-751).

Contraceptive Mandate

The Supreme Court agreed to review two of the numerous lawsuits challenging the Affordable Care Act's requirement that group health plans and insurers cover, without cost-sharing, contraceptives and/or abortifacients.

The plaintiffs in these suits are secular, for-profit corporations and their owners, who assert that being forced to comply with the contraceptive mandate would violate both their First Amendment religious rights and the Religious Freedoms Restoration Act.

All courts addressing the various contraceptive mandate suits have struggled with the issue. Over the past year, a circuit split developed: some circuits adopted a "pass through" theory that allowed corporations to assert the free exercise rights of their owners and held that the contraceptive mandate places a substantial burden on their religious freedoms.

Other circuits, in contrast, have rejected the argument that secular, for-profit corporations are protected by the free exercise clause and have held that the owners are not burdened by the mandate, since it is the corporation, not the

owners, who would be funding this coverage. *Sebelius v. Hobby Lobby Stores* and *Conestoga Wood Specialties Corp. v. Sebelius* (U.S. No. 13-354, 13-356).

Applicability of FICA to RIF-Related Severance Pay

It is anticipated that the Supreme Court will once and for all put to rest the question of whether severance payments made to former employees pursuant to an involuntary reduction-in-force are wages for the purposes of Social Security and Medicare withholding under FICA. *United States v. Quality Stores Inc*. (U.S. No. 12-1408).

The issue has become particularly relevant given the increase in workforce reductions over the past several years. The Supreme Court's decision to consider the issue provides a reminder to employers to consider filing protective refund claims to preserve their rights and prevent the statute of limitations from expiring on tax refund claims for still open years.

The View From Proskauer

While it will take time for the full impact of last year's Supreme Court's decisions to be seen, some of the court's rulings should provide plan sponsors and fiduciaries with additional mechanisms for prosecuting and defending lawsuits on behalf of plans. Depending on the outcome of some of this year's rulings, however, we could see an expansion of claims and legal exposure in certain areas.

Rulings, Filings, and Settlements of Interest

They're Back! Final Regulations On Employer "Pay-or-Play" Mandate Released – IRS Provides Transition Relief To Employers with 50-100 Employees

By Stacy Barrow and Paul Hamburger

- On Monday, February 10, 2014, the IRS released final regulations on the Affordable Care Act's (ACA) employer "shared responsibility" provisions, also known as the "pay-or-play" mandate.

  The final regulations weigh in at 227 pages. We will review them over the coming days and will release additional communication pieces once we fully digest these new regulations. In the meantime, below are some highlights of the new guidance.

Transition Relief

  - For 2015, the rules will apply to employers with 100 or more full-time employees. Employers in the 50-100 range will need to certify eligibility for this transition relief and must meet other requirements, including not reducing the employer's workforce to qualify for transition relief and maintaining previously-offered coverage.

- For 2016, the rules will apply to employers with 50 or more full-time employees.
- To avoid a penalty in 2015, employers subject to the mandate must offer coverage to 70% of their full-time employees or risk penalties for failure to offer coverage to all full-time employees and dependents.
- To avoid a penalty in 2016, employers subject to the mandate must offer coverage to 95% of their full-time employees (and dependents).
- Employers with non-calendar year plans are subject to the mandate based on the start of their 2015 plan year rather than on January 1, 2015, and the conditions for this relief are expanded to include more employers. The IRS is evaluating whether this relief will extend to employers who first become subject to the mandate in 2016.
- Importantly, the transition relief included in the proposed regulations for multiemployer plans has been continued indefinitely. Under this transition relief, an applicable large employer will not be subject to shared responsibility penalties with respect to employees for whom the employer is required by the collective bargaining agreement or appropriate related participation agreement to make contributions to the multiemployer plan.
- Other transition relief contained in the proposed regulations was also extended, including the ability to use a short timeframe (at least 6 months) to determine whether an employer is large enough to be subject to the mandate, a delay in the requirement to provide coverage to dependent children to 2016 (as long as the employer is taking steps to arrange for such coverage to begin in 2016), and the permitted use of a short measurement period in 2014 to prepare for 2015.

