Duties, Costs, and Liabilities Created for California Employers and Taxpayers by SB 1234

Executive Summary

Subject to ERISA. The Program described in the Bill is not maintained for governmental employees. It is a plan for private sector workers. Therefore, ERISA requirements would apply.

ERISA Issues New to State. State plans for state employees are not subject to ERISA. The legislature should fully examine and consider the cost to the state and its employers to implement, administer and comply with ERISA and its nondiscrimination rules.

PBGC Premiums. The Program described in the bill is a defined benefit plan. Unlike CALPERS and other governmental defined benefit plans, ERISA plans must pay an annual premium to the Pension Benefit Guaranty Corporation for insurance in the event the plan terminates with insufficient assets. The current rate for single employer and multiple employer plans is $35 per participant.* In addition, there is a variable-rate premium that also applies to plans that have unfunded vested benefits. In general, the rate for the variable-rate premium is $9 per $1,000 of underfunding.

Minimum Funding Contributions. Under a defined benefit plan, funding obligations are determined actuarially based on the plan's benefit commitments. Under the Program, if participant contributions to the plan do not equal the required minimum funding obligation for a year based on the funding rules and the annual actuarial valuations of plan assets, then additional contributions must be made. Generally under the Internal Revenue Code, each participating employer is liable for the plan's funding deficiencies.

Nondiscrimination Testing. Defined benefit plans for private sector workers are subject to a number of nondiscrimination rules under the Internal Revenue Code. These rules apply separately to each participating employer. These rules will add significant cost and complexity to plan administration.

Qualification Errors. A failure on the part of any one participating employer to comply with ERISA and the nondiscrimination rules will jeopardize the qualification of the entire plan, subjecting the plan to possible disqualification by the IRS.

Fiduciary Liability. The fiduciary duty and potential liability under ERISA is substantial, and is one of the often cited reasons for why many employers do not sponsor retirement plans. Each participating employer will have ERISA fiduciary duties and the state may be undertaking a fiduciary responsibility.

Prohibited Transactions. To preclude conflicts of interest, ERISA prohibits a range of transactions. The Program could not simply adopt the investment strategies and procedures of CALPERS, which is a governmental plan exempt from ERISA and these prohibitions, without a thorough review.

Administrative Duties. The Program will give significant administrative responsibilities to both the state and the participating employers.

Costs. The bill sets aside one percent (1%) of the total Program fund to administer the Program trust. It is highly likely that the PBGC premiums, the plan's administrative, compliance and other cost of the plan and trust would exceed this amount.

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* Proponents of the bill estimate the Program will cover 7 million workers. At $35 per participant, PBGC premiums would total $245 million per year.

Overview

SB 1234 (the "Bill") would create a program (the "Program") run by the State of California for employees of private employers in California. The Bill would also establish a Board (the "Board") to administer the Program. The Program appears to be a defined benefit cash balance multiple employer plan,[1] funded by employee contributions and subject to ERISA. Under the Program, participants will be provided a "defined benefit" equal to the sum of their contributions plus declared interest credits accrued under the terms of the plan.

Normally, plans maintained by a state or other governmental entity are exempt from ERISA. Internal Revenue Code ("Code") section 414(d) defines governmental plans for this purpose as "a plan established and maintained for its employees by [a governmental entity]."[2] Although it would be established and maintained by the State of California, the Program described by the Bill would not qualify as a governmental plan because it would not be established or maintained for employees of the state.[3] Therefore, ERISA requirements would apply.

Because the state usually does not have to comply with ERISA and a number of qualified plan rules, there may be issues applicable to the Program that have not been considered.

PBGC Premiums. Cash balance plans are defined benefit plans. The benefits accrued under cash balance plans are generally insured by the Pension Benefit Guaranty Corporation ("PBGC"). PBGC collects premiums from all defined benefit plans that are subject to ERISA, and if a plan terminates without enough assets to pay all accrued benefits, the PBGC has authority to assume trusteeship of the plan and to begin to pay pension benefits up to the limits set by law. PBGC charges a flat-rate premium based on the number of participants. The current rate for single employer and multiple employer plans is $35 per participant. In addition, there is a variable-rate premium that also applies to plans that have unfunded vested benefits. In general, the rate for the variable-rate premium is $9 per $1,000 of underfunding.

Every year, the plan administrator for each defined benefit plan is required to submit a premium filing and pay the premium due. A multiple employer plan where funds from employers are comingled and used to pay benefits to all plan participants is treated as a single plan. The plan administrator must file and pay premiums for the plan as a whole – PBGC will not accept separate payments from each participating employer. Plan sponsors must retain, for a period of six years after the premium due date, all plan records necessary to support the amount of premium paid and any information required to be reported, including records that establish the number of participants and that support the calculation of unfunded vested benefits.

