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BENEFITS REPORT

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Late Deposits – A Timely Topic

SUSAN QUINTANAR

Plan sponsors need to remain attentive about ensuring that elective deferrals are deposited into their 401(k) plans on a timely basis. Plans may be subject to a higher risk for audit where late deposits are concerned, especially in those cases where there has been a pattern of recurring delinquent deposits reported on the annual Form 5500s. Recently, the U.S. Department of Labor (the "DOL") has increased its focus on this issue by sending informational letters to plan sponsors who report such failures on their annual returns. In such situations, the DOL generally recommends filing an application under its Voluntary Fiduciary Correction Program ("VFCP") to correct the issue and minimize the plan's risk for audit.

DOL Deadline for Timely Deposits

As part of their fiduciary responsibilities, plan sponsors are required to ensure that participant contributions are deposited in a plan's trust on a timely basis. The DOL defines participant contributions to include any amounts withheld from wages by an employer for a participant or received by an employer from a participant, such as elective deferrals and voluntary after-tax contributions, as well as participant loan repayments.

Unlike employer contributions (which become plan assets when they are actually contributed), participant contributions are treated as plan assets as of the date they can reasonably be segregated from the employer's general assets. The DOL regulations state that participant contributions become plan assets on the earlier of:

1. The 15th business day of the month following the month in which the contribution is withheld by the employer from the employee's wages (or the amount is received by the employer);

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2. The earliest date on which the contributions can reasonably be segregated from the employer's general assets.

**Note that the date in item 1 is not a safe harbor deadline; it is instead the maximum deadline which is applicable only if the date in item 2 is not earlier.*

7-Business Day Safe Harbor for Small Plans

For plans that have fewer than 100 participants at the beginning of the plan year, there is a safe harbor deadline in effect for depositing participant contributions. Such contributions are considered to have been timely deposited if the segregation from the employer's general assets occurs within 7-business days following the date that they are withheld from participants' wages (or otherwise received by the employer, in the case of voluntary after-tax contributions). For this purpose, business days exclude both weekends and federal holidays. The safe harbor is determined on a payroll by payroll basis. As a result, the failure to satisfy the safe harbor for any one payroll period will not prevent the plan sponsor from meeting the safe harbor for any other payroll period during the plan year.

The benefit of the safe harbor is that participant contributions are treated as being deposited into the plan by the 7-business day safe harbor deadline, even in those cases where the "earliest reasonable segregation" date might have otherwise occurred earlier under the regular DOL deadline. If, however, a plan sponsor of a small plan does not deposit participant contributions by the safe harbor deadline, the standard DOL deadline will be used to make corrections, not the 7-business day safe harbor deadline. As a result, if the employer could have segregated participant contributions earlier than the 7-business day safe harbor deadline, corrections will be determined based upon the earlier date.

"Earliest Reasonable Date" for Segregation

For large plans that cannot rely on the 7-business day safe harbor deadline, there is no definitive time frame used to determine the "earliest reasonable date" participant contributions can be segregated from an employer's general assets. It is essentially determined by the recurring pattern established in connection with the regular processing of an employer's payroll, based upon each employer's individual payroll processing system. There is no clear guidance in the DOL regulations on this point.

Some factors to consider when determining the reasonableness of an employer's payroll and deposit processing system are:

- How fast the segregation can reasonably occur;
- What the current processing costs are, as well as the additional expense that might be associated with expediting the process;
- Any additional assurance and comfort the plan sponsor might gain from using a faster system, and
- Any income plan participants might recognize by having their participant contributions transferred sooner into the plan's assets, weighing in any potential increase in cost for improved/expedited processing.

Another factor to recognize is that any plan documents or employer participation agreements (including collective bargaining agreements) which establish the timing for making participant contributions to the plan will also generally need to be taken into account. In most cases, where the procedures in those documents conflict with the general DOL deadline, it will be necessary to examine how reasonable the procedures are in actual practice. In such cases, it may also be necessary to examine whether an application under the Internal Revenue Service (the "IRS") Employee Plans Compliance Resolution System ("EPCRS") is desirable, if the terms of the plan have not been followed in this regard.