Various Employee Categories

- Volunteers: Hours contributed by bona fide volunteers for a government or tax-exempt entity, such as volunteer firefighters and emergency responders, will not cause them to be considered full-time employees.
- Educational employees: Teachers and other educational employees will not be treated as part-time for the year simply because their school is closed or operating on a limited schedule during the summer.
- Seasonal employees: Those in positions for which the customary annual employment is six months or less generally will not be considered full-time employees.

- Student work-study programs: Service performed by students under federal or state-sponsored work-study programs will not be counted in determining whether they are full-time employees.

- Adjunct faculty: Until further guidance is issued, employers of adjunct faculty may credit an adjunct faculty member with 2 ¼ hours of service per week for each hour of teaching or classroom time.

Other Matters

- The final regulations do not provide safe harbor relief for employers hiring independent contractors. Instead, employers need to determine who their employees are based on a common law standard without regard to rules, such as "section 530 relief" applicable in the employment tax area.

- The regulations also do not provide any specific relief for employers in "high turnover" industries.

- Employers who hire workers through staffing agencies need to consider a new rule. For an offer of coverage to an employee performing services for an employer that is a client of a staffing agency, in cases where the staffing agency is not the common law employer of the worker and the staffing firm makes an offer of coverage to the employee on behalf of the client employer under a staffing agency plan, the offer is treated as made by the client employer for pay-or-play purposes only if the fee the client employer would pay to the staffing agency for an employee enrolled in health coverage is higher than the fee the client employer would pay the staffing agency for the same employee if that employee did not enroll in health coverage.

The IRS is also evaluating how to best simplify the employer reporting requirements set to apply in 2015. The IRS expects to release additional guidance shortly that aims to substantially simplify and streamline these reporting requirements.

The bottom line is that employers need to consider how they will implement the new rules and create or adjust their systems to capture their full-time employee population.

The final regulations are available here.

An IRS Q&A is available here.

ACA Shared Responsibility Penalties – Am I subject to (b) or not to (b)? That is the $3,000 question!

By Paul Hamburger

> As previously reported, on Monday, February 10, 2014, the IRS released final regulations on the Affordable Care Act's (ACA) employer "shared responsibility" provisions, also known as the "pay-or-play" mandate. The final regulations include a number of important transition rules that are intended to phase in the pay-or-play penalties during 2015 and 2016. A number of questions have arisen as to how the penalty provisions work during the 2015 transition period for applicable large employers.

By way of background, the pay-or-play penalties consist of two parts: the "(a)" penalty, which generally is equal to the number of full-time employees the employer employed for the year (minus up to 30) multiplied by $2,000; and the "(b)" penalty, which is $3,000 per year times the number of full-time employees who obtain a premium tax credit on the exchanges, but not more than the "(a)" penalty amount. The "(a)" penalty could apply if an applicable large employer fails to offer coverage at all to a sufficient number of its full-time employees and dependents. The "(b)" penalty could apply if the employer does offer coverage, but that coverage is either unaffordable or does not provide "minimum value" as defined by regulation. Also, these penalties are only triggered if a full-time employee otherwise purchases coverage on a public insurance exchange and obtains a premium tax credit or subsidy for that coverage.

Under one of the new regulatory transition rules for 2015, an employer in the 50-99 full-time employee range will not face any pay-or-play penalties at all (neither the "(a)" nor the "(b)" penalty) as long as the employer can demonstrate that it has not reduced its workforce to qualify for transition relief and it maintains any previously-offered coverage.

Under a separate 2015 transition rule for employers of 100 or more full-time employees, an employer can avoid the "(a)" penalty for 2015 as long as it offers coverage to at least 70% of its full-time employees. After 2015, all large employers of 50 or more full-time employees can avoid the "(a)" penalty as long as they offer coverage to at least 95% of their full-time employees.

But what about the "(b)" penalty? Could an employer that offers coverage to at least 70% of its full-time employees in 2015 still be subject to the "(b)" penalty for 2015? If so, would that penalty apply only to the employees who are actually offered coverage that is either unaffordable or fails to provide minimum value? Or, does that "(b)" penalty also potentially apply to the group of employees who had no offer of coverage at all, *i.e.*, those in the up to 30% group to whom coverage does not have to be offered under the transition rule?

