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Employee Benefits Briefing

A bulletin designed to keep clients and other friends informed on employee benefits law matters

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U.S. Supreme Court Supports Subrogation—with Limits

To no one's surprise, the confirmation hearings for Chief Justice Roberts provided no insight into his views on ERISA. But now he has authored the Supreme Court's unanimous ERISA decision in *Sereboff v. Mid Atlantic Medical Services, Inc.* (May 15, 2006).

Issue

At issue was the right of an ERISA medical plan to seek reimbursement for the plan's payment of medical expenses in cases where the participant has in turn recovered from third parties for those same expenses.

As most health plan administrators know, this issue has divided the lower courts. Two prior Supreme Court decisions framed the question. In *Mertens v. Hewitt Associates* (1993), the Supreme Court held that an ERISA plan was entitled only to such relief as was available in equity (thus, not compensatory damages). Then, in 2002, in *Great-West Life & Annuity Ins. Co. v. Knudson*, the Supreme Court limited remedies in equity to those remedies historically available in equity before the consolidation of equity and law actions (a limitation the dissent in *Knudson* characterized as an "ancient classification" and "an obsolete distinction").

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Decision

In *Sereboff*, the participant and her husband had received a substantial tort settlement for the injuries they sustained in an automobile accident. When the ERISA plan filed to recover its expenditures, the Sereboffs agreed to hold the amount in dispute, nearly $75,000 of the settlement proceeds, in an investment account until a final court ruling. The Supreme Court determined that those investment account funds were particular funds in the participant's possession and therefore subject to the plan's subrogation claim. The Court had reached the opposite conclusion in *Knudson*, where the settlement funds had been placed in a "special needs trust" under California law.

The *Sereboff* plaintiffs argued that the "strict tracing rules" for equitable restitution at common law were not satisfied. They also argued that the funds had to be identified when the right to a lien was created and that certain equitable defenses to subrogation, such as the "make-whole doctrine," were available to them. The Court rejected all those arguments. The Court held that

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the investment account funds were subject to the ERISA plan's right of reimbursement.

Although the Court upheld the plan's right of reimbursement in this case, it did not overrule the earlier *Knudson* decision. As a result, we are likely to see continued litigation over what is "appropriate" relief and when identifiable funds are in the participant's possession. Consequently, plans will need to know how to stay within the limits established by the Court.

Action Points

Plan fiduciaries who intend to exercise their subrogation and reimbursement rights need to take several steps.

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1. **Review Plan Language.** The starting point for these recoveries is the plan language. Be sure that the subrogation and reimbursement provisions are clear and comprehensive. (Also make sure these rights appear in the summary plan description.)
2. **Identify Potential Subrogation Claims at the Outset.** The sooner the plan identifies potential subrogation and reimbursement claims, the better its chances of deciding on an effective action plan.
3. **Consider Earlier Intervention.** Participants' attorneys will presumably take steps to avoid the clear "possession" facts reflected in the *Sereboff* decision. Plans will need to determine whether injunctive action or intervention in the tort proceeding itself is essential to the ERISA plan's recovery.

Failure to critically review all your relevant procedures and practices will make it difficult to obtain any reimbursement.

If you want to discuss the *Sereboff* decision or wish to review your procedures for reimbursement, please contact John Jacobsen or any member of the Vedder Price Employee Benefits Group.

Internal Revenue Service and Department of Labor Update Correction Programs

Both the Internal Revenue Service (IRS) and the Department of Labor (DOL) have recently announced several positive changes to their voluntary correction programs for retirement plans. On May 5, 2006, the IRS released Revenue Procedure 2006-27, which updates and expands its correction program, known as the Employee Plans Compliance Resolution System (EPCRS). On April 19, 2006, the DOL published an update to its correction program, known as the Voluntary Fiduciary Correction Program (the 2006 VFC Program).

Employee Plans Compliance Resolution System

Rev. Proc. 2006-27 supersedes and updates the prior guidance published in 2003 and sets forth the rules to correct certain plan qualification errors and defects in tax-qualified retirement plans under EPCRS. There are three correction programs in EPCRS:

1. Self-Correction Program (SCP), which generally permits a plan sponsor to self-correct certain insignificant operational failures at any time and certain significant operation failures within a two-year period, without having to notify the IRS or pay the IRS a correction fee;
2. Voluntary Correction Program (VCP), which generally permits a plan sponsor, at any time before an IRS audit of the plan, to self-correct certain failures or errors that do not fit within the SCP, by paying a limited fee and filing the correction for IRS approval; and

3. Audit Closing Agreement Program, which generally permits a plan sponsor to self-correct certain failures or errors that were not corrected under SCP or VCP and discovered on audit by paying a sanction with the amount determined based on the nature, extent and severity of the failure.