Correction for Delinquent Deposits

The correction for the late transmittal of participants contributions is to transfer the funds from the employer's general assets into the plan's trust as quickly as possible after the error has been detected. Lost earnings on the late deposits will also need to be allocated to the accounts

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of affected plan participants. This allocation is required because such participants are considered to have lost the opportunity to earn investment income on their participant contributions while those amounts were held as part of the employer's general assets. Lost earnings are provided on the late participant contributions from the "earliest reasonable date" those contributions could have been deposited into the plan's trust through the date they are actually deposited. If the deposit dates for both the participant contributions and lost earnings differ, earnings on the lost earnings will also need to be included. It is generally advisable to complete the correction before the annual Form 5500 is filed for the associated late deposits. That way, the annual report will reflect that the late deposits have been corrected and are not outstanding, thereby reducing the plan's risk for audit.

Prohibited Transaction and Excise Taxes

Delinquent deposits result in a prohibited transaction under Internal Revenue Code ("Code") §4975 for which applicable excise taxes are assessed. Because the employer is treated as a "disqualified person" under Code §4975, the DOL views the employer as using the amount of the plan assets represented by the participant contributions for its own business purposes: either (i) that the employer has effectively received a loan from the plan for the amount of the plan assets the employer failed to contribute on a timely basis, in violation of ERISA §406(a)(1)(B) and Code §4975(c)(1)(A), or (ii) that the employer is benefiting from the use of plan assets, in violation of ERISA §406(a)(1)(D) and Code §4975(c)(1)(D). The penalty on a prohibited transaction is at least 15% of the lost earnings associated with the late deposits, with possible additional penalties assessed at the DOL level. The excise tax penalties are paid to the IRS by submitting Form 5330. The DOL's VFCP allows for a waiver of the related excises taxes on delinquent deposits in certain circumstances.

DOL VFCP

Submitting under the DOL's VFCP essentially provides applicants with the assurance that the DOL will not recommend the plan for audit for the fiduciary breaches associated with the delinquent deposits reported as part of the VFCP. Under ERISA, the DOL is required to assess a civil penalty for fiduciary breaches equal to 20% of the amount recovered as part of a settlement or litigation. However, this penalty is waived since the applicant is voluntarily reporting and correcting the violations under VFCP.

To receive relief under VFCP from the fiduciary breach, the employer (or other responsible fiduciary) must correct the failure in the manner described above (*i.e.*, by transferring the delinquent deposits from the employer's general assets into the plan's trust and providing affected participants with lost earnings on their late deposits). Under VFCP, applicants have the benefit of relying on the DOL's online calculator to compute the lost earnings, which greatly simplifies the interest rate to use for this purpose.

In addition, excise tax relief on the prohibited transactions associated with the late deposits may be available under certain circumstances, provided (i) the delinquent deposits were made not more than 180 days after the payroll withholding date (determined using calendar days, rather than business days), (ii) the applicant has not taken advantage of VFCP and its related excise tax relief during the three (3) year period prior to the VFCP submission, and (iii) notice is provided to "interested parties" (and the appropriate regional office of the DOL's Employee Benefits Security Administration) within sixty (60) calendar days following the date of the VFCP submission. While not defined under the VFCP procedures, "interested parties" are generally all participants who were affected by the delinquent deposits, including beneficiaries of deceased participants, as well as alternate payees. Satisfaction of these conditions automatically grants excise tax relief, thereby eliminating the need to file Form 5330 and the related excise taxes with the IRS.

An exception to the notice requirement occurs where the amount of the excise tax that would otherwise apply is less than $100. To meet this exception, the applicant must agree to pay the excise tax to the plan and have it allocated to affected participants in the same manner as plan earnings. Proof of payment must also be included with the VFCP application, as well as either a completed copy of Form 5330 or written documentation containing the same information.