Some have questioned whether large employers of 100 or more full-time employees subject to the new 2015 transition relief would be exposed to any

penalties at all for 2015 with respect to those full-time employees to whom coverage is not offered as long as coverage is offered to at least 70% of the full-time employees.

As explained below, the preamble to the IRS final regulations, as well as the recently issued IRS FAQs on the shared responsibility payment rules, appear to answer this question by indicating that a "(b)" penalty could still apply.

After describing the new 2015 transition relief, the regulatory preamble states: "Applicable large employer members qualifying for the transition relief set forth in this section XV.D.7.a continue to be subject to a potential assessable payment under section 4980H(b)." The preamble does not say whether this potential application of the "(b)" penalty is only for the 70% or more full-time employees to whom coverage is offered or also to the group of employees to whom no coverage is offered.

However, the separate IRS FAQs issued at the same time as the final regulations (in particular FAQ 37) answer this question by stating that an employer offering health coverage to at least 70% of its full-time employees and dependents of those employees could still be exposed to a "(b)" penalty if a full-time employee obtains a premium tax credit "because the employer did not offer coverage to that employee or because the coverage the employer offered that employee was either unaffordable … to the employee or did not provide minimum value …." (Emphasis added.)

Similarly, once 2016 arrives and all applicable large employers are subject to the pay-or-play requirements, employers need to be mindful of the fact that as long as they offer coverage to 95% or more of their full-time employees (and dependents), they should not be subject to the "(a)" penalty. However, they could be subject to the "(b)" penalty if the coverage offered is not affordable or does not provide minimum value or the full-time employee triggering the penalty was in the up to 5% of full-time employees to whom coverage was not offered.

It remains to be seen whether the government will try to clarify these rules further in any future guidance.

"Pay-or-Play" & Contingent Workers: Final Regulations Provide Clarity But Not Complete Relief

By Peter Marathas and Damian A. Myers

> As previously reported, on February 10, 2014, the IRS issued final regulations on the Affordable Care Act's (ACA) employer shared responsibility requirements—the so-called "pay-or-play" mandate. In the regulations, the IRS provides new and additional guidance on a wide range of issues relating to the implementation of the pay-or-play rules. Among them, the IRS has restated its position and introduced some new rules relating to the engagement by employers of "contingent workers," including temporary employees, individuals hired through temporary staffing firms and

independent contractors ("1099 employees"). Not surprisingly, in its proposed regulations released about a year ago, the IRS had flagged contingent workers as presenting challenging issues for compliance with the pay-or-play requirements.

Key provisions of the final regulations' rules for contingent workers are summarized below.

- Definition of Employee. In the final regulations the IRS reaffirms its position that it will use a common law definition of employee to determine employer-employee status. Generally, an individual is the common law employee of an entity if that entity has the right to control the individual's performance of services. The final regulations continue to exclude leased employees, sole proprietors, partners in a partnership, 2-percent S corporation shareholders, and certain direct sellers and real estate agents from the definition of employee.

- Common Law Employees of the Client Employer. For purposes of the pay-or-play mandate, when the client is the common law employer, an offer of coverage made by the temporary staffing firm "on behalf of" the client employer will be considered to be an offer of coverage by the client employer. In order for an offer of coverage to be "on behalf of" the client employer, the client employer must pay a higher fee to the temporary staffing firm for those employees who enroll in the temporary staffing firm's plan. In other words, if the contract provides for a flat fee per employee placement irrespective of whether the employee enrolls in the staffing company's coverage, the employer will not be considered to have made an offer of coverage. This could lead to exposure under the pay-or-play mandate's $2,000 per full-time employee "no coverage offered" penalty if more than 5% of its full-time employees (30% in 2015) are employed through the staffing agency.

