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E-NEWSLETTER

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Employee Benefits E-News

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May 2006 Employee Benefits Update

SELECT COMPLIANCE DEADLINES

New Medicare Part D Disclosure Model Notices Available

The Centers for Medicare and Medicaid Services ("CMS") published new model creditable and noncreditable disclosure notices that substantially revise the model notices that CMS published in late 2005. Plan sponsors should review their Medicare Part D disclosure notices to ensure that all notices distributed on and after May 15, 2006 comply with CMS requirements.

Extension of Relief for Some Taxpayers Affected by Hurricane Katrina

The Internal Revenue Service ("IRS") granted additional relief to certain "affected taxpayers" due to Hurricane Katrina. The extension ends August 28, 2006, and includes relief from filing deadlines for Form 5500 series and plan contribution deadlines. An additional six-month extension may be available upon request. A copy of IRS Notice 2006-20 is available at: *http://www.irs.gov/irb/2006-10_IRB/ar09.html*.

PENSION PLAN DEVELOPMENTS

IRS Issues Updated Employee Plans Compliance Resolution System

The IRS finally published Revenue Procedure 2006-27 to revise and update the Employee Plans Compliance Resolution System ("EPCRS"), its system of voluntary correction programs for retirement plans. The IRS expanded the types of failures that may be corrected under EPCRS as well as the allowable correction methods. Some of the most significant improvements include:

• A new correction method for the exclusion of an employee from a 401(k) plan that takes into account the actual economic loss to the employee;

• New correction methods under the Voluntary Correction Program ("VCP") for certain participant loan failures;

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• Expanded availability of the VCP and the Audit Closing Agreement Program to terminate certain orphan plans;

• A streamlined submission process and fee schedule under the VCP for failures to make required good faith and interim plan amendments; and

• An alternative correction method for failure to obtain spousal consent.

Revenue Procedure 2006-27 is generally effective September 1, 2006. However, plan sponsors may apply the procedure to corrections on or after May 30, 2006.

DOL Issues Updated Voluntary Fiduciary Correction Program

The Department of Labor ("DOL") issued the revised, updated Voluntary Fiduciary Correction Program ("VFCP"). VFCP allows employers to report certain plan mistakes under the Employee Retirement Income Security Act of 1974 ("ERISA"), correct those mistakes without penalty and obtain a no action letter from the DOL. The DOL expanded the final VFCP to include the following transactions as eligible for correction:

• Certain transactions involving the failure of participant loans to comply with plan provisions and certain delinquent loan repayments that are corrected under EPCRS;

• Certain circumstances where a plan acquired an illiquid asset and the only available purchaser is a party in interest; and

• Payment of certain expenses by the plan that should have been paid by the plan sponsor.

The DOL simultaneously published an amendment to Prohibited Transaction Class Exemption ("PTE") 2002-51 that provides relief from the fiduciary restrictions that would impact the correction methods requiring a transaction between the plan and a party in interest. The final VFCP and the amendments to PTE 2002-51 are effective May 19, 2006.

DOL Issues Final Regulations for Orphan Plan Terminations

The DOL finalized a series of regulations and a class prohibited transaction exemption allowing a qualified termination administrator ("QTA") to terminate and wind up the affairs of an abandoned plan. The regulations and PTE 2006-06 facilitate the process of winding up the affairs of an orphan plan so that participants and beneficiaries can access their benefits. The regulations and PTE 2006-06 are effective May 22, 2006.

To qualify as a QTA, an entity must (1) hold the abandoned plan's assets; and (2) be eligible to be a trustee or issuer of an individual retirement plan (e.g., a bank, trust company, mutual fund family or insurance company). The QTA is responsible for determining whether a plan is abandoned. A plan is abandoned if (1) no contributions to, or distributions from, the plan have been made for a 12 consecutive month period or other facts and circumstances known to the QTA suggest that the plan is, or may become, abandoned (such as the plan sponsor's bankruptcy filing) and (2) after

making reasonable efforts to locate or communicate with the plan sponsor, the QTA determines that the plan sponsor no longer exists, cannot be located or is unable to maintain the plan.