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Self-Correction

Delinquent deposits are not required to be corrected through VFCP. However, employers who elect not to correct through VFCP won't be able to rely on the DOL online calculator for purposes of calculating lost earnings. In this case, the general practice is to use the greater of (i) the plan's actual rate of return (as otherwise required under EPCRS) or (ii) the IRS §6621 underpayment rate (*i.e.*, the rate used under VFCP, which is essentially the rate replicated by the DOL's online calculator). Note that there is no statutory requirement to contribute the rate of earnings required under the DOL's VFCP. Also note that the excise tax relief provided under VFCP will not be available when self-correcting. The excise tax penalties will need to be submitted to the IRS with Form 5330.

Preventive Measures

To help prevent late deposits, it is useful to examine some of the common reasons why they occur. Modifications in an employer's payroll processing system may result in deposit delays, causing them to occur past their "earliest reasonable segregation" deadline. Some common reasons are (i) knowledgeable people involved in the process are out of the office unexpectedly or on vacation, (ii) staff shortages, changes in personnel and/or training of new hires in the processing system, (iii) changes in payroll providers and/or modification of the payroll depositing system. It is advisable to institute protective measures in anticipation of such occurrences to avoid delays. Such measures might include training back-up personnel to assist when knowledgeable people are out and enforcing stricter observance of processing procedures during new hire training. It is also important to allow enough time to implement new procedures or changes in processing or the selection of new payroll vendors.

It is also advisable to document the payroll processing procedures. Such documentation might include establishing a written timeline showing the actual steps and time involved in the transmittal process. Such a timeline might include (i) the time required to calculate the participant contributions to be transmitted for each payroll (whether that is calculated manually in-house or determined by an outside payroll vendor, and even when multiple payroll locations are involved for larger companies), (ii) any manual processing of participant loan repayments made through payroll deduction that may be required, (iii) the time needed to verify and reconcile the steps in the transmittal process (including time needed to submit information back and forth for verification with an outside vendor), (iv) the time required to fund the total amount of participant contributions (including working with the accounting department to issue checks or wire funds to financial institutions, as well as the time involved for the institution to process the funds as contributions), and (v) any instructions to the financial institution on how such funds should be allocated to participants' accounts.

DOL's Heightened Interest

Delinquent deposits of participant contributions continue to be of heightened interest to the DOL, as seen by its monitoring of Forms 5500s and the issuance of its recent informational letters to those plan sponsors reporting late participant contributions on those Forms. Recently, the DOL has also begun issuing "public service announcements" alerting plan sponsors of their fiduciary duties involved in selecting and monitoring qualified plan auditors to review the financial statements to their Forms 5500. While the announcement is not an indication that the DOL intends to select a plan for audit, it does show that the DOL is taking an accelerated interest in employee benefit plans and how information is reported on the annual reports.

To minimize the risk of an audit, measures should be taken to help prevent late deposits from occurring. Documentation of the steps and time involved in your payroll transmittal process will help you develop and maintain such procedures. It will also help support your selection of your "earliest reasonable segregation" date in the event of an audit. Regular monitoring of your payroll procedures will also help prevent late deposits from occurring and assist in the early detection of any late deposits if they do occur. When late deposits are discovered, correction should be made as soon as possible and any changes made in your transmittal procedures to prevent similar errors from occurring should be documented to demonstrate fiduciary compliance.

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Discourage Costly Stockholder Derivative Lawsuits by Obtaining Stockholder Ratification of Reasonable Limits on Non-Employee Director Equity and Cash Compensation

J. MARC FOSSE

For members of a board of directors who are also officers of the corporation, complying with securities and tax laws will also generally require that their compensation be approved by independent and disinterested non-employee members of the corporation's board. However, similar governance standards are not required by law when these non-employee directors approve their own compensation. In order to prevent potentially costly stockholder derivative suits challenging non-employee director compensation, Delaware corporations should consider obtaining stockholder approval for reasonable limits on non-employee director equity and cash compensation. For example, in *Calma v. Templeton*, a stockholder brought a derivative action in the Delaware Court of Chancery to challenge the excessiveness of restricted stock units ("RSUs") granted to eight non-employee directors of Citrix Systems, Inc. ("Citrix") under its 2005 Equity Incentive Plan. The stockholder claimed that the awards were excessive when combined with cash compensation received by the non-employee directors in comparison to compensation received by directors at certain of Citrix's peer companies. The plaintiff stockholder alleged that because the non-employee directors approved their own compensation, the RSU awards were "conflicted compensation" and the directors must establish the entire fairness of the RSU awards instead of relying on the business judgment presumption.