- Contingent Worker Misclassification Issues. Employers are not required to offer coverage to independent contractors; however, because the final regulations use a common law definition of employee, an IRS examination finding that common law employees have been misclassified as independent contractors could result in significant penalty exposure to the employer. Employers that engage a significant number of "1099 employees" run a tremendous risk of incurring the pay-or-play mandate's $2,000 per full-time employee "no coverage offered" penalty, even when they offer coverage to all of the employees they categorize as full-time. If the number of 1099 employees who are reclassified as common law employees exceeds 5% of the employer's full-time workforce (30% in 2015), the "no coverage offered" penalty may be tripped.

- Another important issue for employers that hire independent contractors is whether they could rely on the IRS so-called "Section

530" relief for identifying common law employees. In short, this relief is based on Section 530 of the Internal Revenue Code of 1978 and provides that no penalties or interest will be incurred as the result of worker misclassification if the employer (i) consistently treated the workers in question as independent contractors, (ii) complied with the Form 1099 tax reporting requirements for the independent contractors and (iii) had a reasonable basis for treating the workers as independent contractors.

- The ACA regulations specifically reject the availability of Section 530 relief for purposes of the pay-or-play requirements. Despite the requirement for a reasonable basis as a condition for Section 530 relief, the IRS based its decision on the concern that allowing Section 530 relief would incentivize worker misclassification. Given the lack of available relief, employers should carefully review their contractual arrangements with service providers to ensure that they have been properly classified as independent contractors as opposed to common law employees under the more traditional common law tests.

- Short-Term Employees. The final regulations confirm the IRS's position that short-term employees (other than seasonal employees) who are reasonably expected to work full-time (30 hours or more per week) at date of hire must generally be offered coverage within 90 days. There is no blanket exemption for short-term employees—if employment extends beyond the end of the third full calendar month of employment, the employer must offer coverage regardless of the projected termination date (the offer of coverage will generally be within 90 days from date of hire due to the ACA's waiting period rules).

- Employees of Temporary Staffing Firms. There are special rules for determining whether a variable hour employee is a full-time employee. Variable hour employees are employees with no set schedule or seasonal employees (generally those working 6 months or less on a seasonal basis). Under these rules, the employer (staffing company) can use a determination period of from 3 to 6 to 12 months to determine an individual's full-time status for a following so-called "stability period" of 6 or 12 months. Because of the nature of the business—where employees may work for several client employers during a certain period of time—commenters observed that it would be difficult to determine when a staffing company employee was a variable hour employee. Some commenters asked that a presumption—either for or against variable hour status—be developed. Noting the varying nature of the industry, the regulators rejected the idea of a presumption. Instead, the final regulations provide criteria that a staffing company may consider to determine whether a new employee is "variable hour." This assessment is done at the time of hire based on the staffing company's reasonable expectations. Considerations may include whether other similar

employees of the staffing company: retain the right to reject assignments; have periods during which no assignments are available; are offered assignments of differing lengths; and are typically offered assignments that do not extend more than thirteen weeks. No one factor is dispositive.

These are just a few of the significant issues employers need to consider as they identify their worker classification arrangements in light of the ACA rules. Of course, employers also need to consider their contractual agreements with any temporary staffing agencies and all of the other possible legal requirements that could apply in this context (such as ERISA section 510 liability for intentional interference with attainment of benefits and the ACA whistleblower protections).

Coverage of Dependents: Final "Pay-or-Play" Regulations Exclude Stepchildren and Others; Extend Prior Transitional Relief

By Tzvia Feiertag and Stacy Barrow

> As previously reported, the IRS recently released final regulations on the Affordable Care Act's (ACA) employer "shared responsibility" provisions, also known as the "pay-or-play" mandate. Under the mandate, in order to avoid potential penalties, an applicable large employer (generally, 50 or more full-time equivalent employees (100 or more in 2015)) must offer affordable, minimum value health coverage to its full-time employees and their "dependents."

For purposes of the pay-or-play mandate, "dependents" are an employee's natural or adopted children under age 26 (not spouses). The final regulations clarify that an employer may ***exclude*** employees' stepchildren, foster children, and children who are non-U.S. citizens or nationals (with certain exceptions) from coverage under its group health plan without exposing itself to a potential penalty.

The final regulations also provide welcome news for employers who do not yet offer coverage their full-time employees' dependents. An employer that is planning to offer dependent coverage has until the start of its 2016 plan year to do so, as long as it ***takes steps*** during its 2015 plan year.