The DOL also finalized a fiduciary safe harbor for plan fiduciaries administering the termination and winding-up process of an individual account plan that a plan sponsor or QTA has decided to terminate. ERISA's fiduciary obligations generally apply to the process of terminating and winding up the affairs of a retirement plan; however, a plan fiduciary that satisfies the safe harbor will be deemed to have satisfied his or her ERISA fiduciary obligations. The safe harbor generally requires plan fiduciaries to provide certain notices to participants, to attempt to locate missing participants and to distribute participant accounts into certain investment vehicles selected by the plan fiduciary in accordance with specified criteria.

IRS Issues Sample Roth 401(k) Plan Amendment

The IRS issued a long-awaited sample Roth 401(k) plan amendment. Plans could implement a Roth 401(k) program beginning on January 1, 2006. Plan sponsors who want to provide for designated Roth contributions to their 401(k) plans must amend their plan documents by the end of the plan year in which the Roth 401(k) program is effective. Thus, for calendar year plans that adopt a Roth 401(k) program in 2006, the plan amendment must be adopted by December 31, 2006.

DOL Issues Guidance on Fiduciary Responsibility for Mutual Fund Settlements

The DOL issued Field Assistance Bulletin ("FAB") 2006-1 to provide fiduciary guidelines regarding the proceeds of recent mutual fund settlements entered into between mutual fund advisors and the Securities and Exchange Commission. The settlement agreements typically require the establishment of settlement funds to remedy losses experienced by mutual fund shareholders, including ERISA plans, resulting from late trading and market timing in mutual funds.

FAB 2006-1 generally provides that settlement proceeds are not deemed plan assets until distributed from the settlement fund. Allocation of the settlement proceeds to participants is a fiduciary act. Thus, the allocation method must be prudent and solely in the interest of plan participants.

Seventh Circuit Confirms ERISA Exception for Participant-Directed Accounts

In a favorable decision for plan sponsors, the Seventh Circuit Court of Appeals confirmed that a 401(k) plan trustee may delegate to plan participants investment authority over the participant's individual account even if the plan does not satisfy section 404(c) of ERISA. Jenkins v. Yager, 2006 WL 956944 (April 14, 2006).

A plan participant sued the plan trustee after her 401(k) plan account suffered substantial losses between 2000 and 2002. The participant claimed that the trustee violated ERISA by requiring participants to direct the investment of their accounts even though the plan did not satisfy ERISA section 404(c). ERISA section 404(c) provides pan fiduciaries with a shield from liability for any losses that result from a participant's investment directions provided the plan satisfies certain criteria. The parties agreed that the plan did not satisfy ERISA section 404(c) because the plan did not allow participants to change their investment elections at least once every three months.

The court examined the rules under ERISA regarding trustee delegation of the duty to manage and control plan assets. Although the court found no explicit authority for a trustee to delegate management authority to participants to direct their own accounts, the court held that ERISA contains an implied exception allowing trustees to delegate investment responsibility to participants. A trustee will not violate ERISA merely by requiring participants to direct the investment of their own accounts.

A trustee may take advantage of the fiduciary liability shield of ERISA section 404(c) by satisfying all of the requirements of ERISA section 404(c). However, the Seventh Circuit confirmed that failure to satisfy ERISA section 404(c) is not, by itself, a violation of the trustee's fiduciary duty. Rather, failure to comply with ERISA section 404(c) means only that the trustee remains subject to the fiduciary standards of ERISA. The trustee must act prudently and solely in the interest of plan participants in the initial selection of funds, the monitoring of funds and the changing of funds, if necessary. The court will look at all of the surrounding facts and circumstances to determine whether a trustee satisfies the ERISA fiduciary standards in each specific case.

Many 401(k) plan designs require participants to direct the investment of their own accounts. While most participant-directed plan designs intend to comply with ERISA section 404(c), actual compliance may be difficult to achieve. The Seventh Circuit is the first court to bless participant-directed plan designs regardless of whether the plan complies with ERISA section 404(c).