Normally, when a Delaware court reviews a stockholder's derivative claim that certain directors have breached their fiduciary duty by approving excessive compensation, there is a presumption that the business judgment standard applies. Under this standard, the stockholder plaintiff is required to show that the board's decision cannot be attributed to any rational business purpose. (This is also the test for corporate waste under Delaware law). However, if the plaintiff rebuts this presumption by showing that at least half of the directors that made the decision were not independent or disinterested, then the court reviews the decision under the entire fairness standard. Under that standard, the company has the burden to demonstrate to the court's satisfaction that the transaction was the product of both fair dealing and a fair price.

In *Calma*, the court found that the stockholder had rebutted the business judgment presumption because Citrix's compensation committee had approved its own compensation and that of the other non-employee directors. Citrix moved to dismiss the complaint based on the defense of stockholder ratification. Citrix argued that because the stockholders had ratified the terms of the equity plan, which contained a limit of 1,000,000 shares per person on the number of RSUs that can be granted annually, the board's decision must be reviewed under a waste standard (*i.e.*, business judgment) and that it is not reasonably conceivable that the RSU awards would constitute waste. The Chancery court denied Citrix's motion to dismiss because it found that the stockholders' approval of the equity plan was not ratification of the RSU awards. The court noted that based on the stock price for Citrix on the date of grant of the applicable RSUs, one million RSUs would have been worth over $55 million. The court found that this limit was not a reasonable stockholder approved limitation on the amount of director compensation that could be granted under the equity plan. Without the ratification defense, the court held that whether or not the compensation of the directors is excessive would be subject to review under the entire fairness standard and denied the motion to dismiss.

Citrix may ultimately be able to demonstrate to the court that the compensation paid to its non-employee

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directors would pass the entire fairness standard. However, it is more likely that the directors will settle the case to avoid costly litigation. The point is that once the stockholder derivative suit survives a motion to dismiss, the plaintiff will have leverage to exact a settlement from the company to avoid costly litigation. So how can a Delaware corporation place itself in a better position to prevail in a motion to dismiss? Stockholders should ratify meaningful limits on equity and cash compensation that can be awarded to non-employee directors.

In most equity compensation plans, the plans will already have certain per person limits on certain equity grants. For example, in order for compensation to qualify as performance-based compensation under section 162(m) of the Internal Revenue Code (the "Code"), the compensation must be subject to performance criteria that are approved by the stockholders. If the company places a per person limit on the compensation that can be granted, the company can have discretion to select from a range of pre-approved stockholder performance standards that must be re-approved by stockholders every five years. For this reason, most public companies have a per person limit on the performance-based awards that can be granted under the equity plan. The 1,000,000 share annual grant limit in the Citrix equity plan was probably included in the plan to comply with Code section 162(m), and then Citrix tried to argue that it was also a stockholder-approved limit on non-employee director compensation. A company stock option plan may also have a $100,000 limit on the amount of statutory stock options that can first become exercisable in any one calendar year to comply with section 422 of the Code. However, statutory stock options cannot be granted to non-employee directors, so this limit will also not apply as a reasonable limit to non-employee director compensation. As the above examples illustrate, just because a corporation's existing equity plans contain certain stockholder-approved grant limits, that does not mean that those limits will be "meaningful" limits on non-employee director compensation under Delaware law.

While the *Calma* decision did not specifically address cash compensation, it seems the reasoning in the decision would apply. We recommend that Delaware corporations evaluate their current compensation policies for non-employee directors and obtain stockholder approval for reasonable limits on the amount of compensation that directors can approve for themselves. By having stockholders adopt these reasonable limitations, stockholders should be discouraged from bringing future derivative suits similar to *Calma*.