Transitional Relief Extended for 2015 Plan Year

To provide employers sufficient time to expand their group health plans to include dependents, the final regulations provide that any employer that ***takes steps*** during its 2015 plan year toward satisfying the requirement will not be subject to a pay-or-play penalty solely due to failing to offer coverage to dependents for the 2015 plan year.

The extended transition relief applies to plans under which:

1. dependent coverage is not offered,

2. dependent coverage that does not constitute minimum essential coverage is offered, or
3. dependent coverage is offered for some (e.g., biological children), but not all, dependents (e.g., adopted children).

This transitional relief is not available to an employer that eliminates dependent coverage after having offered it during its 2013 or 2014 plan years.

How may an employer avail itself of this transitional relief? The guidance doesn't say. It is reasonable to assume that it means actions taken in the normal course to secure coverage, such as, cost/budget analysis of adding the additional coverage, solicitation of premium quotes from insurance companies (for a fully-insured plan), and negotiating additional third party administrator fees (for a self-insured plan). Employers wishing to rely on the extended transitional relief should consider documenting any steps taken in 2015 to secure dependent coverage beginning in the 2016 plan year. This may come in handy to support an employer's reliance on the transitional relief in the event a penalty is assessed for failure to provide such coverage during the transitional period.

New Exclusions for Stepchildren, Foster Children and Children who are non-U.S. Citizens of Nationals (subject to certain exceptions)

For purposes of the pay-or-play mandate, the proposed regulations had defined the term "dependents" to include biological children, stepchildren, adopted children and foster children.

The final regulations define a "dependent" as a child of the employee who has not attained age 26 (with the child being considered a dependent for the ***entire*** calendar month in which he or she attains age 26). Solely for purposes of any potential penalties under the pay-or-play mandate, the final regulations ***exclude*** from the definition of dependent:

- foster children;
- stepchildren; and
- children who are not U.S. citizens or nationals, unless the children are residents of a country contiguous to the U.S. (Canada or Mexico) or are within a special tax exception that applies to adopted children.

This means that employers sponsoring group health plans with exclusions for any of these categories of dependent may retain these exclusions without fear of triggering pay-or-play penalties. Of course, employers may cover any of these dependents under their group health plans if they wish. However, if they do offer that coverage, the ACA requires that this coverage extend until age 26 and without regard to the child's marital status, student status or other dependency factor, including the availability of other employer coverage.

Does this mean that foster children and stepchildren will be left without health coverage? Not necessarily. The final regulations note that that requiring employer-provided health insurance coverage for foster children would result in duplicative coverage because government agencies typically provide this coverage. Similarly, the final regulations note the possibility of duplicative coverage with respect to stepchildren, where the employers of the child's biological parents may have an obligation under the ACA to provide group health coverage.

The final regulations also confirm that employers are not required to offer spousal coverage for purposes of avoiding a pay-or-play penalty.

In evaluating the final regulations, employers may be relieved to learn that they have the flexibility to exclude from their health plans stepchildren, foster children, and most children who are not U.S. citizens or nationals, and have more time to cover qualifying dependents in order to avoid penalties.

Relief for Multiemployer Plans (and the Employers That Love Them)

By Robert Projansky and Peter Marathas

> As previously reported, on Monday, February 10, 2014, the IRS released final regulations on the Affordable Care Act's (ACA) employer "shared responsibility" provisions, also known as the "pay-or-play" mandate. While the final regulations have (predictably) received mixed reviews, some employers – most notably those with 50 to 99 employees or those that covered almost but not quite 95% of their full-time employees – were likely pleased with at least some of the provisions.

A review of the final regulations shows that there is another group with something to celebrate, at least for now – employers contributing to multiemployer plans. The final regulations contain interim guidance that largely mimics and extends a special transition rule contained in the preamble to the proposed regulations. This rule, which previously only applied in 2014, simplified compliance with the pay-or-play mandate for employers with collectively bargained employees for whom contributions are made to a multiemployer plan. It was unclear whether this interim guidance would be extended.