Rev. Proc. 2006-27 expands the types of failures that may be corrected under EPCRS and the correction methods available. Some of the more significant changes set forth in Rev. Proc. 2006-27 include the following:

- A modified correction method for failing to include an eligible employee in the participation of a 401(k) or 401(m) plan;
- New correction methods for errors in plan loans provided to participants (note that the DOL's 2006 VFC Program provides relief for plan fiduciaries who correct plan loan failures in coordination with EPCRS);
- An alternative correction method for a failure to obtain spousal consent;
- New rules on the ability (or inability) to use EPCRS to correct failures where the IRS has identified the plan or plan sponsor as a party to an abusive tax-avoidance transaction and the plan failure is directly or indirectly related to the abusive tax-avoidance transaction;
- A non-amender compliance fee schedule for plans found by the IRS during a determination letter request review not to have been timely amended for recent tax law changes;
- A simplified correction method under VCP for plans that failed to timely adopt certain amendments required for recent law changes (e.g., good-faith EGTRRA amendments); and
- Waiver of the excise tax in connection with the correction of a minimum required distribution failure; and
- A variety of procedural enhancements for the three correction programs.

The new EPCRS rules in Rev. Proc. 2006-27 are generally not effective until September 1, 2006, but certain provisions are effective beginning on May 30, 2006. Plan sponsors may, however, choose to apply the new correction rules as of May 30, 2006.

Voluntary Fiduciary Correction Program

The VFC Program was originally established by the DOL's Pension and Welfare Benefits Administration (which now goes by the title Employee Benefits Security Administration) as an interim program in March 2000 and adopted on a permanent basis in 2002. The VFC Program encourages plan fiduciaries to voluntarily self-correct certain ERISA violations (e.g., breach of fiduciary duty) without the risk that the DOL will bring civil actions or impose penalties. Applicants must fully correct violations under the VFC Program which entails correction of the violation, calculation and full restoration of the losses to the plan with interest or profits, and, if applicable, distribution of supplemental benefits owed to eligible participants and beneficiaries. If the steps are properly followed, the DOL will issue a "no-action" letter.

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The DOL revised the original VFC Program in April 2005. The 2006 VFC Program maintains the same basic rules as the revised VFC Program of April 2005. However, the 2006 changes expand the program further. Some of the more significant updates set forth in the 2006 VFC Program include the following:

- **Scope of Relief.** When correction is undertaken in accordance with the 2006 VFC Program, relief is granted from civil penalties imposed by the

DOL under ERISA section 502(i), which allows the DOL to assess civil penalties for prohibited transactions with respect to welfare plans and nonqualified pension plans;

- **Covered Transactions.** Expansion of the transactions eligible for correction to include the following (it now covers nineteen specific transactions):
  - the plan's purchase of an illiquid asset from a party in interest to which a statutory or administrative exemption applies;
  - participant loan transactions for violations involving level amortization or default loans (with corrections made under the IRS's EPCRS program); and
  - payment of certain plan expenses with plan assets which should have been paid by the plan sponsor;
- **Under Investigation.** Narrows the definition of "under investigation" for purposes of determining whether a plan or person qualifies for the VFC Program so that it now only applies to an investigation involving the plan or an act or transaction involving the plan;
- **Correction Methodology.** New correction methods for a transaction that involves a party in interest; and
- **Program Calculations.** New program calculations for corrections involving multiple transactions with different time periods.

Note that in connection with the 2006 VFC Program update, the DOL also finalized its amendments to Prohibited Transaction Exemption 2002-51. PTE 2002-51 generally provides relief for certain transactions corrected under the VFC Program from excise taxes that would otherwise apply. The DOL revised PTE 2002-51 to expand the relief under the exemption to include the transactions added in the 2006 VFC Program, including the use of plan assets to pay for service provider expenses that have been characterized as "settlor" expenses, provided such payments were not expressly prohibited by the plan documents.

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The new rules under the 2006 VFC Program as well as the amendments to PTE 2002-51 are in effect as of May 19, 2006. If you have any questions about this issue, please contact Jonathan Hyun or any benefits attorney with whom you work.

New Procedures for IRS Determination Letters

The IRS recently implemented new procedures for its determination letter program for individually designed qualified plans. The most significant change is that each qualified retirement plan is assigned a regular cycle in which the plan must be updated for statutory compliance and filed for a new favorable determination letter. The cycles are staggered and spread over five-year periods.