According to the Bill, the Board is authorized to appoint a program administrator. It appears that this administrator would be responsible for the PBGC filing for the Program as a whole and that the funds

[1] A multiple employer plan is a qualified retirement plan that is sponsored by multiple unrelated employers. Plans operated for the benefit of adopting employers that have no nexus or commonality, other than participation in the plan, are referred to as open multiple employer plans.
[2] ERISA section 3(32) contains a similar language defining governmental plan.
[3] See DOL Advisory Opinion 2012-01A (April 27, 2012) (DOL states that the participation of a relatively small number of employees of nonprofit organization in a state group health plan will adversely affect the status of the state plan as governmental under ERISA section 3(32)).

to pay for the premiums would be taken from the administrative fund. Note that expenditures from this fund cannot exceed one percent of the total program fund. This annual per participant PBGC premium cost has the potential to put the Program "in the red" in the first year of operation.

Funding Shortfalls. As with any defined benefit plan, the employer/plan sponsor bears investment risk. Changes in the value of the plan's investments (usually managed by the employer or an investment manager) generally do not affect the amount of benefits owed to participants. The funding rules for defined benefit plans also apply to cash balance plans. Under a cash balance plan, funding obligations are determined actuarially based on the plan's benefit commitments which include interest credits, the value of the plan's asset and expected plan demographic experience. Required contributions do not necessarily equal the sum of contributions to the hypothetical accounts. Under the Program, based on annual actuarial valuations of plan assets, if participant contributions to the plan do not equal the required minimum funding obligation for a year based on the funding rules, then additional contributions must be made.

Under the Bill, the Board is directed to annually adopt a statement of investment policy and to select an investment management entity or entities. However, it does not address who is responsible for any funding shortfalls. Generally, under the Code provisions applicable to multiple employer plans, each employer is treated as maintaining a separate plan for purposes of minimum funding standards.[4] This would suggest that each participating employer will be left liable for any funding deficiencies. What if a participating employer has gone out of business? What if the employer no longer employs any participating employees? Would the State (state taxpayers) step in?

Sponsors of the Bill counter that an insurance policy will address this issue.[5] The state assumes the existence of an insurance policy that would cover market risk regarding the assets, longevity risk (because defined benefit plans must offer an annuity form of payment), benefit guarantees set by the Board, and a risk regarding administration. If this type of coverage is available, we expect it will be very expensive. This expense would also likely be paid from the administrative fund, which has the 1% limit on expenses cited above. Note however, that even if an insurer did cover these costs, ERISA would not shift liability to the insurer; the participating employer would retain liability for payment of any underfunding. This is significant because in the event the insurance contract is discontinued or for some reason the specifics of the contract do not require payment in any case, the participating employer is the entity who would be left responsible for these amounts under the federal tax code. Note that an excise tax also will apply if these minimum funding contributions are not made.

Cash Balance Plan Rules. Under the Pension Protection Act of 2006, cash balance plans are subject to special rules that strictly constrain their benefit formulas. Governmental plans are not subject to many of the rules that apply to cash balance plans (including Code section 411[6]), but the Program is not a governmental plan. For example, a cash balance plan may not provide for an interest credit

[4] Code section 413(c)(4)(A).
[5] The Bill would authorize the Board to "[p]rocure insurance against any loss in connection with the property, assets, or activities of the trust, and secure private underwriting to insure the retirement savings benefit that is guaranteed to program participants." Proposed section 100006(a)(9).
[6] Code section 411(e)(1)(A).

which is greater than a "market rate of return."[7] The Program will need to provide a crediting rate that complies with this rule. Regulations as to the meaning of "market rate of return" have yet to be finalized by the IRS, and when they are, the Program may need to change its crediting rate to comply with the rules. Thus the State can have no assurance about the liability it is taking on in adopting this Program in terms of future required interest credits.[8]

The Bill contemplates that the crediting rate will simply be set by the Board each year by the adoption of a "program amendment."[9] Cash balance plans generally set forth the interest crediting rate in the plan document. There is a significant question whether the Program structure is even permissible. A pattern of repeated plan amendments adjusting a cash balance account causes those adjustments to be treated as permanent.[10] Once permanent, the plan's crediting rate is part of the accrued benefit that cannot be reduced. A plan cannot simply decide that it will reduce the interest crediting rate with respect to benefits based on past service. (This prohibition against cutbacks of the accrued benefit does not apply to governmental plans.) Therefore, changes to the rate would generally apply to interest credits applied to future contributions, not on interest credits based on past contributions, which would be part of the accrued benefit.