Specifically, the interim guidance provides that an employer that is required by a collective bargaining (or participation) agreement to contribute to a multiemployer plan will not be treated, with respect to employees for whom the employer is required to contribute to the plan, as failing to offer full-time employees (and their dependents) the opportunity to enroll in minimum essential coverage (*i.e.*, for the purposes of the "4980H(a) penalty" which may apply if an employer does not offer a specified percentage of its full-time employees (and their children) insurance coverage) and will not be subject to a penalty for failing to offer affordable, minimum value coverage (*i.e.*, for the purposes of the "4980H(b) penalty" which may apply if an employer does not offer affordable coverage that reimburses claims at least at a 60% level —

so-called, minimum value coverage — to its full-time employees) as long as the following conditions are met:

- the multiemployer plan offers dependent coverage;
- the multiemployer plan provides minimum value coverage; and
- the coverage is affordable.

Like the preamble to the proposed regulations, the preamble to the final regulations provides that employers can treat multiemployer plan coverage as affordable using any of the safe harbor tests set forth in the final regulations (*i.e.*, the "Rate of Pay," "W-2" or "Federal Poverty Level" safe harbors). In addition, coverage is affordable if the employee's required contribution toward self-only coverage does not exceed 9.5% of the wages reported to the multiemployer plan (using actual wages or an hourly wage rate under the agreement requiring contributions).

Why is this so significant if there is still a dependent coverage, affordability and minimum value requirement? Absent this guidance, there was concern that employers would question their participation in multiemployer plans because they had no control over whether their full-time employees were actually offered coverage by the multiemployer plan. However, the interim guidance now provides that an employer is treated as offering coverage for all employees for whom it is required to contribute to the multiemployer plan, *even those full-time employees who never satisfy that plan's eligibility rules and therefore are never offered coverage*.

While this solves a key concern, employers may still wish to take steps to ensure that the interim guidance applies. For example, employers would be wise to confirm with the multiemployer plans to which they contribute that those plans offer dependent coverage, provide minimum value and are affordable.

The other piece of good news is that this is not a rule we expect to last only a year, unlike the transition rule in the proposed regulations, which only applied in 2014. The preamble to the final regulations provides that employers can rely on the interim guidance until it is modified. In addition, any future guidance that limits the scope of the interim guidance will apply no earlier than January 1 of the calendar year that is at least six months from the issuance of the new guidance. While a more permanent rule would certainly be preferable, the extension of this rule beyond one year provides employers with somewhat greater comfort as they enter into collective bargaining agreements, which typically extend beyond one year.

IRS Issues Final Regulations under Internal Revenue Code Section 83 Regarding Substantial Risk of Forfeiture Analysis

By Joshua Miller

> Companies that compensate their employees with annual or long-term awards of restricted property such as restricted stock grants should take note of the final regulations relating to property transferred in connection with the performance of services under Internal Revenue Code Section 83 issued by the Internal Revenue Service on February 25, 2014 (the "Final Regulations"). These rules impact the timing of taxation of restricted stock grants and other compensatory transfers of property.

The Final Regulations are substantially similar to the proposed regulations issued by the IRS in May 2012, which we discussed in our June 2012 Client Alert, *"IRS Issues Proposed Regulations under Internal Revenue Code Section 83 Regarding Substantial Risk of Forfeiture Analysis,"* available here, but further clarify the impact of insider trading restrictions under Section 16(b) of the Securities Exchange Act of 1934 and involuntary separations from service on the Section 83 "substantial risk of forfeiture" analysis.

Generally, Section 83 requires the inclusion in gross income of property transferred in connection with the performance of services when the property is no longer "subject to a substantial risk of forfeiture." Section 83 regulations provide that whether a risk of forfeiture is "substantial" depends upon the particular facts and circumstances. Under these regulations, a substantial risk of forfeiture may exist where vesting of property is subject to (i) a service condition (*e.g.*, employee must work for a specified period to become vested) or (ii) a condition related to the purpose of the transfer (*e.g.*, a performance-based condition).

