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ERISA AND EMPLOYEE BENEFITS ATTORNEYS

One Embarcadero Center, 12th Floor
San Francisco, California 94111-3617
Tel: (415) 788-3111
Fax: (415) 421-2017
Email: info@truckerhuss.com

633 West 5th Street, 26th Floor
Los Angeles, California 90071-2053
Tel: (213) 537-1016
Fax: (213) 537-1020

www.truckerhuss.com

(Mild) Relief for Safe-Harbor Hardship Administration

ADRINE ADJEMIAN
AND BENJAMIN F. SPATER

Provided that certain notice requirements have been satisfied, employers and third-party administrators ("TPAs") can now allow participants requesting safe-harbor hardship distributions to provide a summary of information contained in source documents evidencing their hardship event in lieu of the source documents, as long as they maintain the source documents themselves.

On February 23, 2017, the Internal Revenue Service ("IRS") issued a memorandum setting forth substantiation guidelines for Employee Plans ("EP") Examination employees examining whether a 401(k) plan hardship distribution "is deemed to be on account of an immediate and heavy financial need" under safe-harbor standards set out in the Income Tax Regulations ("Regulations"). Under the Regulations a hardship distribution from a 403(b) plan has the same meaning as a hardship distribution from a 401(k) plan, and therefore, the memorandum also applies to hardship distributions from 403(b) plans.[i]

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TRUCKER HUSS QPCP

Trucker Huss Announces Qualified Plan Compliance Program

Providing Plan Qualification Confidence in a Post–Determination Letter Era

The memorandum provides guidance for EP Examination employees and is not a pronouncement of law which can be relied on. However, it does provide insight as to how the safe-harbor standards for 401(k) and 403(b) plan hardship distributions will be examined. The memorandum is in force for two years, until February 23, 2019.

Background

Section 401(k) plans generally may, but are not required to, allow employees to receive a distribution of elective contributions from the plan on account of hardship. A distribution is made on account of hardship only if the distribution is made on account of an immediate and heavy financial need of the employee *and* is necessary to satisfy such financial need.[ii]

A distribution is deemed to be on account of an immediate and heavy financial need if it is for one or more of the items below and the need cannot be relieved from other resources reasonably available to the employee, including assets of the employee's spouse and minor children, based on facts and circumstances:[iii]

1. Expenses for (or necessary to obtain) medical care that would be deductible under Section 213(d) of the Internal Revenue Code (the "Code") for the employee or the employee's spouse, children or dependents (as defined in Code Section 152) or primary beneficiary under the plan;
2. Costs directly related to the purchase of a principal residence for the employee;
3. Payment of tuition, related educational fees, room and board expenses, for up to the next 12 months of post-secondary education for the employee, or the employee's spouse, children or dependents (as defined in Code Section 152) or primary beneficiary under the plan;
4. Payments necessary to prevent the eviction of the employee from the employee's principal residence or foreclosure on the mortgage on that residence;
5. Payments for burial or funeral expenses for the employee's deceased parent, spouse, children or dependents (as defined in Code Section 152) or primary beneficiary under the plan; or
6. Expenses for the repair of damage to the employee's principal residence that would qualify for the casualty deduction under Code Section 165.[iv]

Plans that provide for safe-harbor hardship distributions must still provide the specific criteria used to make the

determination of hardship. For example, a plan may provide that a distribution can be made only for medical expenses, but not for payment of tuition and education expenses.

Prior to 2015, some plans required detailed documentation for hardship requests while others simply asked participants to self-certify that a hardship existed. In an April 1, 2015 publication, the IRS said that plans must obtain and keep hardship distribution records, and that the failure to have these records available for examination is a qualification failure that should be corrected using the Employee Plans Compliance Resolution System.[v] This publication emphasized that self-certification was not acceptable to document a hardship.

The memorandum seems to accommodate alternative substantiation methods, including methods that are more compatible with electronic administration.

Administrative Guidelines

The IRS instructs that EP Examination employees follow the two-step process discussed below when determining whether a plan's hardship distributions are for safe harbor events, based on either source documents or summaries of source documents. Attachment I to the memorandum describes notifications that must be given and information that must be obtained when a plan relies on source document summaries.

Step 1

The EP Examination employees must first determine whether the employer or TPA, prior to making a distribution, obtains: (a) source documents (such as estimates, contracts, bills and statements from third parties); or (b) a summary (in paper, electronic format, or telephone records) of the information contained in source documents.

For example, source documents for a home purchase would include things like a copy of the purchase agreement signed by the buyer and the seller that includes the closing date and the balance of the purchase price.

If the employer or TPA obtains a summary of the information, the EP Examination employees must determine whether the employer or TPA provides the employee with notification that states:

- The hardship distribution is taxable and additional taxes could apply;
- The amount of the distribution cannot exceed the immediate and heavy financial need;
- Hardship distributions cannot be made from earnings on elective contributions or from QNEC or QMAC accounts, if applicable;
- The recipient agrees to preserve source documents and to make them available at any time, upon request, to the employer or administrator.[vi]

Step 2

If the employer or TPA obtains source documents, the EP Examination employees will review the documents to determine if they substantiate the hardship distribution. If instead they obtain a summary of information on source documents, they will review the summary to determine whether it contains the following information[vii]:

1. **General Information for All Hardship Requests**
   - Participant's name
   - Total cost of the event causing hardship (for example, total cost of medical care, total cost of funeral/burial expenses, payment needed to avoid foreclosure or eviction)
   - Amount of distribution requested

continued...