Under the new procedures, plans are assigned a cycle based on the last digit of the plan sponsor's employer identification number (EIN). The first cycle, "Cycle A," is assigned to plans whose sponsor's EIN ends in either "1" or "6" and *ends January 31, 2007*. The next five-year cycle for plans in Cycle A ends January 31, 2012. Plans in Cycle B, for employers with an EIN that ends in "2" or "7," must file in the 12-month period ending January 31, 2008. Cycles C (EINs ending in "3" or "8"), D (EINs ending in "4" or "9") and E (EINs ending in "5" or "0") will end on January 31, 2009, January 31, 2010 and January 31, 2111, respectively.

During the last 12 months of each five-year cycle, a plan sponsor must file for a favorable determination letter. The new determination letter will expire on the last day of the next five-year cycle. The effect of the new system is that plan sponsors need to apply for new determination letters generally only once every five years. Of course, it is permissible to file "off-cycle" if a plan sponsor has made changes to its plan and does not want to wait until its next cycle filing year.

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A plan's assigned five-year cycle also applies to timely amending the plan for any changes as a result of guidance or statutory changes in the Internal Revenue Code's plan qualification requirements. All such amendments must be adopted by the end of the applicable five-year cycle. However, a plan must operate in compliance with any required changes that become effective during the cycle, even though adoption of the amendments may be delayed and adopted retroactively.

If you sponsor a plan assigned to Cycle A and we have not already contacted you, we will do so in the near future. In the meantime, if you have any questions, please contact Paul Russell or any Vedder Price employee benefits attorney.

> ***The new model notices should be used beginning May 15, 2006.***

Medicare Part D
Updated Guidance and Notices

The Centers for Medicare and Medicaid Services (CMS) recently released updated guidance on Medicare Part D Notices of Creditable Coverage and issued revised model notices of creditable coverage.

Background

All group health plans that provide prescription drug coverage must furnish Medicare Part D-eligible individuals a notice that discloses whether the plan's prescription drug coverage is creditable. This disclosure provides Part D-eligible individuals with information on whether they should enroll in Medicare Part D. Prescription drug coverage is creditable if the actuarial value of such coverage equals or exceeds the actuarial value of the standard Medicare Part D drug benefit. A simplified method of determining whether a plan provides creditable coverage may be used by plans not seeking the retiree drug subsidy.

Model Notices

In this round of guidance, CMS revised the model notices issued in 2005 and issued a new model personalized notice. The personalized notice allows the plan sponsor to fill in personal information for each individual including the date ranges of creditable coverage. Use of these model notices is not required. The model notices may be found at the CMS website (www.cms.hhs.gov/creditablecoverage).

Who Gets the Notice and When

The new rules provide that a creditable coverage notice must be provided to all Part D-eligible individuals, including active employees, retirees and employees who are disabled or on COBRA as well as Medicare beneficiaries who are covered as a spouse or dependent of the Part D-eligible individual. The new model notices should be used beginning May 15, 2006. Generally, creditable coverage notices must be provided annually before November 15. However, if a Part D-eligible individual enrolls in a plan or requests a notice on or after May 15, 2006, the notice must be provided at that time and must comply with these new regulations (e.g., use the revised model notice).

Integrated Plan

The new guidance clarifies what constitutes an "integrated plan" for purposes of using the simplified method of determining whether a plan provides creditable coverage. An integrated plan is a benefit plan that is offered to Medicare-eligible individuals in which the prescription drug benefit is combined with other medical or dental benefits and the plan contains the following terms: (a) a combined plan year deductible for all benefits under the plan, (b) a combined annual benefit maximum for all benefits under the plan, and (c) a combined lifetime benefit maximum for all benefits under the plan.

What to Do Now

The sponsor of a health plan covering Part D eligible individuals should review the new notices at the CMS website, update its current notices and decide if it wants to utilize the new personalized notice. A plan sponsor should also review the new definition of an integrated plan to see if it is helpful in determining whether its plan provides creditable coverage.

Please call Chris Collins or any other Vedder Price benefits attorney if you have any questions about Medicare Part D.

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If you have any questions regarding material in this issue of *Employee Benefits Briefing*, contact Paul F. Russell (practice leader) at 312/609-7740 or at prussell@vedderprice.com or any member of the Employee Benefits Group.

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The Employee Benefits Group

Vedder Price has one of the nation's largest employee benefits practices, with ongoing responsibility for the design, administration and legal compliance of pension, profit sharing and welfare benefit plans with aggregate assets of several billion dollars. Our employee benefits lawyers also have been involved in major litigation on behalf of benefit plans and their sponsors. Our clients include large national corporations, smaller professional and business corporations, multiemployer trust funds, investment managers and other plan fiduciaries.

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