The Final Regulations make three important clarifications relevant to "substantial risk of forfeiture" analysis:

> A substantial risk of forfeiture generally may only be established through a service condition or a condition related to the purpose of the transfer (except as otherwise specifically provided in the Section 83 regulations with regard to a sale or other transfer of securities that could subject the seller to a suit under Section 16(b) of the Securities Exchange Act of 1934).

> In determining whether a substantial risk of forfeiture exists, both (1) the likelihood that a forfeiture condition will occur and (2) the likelihood that the forfeiture condition will be enforced must be taken into consideration.

> Transfer restrictions on securities (such as lock-up provisions, buyback provisions, blackout periods and limited trading windows insider trading compliance programs) generally do not create a substantial risk of forfeiture; however, a substantial risk of forfeiture

would exist for so long as the sale or other transfer of the property not exempt from Securities Exchange Act Section 16(b) could subject the seller to a suit under Section 16(b).

The Final Regulations make clear that, although Section 16(b) liability may constitute a substantial risk of forfeiture, the purchase of stock subject to Section 16(b) in an open market transaction separate from the exercise of an option cannot create a substantial risk of forfeiture as to the shares acquired upon the exercise of the option. Taxation of compensatory stock options ordinarily occurs upon the exercise of the option, but such taxation could be delayed for so long as the underlying shares remain subject to a substantial risk of forfeiture by virtue of potential Section 16(b) insider trading liability.

While most companies make exempt stock option grants, if an option was not granted pursuant to an exemption, then the shares underlying the option generally would be subject to Section 16(b) restrictions for six months from the date of grant. This is because the "purchase" of the option shares (which, for Section 16(b) purposes, occurs on the date of grant of the option) could be matched for Section 16(b) purposes with any non-exempt sales occurring within six months of the option grant date. By adding a new example, the Final Regulations highlight than an option holder may not use a non-exempt open market purchase of stock after the date of a non-exempt option grant to defer taxation of option shares subsequently acquired upon the exercise of the option on the grounds that there is Section 16(b) risk from the "match" of the future sale of such option shares against the open market purchase. Instead for purposes of 83(b) and stock options, the relevant Section 16(b) six-month time frame commences on the date of grant of the non-exempt option, and the period during which option shares acquired upon exercise remain subject to a substantial risk of forfeiture by virtue of Section 16(b) risk is limited to this six-month period.

Finally, in response to comments received on the Proposed Rules, the preamble to the Final Regulations restates the principle that the right to receive property or cash in the future is not "property" for purposes of Section 83, and thus cannot be taxable unless and until the property is received. As a result, a right to receive property or cash in the future, such as upon an involuntary termination of employment without cause, does not give rise to a substantial risk of forfeiture under Section 83. The preamble acknowledges that this is the case under Section 83 notwithstanding the fact that a right to receive property in the future (such as a share-settled restricted stock unit) might otherwise be deemed to be subject to a substantial risk of forfeiture for purposes of Section 409A regarding nonqualified deferred compensation.

The Final Regulations do not change the principle that property that is conditioned upon refraining from service, such as a covenant not to compete, can constitute a service condition establishing a substantial risk of forfeiture under Section 83. Under the Section 83 regulations, whether a covenant not to complete constitutes a substantial risk of forfeiture depends upon such factors as the employee's age, health and skill set, the availability of other

obtainable employment opportunities and the likelihood that the restrictive covenant will be enforced.

Don't Waive Privilege: Exclude Unnecessary Service Providers From Meetings

By Russell Hirschhorn and Tulio Chirinos

> A recent opinion from a federal district court in Massachusetts provides plan sponsors and fiduciaries with a reminder that plan service providers should be excused from meetings where their attendance is not needed to assist in the provision of legal advice. If they are not, whatever attorney-client privilege that may have protected the confidentiality of the discussion or documents may be waived. In *Hill v. State Street Corp.*, 2013 U.S. Dist. LEXIS 181168 (D. Mass. Dec. 30, 2013), the district court granted in part plaintiff's motion to compel plan committee meeting minutes that defendant sought to shield from discovery because there was no evidence that the presence of a third-party consultant retained by the plan to provide specialized investment and governance consulting services was necessary to assist counsel in providing legal advice to the plan.

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