In addition, there is substantial question whether a multiple employer plan can declare, each year, whatever interest credit that it wishes within its discretion, without violating the requirement that a defined benefit plan's benefits be "definitely determinable"[11]

Because of these reasons, we believe that changes to the interest rate would generally apply to interest credits based on future contributions, not on interest credits based on past contributions, which would be part of the accrued benefit.

Various Nondiscrimination Rules. Qualified plans for private sector workers are subject to a number of nondiscrimination rules under the Code, from which governmental plans are generally exempt.[12] The rules for multiple employer plans (Code section 413(c) and the regulations thereunder) make clear that these rules are applied to each employer separately.[13] For example:

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[7] Code section 411(b)(5)(B)(i).

[8] The Bill states that interest credited at the stated interest rate and any additional earnings credited thereon shall make up a participant's benefit. It is not clear from the Bill what is envisioned for additional earnings. See section 100005(b). It is not clear what the "additional earnings credited thereon" refer to, but this is not likely permitted under the cash balance rules, because the only "earnings" that are permitted are interest credits that do not exceed a market rate of return.

[9] See Proposed section 100005(c)(1).

[10] Treas. Reg. § 1.411(b)(5)-1(d)(ii)(B).

[11] Treas. Reg. § 1.401-1(b)(1)(i); see also Final Regulation, Hybrid Retirement Plans, 75 Fed. Reg. 64123, 64132 (Oct. 19, 2010).

[12] See Code sections 401(a)(5)(G) (exempting governmental plans from section 401(a)(4)); 401(a)(26)(G) (exempting governmental plans from section 401(a)(26)); 401(a)(10)(B)(iii) (exempting governmental plans from the top-heavy rules of section 416); and 410(c)(1)(A) (exempting governmental plans from sections 410(a) and (b)).

[13] Note that the rules under 410(a) (minimum age and service rules) and 411 (counting service for vesting) are applied to the plan as a whole, aggregating employees of all participating employers. In other words, service with one employer is treated as service with the other employers for purposes of eligibility and vesting. If a participating employer wanted to make matching contributions under the program and apply a vesting

- Code section 401(a)(26) requires defined benefit plans to benefit at least the lesser of 50 employees or 40% of all employees of the employer (unless there is only one or two employees, in which case all employees must be covered). This rule is applied separately to each employer.[14]

- To maintain qualified plan status, a plan must contain special provisions to meet the Code section 416 Top Heavy Rules. If more than 60% of the benefits relate to key employees (company officers and highly paid employees), then alternate plan provisions go into effect.

- Every employer must perform certain coverage tests under 410(b) to demonstrate that their plan benefits a non-discriminatory cross-section of employees by measuring the ratio of non-highly compensated employees ("NHCE") to highly compensated employees ("HCE"). An individual is considered to be benefiting under a defined benefit plan if the individual accrues a benefit under the retirement plan.

- Every employer must perform nondiscrimination testing under 401(a)(4) to show that contributions or benefits do not discriminate in favor of HCEs. Contributions or benefits must be nondiscriminatory in amount.

For defined contribution plans of private employers, these rules often end up limiting the amount of contributions that can be made by HCEs. Plan sponsors can fix this issue by making additional contributions to non-highly compensated employees. There are safe harbors available under which plans can meet nondiscrimination rules by providing a certain level of employer match or nonelective contribution. For defined benefit plans of private employers, these rules are often addressed by plan design.

The Program created under the Bill presents a different situation. Each employer will have no control over what ratio of its HCEs or NHCEs will participate. NHCEs may be more likely to opt-out of the Program because they cannot afford contributions. Regardless of how the nondiscrimination rules are addressed, they add significant cost and complexity. Assuming that the Program Administrator will perform all nondiscrimination tests on behalf of each participating employer, he will have to collect data on all employees of each participating employer, including salary, which employees are also officers, and which employees are at least 5% owners. The rules under 401(a)(26) may be particularly difficult to address. If a participating employer has 10 employees, and only two employees participate, this could cause disqualification. Note that under current multiple employer plan rules, a failure of one participating employer will cause the entire multiple employer plan and all its members to be disqualified by the IRS.[15]

Tax Status of Employee Contributions. The Bill appears to contemplate that an employee whose employer must participant in the plan is given a choice every 24 months as to whether to participate and may elect to terminate participation at any time. Generally, employees cannot be given a choice

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requirement (3 year vesting is permitted for cash balance plans), it would be difficult to determine whether an employer had previously worked for any other unrelated employer who happens to participate in the Program.