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EEOC's Proposed Rule on GINA and Wellness Programs: Approving Spousal HRA Incentives and Clarifying Other Matters

JAHIZ NOEL AGARD

On October 30, 2015, the U.S. Equal Employment Opportunity Commission (EEOC) released proposed regulations on Title II of the Genetic Information Nondiscrimination Act (GINA) that reverse a prior position prohibiting wellness programs from requiring an employee to provide his genetic information (which includes information about a spouse or other family members) as a condition of receiving incentives. The proposed regulations would allow a wellness program to offer incentives for an employee's spouse to provide information about his or her current or past health status (*i.e.*, health status information) as part of a health risk assessment (HRA).

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The proposed regulations add much needed clarity for employers seeking to promote health and prevent disease through wellness programs.

Background

GINA protects individuals from employment discrimination based on their genetic information. GINA also has strong confidentiality requirements which strictly limit entities covered by GINA from disclosing genetic information.

Under the law, *genetic information* includes the following:

1. Information about an individual's genetic tests;
2. Information about the genetic tests of an individual's family member; and
3. Information about the manifestation of a disease or disorder in an individual's family member (*i.e.*, family medical history or family health status information)

The term "*family member*" includes, but is not limited to, an individual's spouse, children, parents and siblings. While health status information of a family member is considered genetic information, health status information of an employee is not considered genetic information.

GINA prohibits covered employers from requesting, requiring or purchasing genetic information unless a specified exception applies. One such exception applies when an employee or dependent voluntarily accepts health or genetic services offered by an employer, including such services offered as part of a wellness program. However, the EEOC's current regulations (issued in 2010) bar employers from requiring employees to provide genetic information as a condition of receiving an incentive.

While many employers have eagerly embraced offering incentives to employees in exchange for employees' health status information, wellness programs have generally been designed to exclude spouses from participation because the 2010 EEOC regulations consider "spousal information" to be "genetic information" about the employee. Thus, the current regulations could be read as prohibiting employers from offering incentives to both employees and spouses if an incentive is conditioned on the spouse providing his or her health status information. Indeed, in a 2014 lawsuit, the EEOC took the position that an employer violated GINA by requiring an employee's covered spouse to provide health status information for the employee to avoid a surcharge with respect to the employer-sponsored group health plan. (See *EEOC vs. Honeywell International, Inc.*) The proposed regulations reverse this prior EEOC position and provide guidance going forward.

How to Offer Incentives for Spousal Health Status Information

The proposed regulations allow an employer to offer limited incentives to an employee when the spouse provides health status information if all of the following requirements are satisfied:

1. **Covered as a Dependent:** The spouse is covered under the employer-sponsored group health plan as the employee's dependent; and
2. **Receives Genetic or Health Services:** The spouse receives health or genetic services offered by the employer, including as part of a wellness program; and
3. **Provides Information via HRA:** The spouse provides information on his or her own current or past health status as part of an HRA, which may include a medical questionnaire, a medical examination (*e.g.*, to detect high blood pressure or high cholesterol), or both; and
4. **No Spousal Personal Genetic Information:** The spouse does not provide his or her own genetic information, including results of his or her genetic tests. In other words, the spouse only provides information on his or her own current or past health status (*i.e.*, the spouse cannot be required to provide information about other family members such as children); and
5. **Authorization:** The spouse provides prior, knowing, voluntary and written authorization (which may be in electronic format) regarding the release of health status information. The authorization form must describe GINA's confidentiality protections and restrictions on the disclosure of genetic

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information. Separate authorization from the employee is not necessary for the spouse to provide health status information.

Incentives: Limits and Types

Under the proposed regulations, the total incentive for an employee and spouse to participate in a wellness program that is part of a group health plan and collects health status information may not exceed **30%** of the total cost of the plan in which the employee and any dependents are enrolled. For example, if an employee and his or her spouse are enrolled in self and family coverage that costs $14,000 per year, the maximum annual incentive that the employer may offer for providing health status information as part of a wellness program is $4,200 (or 30% of $14,000).