DOL Issues Amendment to PTE 80-26 for Interest-Free Loans

On April 7, 2006, the DOL published a final amendment to class PTE 80-26. PTE 80-26 generally permits a party in interest to make certain interest-free loans to employee benefit plans when the plan faces a temporary cash shortage. The primary changes to PTE 80-26 are the elimination of the three business day restriction for loans used for purposes incidental to ordinary plan operation and the introduction of a written loan agreement for loans with a term of 60 days or more.

The amendment to PTE 80-26 is retroactively effective to December 15, 2004. However, the written loan agreement requirement for loans used to pay ordinary plan operating expenses is prospective only and is effective as of April 7, 2006.

HEALTH CARE PLAN DEVELOPMENTS

U.S. Supreme Court Confirms ERISA Health Plan Reimbursement Rights

On May 15, 2006, the United States Supreme Court delivered a unanimous opinion in *Sereboff v. Mid Atlantic Medical Services, Inc*. Settling a dispute among the federal circuit courts, *Sereboff* sustained the use of ERISA section 502(a)(3) to enforce a plan's right to subrogation and reimbursement pursuant to an appropriate plan subrogation and reimbursement provision.

A detailed analysis of the U.S. Supreme Court's decision is provided in a separate newsletter, dated June 5, 2006.

CMS Updates Standard Medicare Part D Benefit for 2007

On April 5, 2006, CMS published the updated standard Part D prescription drug benefit for 2007. The increased standard Part D plan for 2007 will require plan sponsors to reexamine the creditable coverage status of the prescription drug benefits that the plan sponsor offers to Medicare-eligible individuals. Whether a plan sponsor's prescription drug coverage is creditable depends upon whether the actuarial value of the plan sponsor's coverage is greater or less than the standard Part D plan.

The standard Part D benefit in 2007 is:

- Premium: Varies by plan

- Deductible: $265

- Co-insurance: Medicare pays 75% after the deductible up to a coverage limit of $2,400

- Gap in Coverage or "Doughnut Hole": Medicare beneficiary pays 100% of costs between $2,400 and $5,451.25

- Catastrophic Coverage: Once true out-of-pocket costs reach $3,850, Medicare pays 95% of drug costs. Beneficiary co-insurance in 2007 increases to $2.15 for each generic/preferred multi-source drug and $5.35 for all other drugs.

- Subsidy Amount: The cost threshold and cost limit for the 28% retiree drug subsidy increase to $265 and $5,350, respectively.

CMS Issues Updated Medicare Part D Disclosure Guidance

CMS published updated guidance relating to the disclosure notices that most group health plan sponsors must provide to Medicare-eligible individuals, regardless of whether the plan sponsor offers retiree health benefits. This guidance applies to all Medicare Part D disclosure notices issued on or after May 15, 2006.

- Model Notices. CMS has substantially revised its model creditable and non-creditable disclosure notice published last fall to clarify numerous items, such as special enrollment, and to recommend more detailed descriptions of how the plan sponsor's coverage interacts with Medicare Part D coverage. Medicare-eligible individuals must receive a notice because Medicare Part D plans will charge enrollees a higher premium for Part D coverage if the individual delays enrolling in Part D unless the individual can show that he or she had creditable coverage.

Any notices distributed after May 15, 2006, such as notices distributed to newly eligible plan participants, must comply with the updated guidance. Use of the model notice is not mandatory. If the plan sponsor uses the model notice, the updated models can be found at *http://www.cms.hhs.gov/CreditableCoverage/*.

- New Personalized Notice. CMS introduced a new, optional "personalized" notice that should be provided to a beneficiary upon request. The personalized notice includes the individual's identifying information and dates of creditable coverage.

• Integrated Plan. The guidance clarifies the definition of "integrated plan" for purposes of the creditable coverage safe harbor plan design. An "integrated plan" generally combines prescription drug benefits with other medical, dental or vision benefits and has combined benefit deductibles, annual maximums and lifetime maximums for all benefits.

• COBRA. The updated guidance clarifies that Medicare-eligible individuals receiving prescription drug coverage through COBRA are entitled to receive a disclosure notice.

This Employee Benefits Update provides general information about employee benefits issues. It should not be construed as legal advice or a legal opinion. Readers should seek legal counsel concerning specific factual situations confronting them.

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