[14] Treas. Reg. section 1.401(a)(26)-2(d)(1)(ii).

[15] Reg. 1.413-2(a)(3)(iv).

between compensation and a contribution to a retirement plan on a pre-tax basis, unless the plan complies with the cash or deferred rules in Code section 401(k). Because the Program is not a governmental plan, it cannot take advantage of the "pick-up" contribution rules in Code section 414(h)(2). Thus it appears employee contributions will be on an after-tax basis only. In terms of tax-deferral, such an arrangement is less favorable than contributing to an IRA.

Fiduciary Liability. The fiduciary duty and potential liability under ERISA is substantial, and is one of the often cited reasons for why employers do not elect to sponsor a retirement plan for employees. Duty under ERISA is referred to as the "highest known to law." A fiduciary is anyone who uses discretion in administering or managing a plan or controlling plan assets. A fiduciary's duties under ERISA include:

- Acting solely in the interest of plan participants and their beneficiaries, with the exclusive purpose of providing benefits to them;
- Carrying out their duties with skill, prudence, and diligence;
- Following the plan document (unless inconsistent with ERISA);
- Diversifying plan investments;
- Paying only reasonable expenses of administering the plan and investing its assets; and
- Avoiding conflicts of interest.

Fiduciaries who beach these duties can be held personally liable. Liabilities can arise, for example, if the plan assets are not managed prudently or if expertise is not sought as needed, if proper steps are not taken to ensure prudent selection of service providers, etc. There is also liability for failure to follow all of ERISA's requirements, for example, all of the notice and reporting rules.

Generally, the amount of fiduciary duty retained by the sponsor of the multiple employer plan and the amount left to the participating employer is determined on a facts and circumstances basis. Generally, when a private employer decides to participate in a multiple employer plan, it retains the duty to monitor the multiple employer plan. However, under the Bill, because employers would be required to allow participation, it is not clear the amount, if any, of fiduciary liability that they would retain for the selection of the Program. It is clear from the Bill that the intention is that the State would have no liability; however, with its control over the Program's governing board, it appears that the fiduciary duties and liability would fall on the State.

ERISA was drafted to protect participants, and thus a key part of the statute is that participants can enforce their rights under ERISA. Although the state would have liability as the Program sponsor/administrator, a participant may not have recourse to enforce ERISA due to sovereign immunity.[16] Under sovereign immunity doctrine, a state generally may not be sued in federal court,

[16] The U.S. government, because it is a superior sovereign, is permitted to sue a state in federal court. Presumably, this would mean that the Office of the Solicitor could bring suit on behalf of DOL.

unless they waive this protection. As an example, assume an employee participated in the plan and failed to receive an annual funding notice. The participant could sue and claim that if he had received the notice and seen that that the plan was underfunded, he would have stopped participating, and therefore he was injured. Presumably, notices would fall under the state's responsibilities. However, if the participant was unable to sue the state due to sovereign immunity, he would likely direct the lawsuit against his employer instead. Or, imagine that the state was not prudent in the selection of an insurance contract intended to cover funding shortfalls. The contract does not pay out, and the participating employers are left owing minimum funding contributions and penalties, contrary to what had been promised them. These employers may be left without the recourse of bringing a suit.

Prohibited Transactions. Plans subject to ERISA – as the Program would be – are subject to strict prohibitions on transactions between the plan and "parties-in-interest" which include virtually any person or entity that is associated with or provides services to the plan (and most of their affiliates). These prohibitions are *per se* and do not require that there be self-dealing or a conflict in interest. Thus ERISA plans are administered and managed carefully to ensure that no transactions occur with a party-in-interest unless the transaction is subject to a statutory, class, or individual administrative exemption. So for example, plans are generally managed only by entities that qualify as "qualified professional asset managers" or "in-house asset managers."[17] Cross-trading is constrained,[18] and underwriters that sell to ERISA plans limit the plan to purchasing securities within certain rating categories.[19] These examples only scratch the surface. It is simply not the case that the Program could just adopt the investment strategies and procedures of CALPERS, which is a governmental plan exempt from ERISA's prohibited transaction rules.

Administrative Duties. Maintaining a qualified plan requires a significant amount of administration. The plan administrator must deliver documents to the participants (summary plan description, summary of material modifications, benefit statements, summary annual report or annual funding notice, notice of underfunded plan, 402(f) notices), file an annual Form 5500, file annually with the PBGC , perform plan testing, provide participant education, collect and maintain records of beneficiary elections, maintain a plan document and amend it to comply with changing law and regulations, administer qualified joint and survivor annuity rules, manage plan investments or select and oversee investment managers, process enrollment, timely remit contributions to the plan, process plan distributions, indicate contributions on participants' Form W-2 and maintain a plan website (if applicable).