The maximum amount of the incentive for only the spouse to provide health status information may not exceed 30% of the total cost of coverage in which the employee is enrolled **less** 30% of the cost of self-only coverage. For example, if the employer offers health coverage at a total cost of $14,000 for employees and their dependents and $6,000 for self-only coverage, then the maximum incentive that could be offered for the employee's spouse to provide health status information is $2,400, which is $4,200 (30% of $14,000) minus $1,800 (30% of $6,000). The maximum portion of an incentive that may be offered for only the employee to provide health status information may not exceed 30% of the total cost of self-only coverage (or in the above example, $1,800).

The proposed regulations also clarify that incentives may be both financial and in-kind inducements, such as time-off awards, prizes, or other items of value, in the form of either rewards or penalties. This is a change from the current regulations which only address financial inducements.

Other Clarifications

The proposed regulations also provide further clarity regarding the following matters.

No Incentives for Providing Children's Health Status Information

Offering incentives for the current or past health status information of an employee's child or children is strictly prohibited. In the preamble to the regulations, the EEOC explains that there is a minimal, if any, chance of eliciting information about an employee's own genetic make-up or predisposition for disease from spousal health status information. On the other hand, there is a significantly greater likelihood of eliciting information about an employee's own genetic make-up from the health status information of an employee's child or children.

Nonetheless, an employer may offer health or genetic services (*e.g.*, via a wellness program or onsite clinic) to an employee's child or children on a voluntary basis and may ask questions about a child's current or past health status as part of providing the services. However, no incentive may be offered in exchange for the child's or children's health status information.

Services Must be Reasonably Designed to Promote Health or Prevent Disease

The proposed regulations also explain that employers may request, require, or purchase genetic information as part of offering health or genetic services only if the services are reasonably designed to promote health or prevent disease. A program satisfies this standard if:

(i) it has a reasonable chance of improving the health of, or preventing disease in, participating individuals, and

(ii) it is not overly burdensome, and

(iii) it is not a subterfuge for violating GINA or other laws prohibiting employment discrimination, and

(iv) it is not highly suspect in the method chosen to promote health or prevent disease.

The preamble to the proposed regulations gives the following examples of programs which do not satisfy the standard: (1) collecting information on an HRA without providing any follow-up information or advice (*i.e.*, would not be reasonably designed to promote health or prevent disease); and (2), a program that exists merely to shift costs from the employer to targeted employees based on their health.

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No Exchange Involving Sale of Genetic Information or Waiver of Confidentiality

Lastly, the proposed regulations bar employers from conditioning participation in a wellness program or the receipt of any incentive in exchange for an agreement permitting the sale of genetic information or waiver of GINA's confidentiality provisions.

Next Steps

Employers should review their wellness programs to determine whether they comply with these proposed regulations. The EEOC plans to finalize the regulations after evaluating comments on the proposed regulations and other issues, including the following:

1. Must employers that offer incentives to encourage employees' spouses to disclose health status information also offer similar incentives to persons who choose not to disclose such information, but who instead provide certification from a medical professional stating that the spouse is under a physician's care and that any medical risks identified by that physician are under active treatment?
2. Which best practices or procedural safeguards ensure that employer-sponsored wellness programs are designed to promote health or prevent disease and do not operate to shift costs to employees with spouses who have health impairments or stigmatized conditions?
3. Given that most employers today store personnel information electronically, and in light of increasingly frequent breaches to electronically stored information, should the regulations include more specific guidance regarding how to implement GINA's confidentiality requirements in the context of electronically stored records?

Until the regulations are finalized, employers may elect to comply with the proposed regulations. Employers may also want to take the time to ensure that their wellness programs comply with other applicable laws, such as Title I of GINA, the Americans with Disabilities Act, the Health Insurance Portability and Accountability Act, the Affordable Care Act and the regulations issued thereunder (please see our July, 2013 newsletter article for an overview of these regulations). For an overview of the EEOC proposed regs under ADA, see our webinar slides from May 7, 2015.

If you have questions regarding these proposed regulations, please contact the author of this article or the Trucker ✦ Huss attorney with whom you normally work.

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