Most of these functions will presumably be done by the multiple employer plan administrator, however, some will likely fall on the participating employer. The employer will have to timely remit participant contributions to the plan. The employer will be responsible for providing enrollment materials and keeping track of employees who opt out of auto enrollment. The employer will need to keep track of which employees contributed for purposes of W-2 processing.[20] The employers will

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[17] Prohibited Transaction Exemptions 84-14 & 96-23.
[18] ERISA § 408(b)(19).
[19] See 72 Fed. Reg. 13126 (March 20, 2007)
[20] The Retirement Plan box in box 13 of the W-2 would have to be marked, indicating that the employee was an active participant in a retirement plan. The amount of contributions may be included, but is not required, in box

also likely end up educating participants, because employees will need to know what the Program entails. Cash balance plans are complex. Although they look like individual account plans, the accounts are only hypothetical. The plan retains key defined benefit traits. In order to explain the plan, employers will have to understand it themselves. All of these responsibilities, while small in relation to the entire administrative burden of the plan, add significant duties for the employer. If contributions are not sent timely or if mistakes are made in processing enrollment or contributions, then the employer could be subject to liability under ERISA as well as under California law.[21]

ERISA Preemption. ERISA provides that it supersedes any and all state laws that relate to any employee benefit plan governed by ERISA. Thus, there is a substantial question whether the mandate required by the Bill, which is inconsistent with ERISA because it requires employers to offer a retirement plan, could survive an ERISA preemption challenge. But even if does survive such a challenge, it is clear that the Program will not be fully in the control of California once it is created.[22]

Total Costs. As stated above, the Bill would create an administrative fund from which all costs of administration would be paid. Expenditures from the fund "shall not exceed 1 percent of the total program fund," on an annual basis.[23] First, as discussed above, PBGC premiums would be at least $35 per participant. The administrative costs of maintaining a cash balance plan (including participant and employer communications and required notices, maintaining the plan document, completing testing and all other compliance issues, recordkeeping, etc.) would be significant. Premiums for insurance, including the total plan loss insurance described above and fiduciary liability insurance, would also be a considerable cost. It is highly likely that these costs would exceed one percent of the total program fund.

To illustrate, just consider the effect of PBGC premiums. In the Senate Public Employment & Retirement Committee hearing, Senator De Leon testified that over seven million workers in the private sector currently do not have access to a retirement savings plan at their jobs. If seven million workers participated in the Program, PBGC premiums alone at $35 per person would equal $245,000,000. Using mean wage data for California workers ($51,910)[24], a three percent contribution would give the Program $10,901,100,000 in the first year. This would leave $109,011,000 as the one percent permitted for administration of the Program. Note that the PBGC premium total in this example is actually almost 2 ¼ percent of the total Program fund. Lower wage workers are less likely to have a retirement plan at work. Using a number lower than $51,910 as wages for the calculation makes the result worse. If fewer than seven million workers participated, the ratio of premiums to total Program fund would not change. Since this illustration does not include any estimates for administration or insurance, it does not seem possible that expenses could ever be one percent or less of the total Program fund, at least in the earlier years.

14, as they are voluntary, after-tax contributions (that are not Roth contributions), deducted from an employee's pay and contributed to a pension plan.

[21] Under the Bill, a penalty is assessed for failure to make the Program available, without good cause.

[22] See section ERISA 514(a). The Supreme Court has held that a state law is preempted by ERISA if it mandates benefit structures or binds plans to particular administrative choices. See New York State Conference of Blue Cross & Blue Shield Plans v. Travelers Insurance Co, 514 US 645 (1995). The Program does both.

[23] See proposed section 100004(d).

[24] Annual mean wage for all occupations, May 2011 State Occupational Employment and Wage Estimates for California, Bureau of Labor Statistics, US Dept. of Labor.

Conclusion

The details of the Program need to be more thoroughly vetted and analyzed before further consideration is given to this Bill. Neither the extensive requirements of ERISA nor the details of Program funding have been addressed. The only source of funding appears to come from participant contributions (and employer contributions, if the Board elects to allow them). While the intent may be to earn enough income off of plan assets to cover both the interest crediting and plan expenses, this will depend on the financial markets and demands on the plan's assets due to obligations such as the interest credits as well as costs for administration and PBGC premiums. In the case of a market downturn, such as occurred in 2008, a devastating funding shortfall would be likely. The liability will be left to a state which is already struggling financially, or to California employers who were forced to participate. We do not believe that an insurance contract is enough to address these significant concerns.