- Certification by the participant that the information provided is true and accurate

2. Specific Information on Deemed Hardships

A. Medical Care

- Who incurred the medical expenses (name)?
- What is the relationship to the participant (self, spouse, dependent, or primary beneficiary under the plan)?
- What was the purpose of the medical care (not the actual condition but the general category of expense, for example, diagnosis, treatment, prevention, associated transportation, long-term care)?
- Name and address of the service provider (hospital, doctor/dentist/chiropractor/other, pharmacy)
- Amount of medical expenses not covered by insurance

B. Purchase of Principal Residence

- Will this be the participant's principal residence?
- Address of the residence
- Purchase price of the principal residence
- Types of costs and expenses covered (down-payment, closing costs and/or title fees)
- Name and address of the lender
- Date of the purchase/sale agreement
- Expected date of closing

C. Educational Payments

- Who are the educational payments for (name)?
- What is the relationship to the participant (self, spouse, child, dependent, or primary beneficiary under the plan)?
- Name and address of the educational institution
- Categories of educational payments involved (post–high school tuition, related fees, room and board)
- Period covered by the educational payments (beginning/end dates of up to 12 months)

D. Foreclosure/Eviction from Your Principal Residence

- Is this the participant's principal residence?
- Address of the residence
- Type of event (foreclosure or eviction)
- Name and address of the party that issued the foreclosure or eviction notice

continued...

- Date of the notice of foreclosure or eviction
- Due date of the payment to avoid foreclosure or eviction

E. Funeral and Burial Expenses

- Name of the deceased
- Relationship to the participant (parent, spouse, child, dependent, or primary beneficiary under the plan)
- Date of death
- Name and address of the service provider (cemetery, funeral home, etc.)

F. Repairs for Damage to Principal Residence

- Is this the participant's principal residence?
- Address of the residence that sustained damage
- Briefly describe the cause of the casualty loss (fire, flooding, type of weather-related damage, etc.), including the date of the casualty loss
- Briefly describe the repairs, including the date(s) of repair (in process or completed)

The EP Examination employees may ask for source documents if they determine that the required notifications provided to employees or the summary of information on source documents is incomplete or inconsistent on its face.

The memorandum also advises EP Examination employees to scrutinize instances when employees have received more than two hardship distributions in a plan year. Even if an examiner determines that the employer or TPA has obtained a complete and consistent summary of information on source documents, in the absence of an adequate explanation for the multiple distributions (*i.e.*, follow-up medical or funeral expenses or tuition on a quarterly school calendar), the examiner may ask the employer or TPA for source documents to substantiate the distributions.

Finally, if a TPA obtains a summary of information contained in source documents, the TPA should provide the employer with a report or other access to data, at least annually, describing the hardship distributions made during the plan year.

Takeaways

The memorandum provides for some flexibility to employers and TPAs by allowing them to rely on summaries of information from participants. Employers and TPAs that currently require source documents to substantiate hardship distributions do not need to make any changes to their procedures. While they may want to consider whether collecting summaries might streamline their practices, their current practices assure that documentation is available upon an audit without having to rely on participants' recordkeeping abilities to satisfy any substantiation requests by the IRS. As a caution, employers and TPAs should continue to require source documents for non-safe-harbor distributions.

See following page for footnotes

[i] See 26 C.F.R. § 1.403(b)-6(d)(2); see also IRS Memorandum for Employee Plans Examination Employees, "Substantiation Guidelines for Safe-Harbor Hardship Distributions from Section 403(b) Plans" (March 7, 2017).

[ii] See 26 C.F.R. § 1.401(k)- 1(d)(3)(i).

[iii] See 26 C.F.R. § 1.401(k)-1(d)(3)(iv)(B).

[iv] See 26 C.F.R. § 1.401(k)- 1(d)(3)(iii)(B).

[v] Employee Plans News, available at https://www.irs.gov/pub/irs-tege/epn_2015_4.pdf

[vi] Although an agreement by the participant to preserve source documents may relieve certain burdens of hardship administration, we question what adverse consequences would result for a plan, if any, when a participant fails to maintain those source documents.

[vii] These items are taken directly from Attachment I to the memorandum.

MARCH 2017

When Close Is Not Good Enough: A Shift Towards Strict Compliance for ERISA Claim Procedures

JENNIFER D. TRUONG

A string of cases in the Second Circuit Court of Appeals is putting ERISA claims administrators on notice that falling short of strict compliance with the Department of Labor's (DOL's) claims and appeal regulations may cost administrators a deferential standard of review. And, this shift towards "strict compliance" is not limited to the Second Circuit. Under the DOL's final regulations governing disability benefit claims, if a plan fails to strictly comply with the new disability claims regulations, a claimant may file a civil suit under ERISA Section 502(a) immediately without exhausting the plan's administrative remedies and the plan administrator's benefit determination will be subject to *de novo* review.[1] In light of the Second Circuit's and DOL's positions favoring "strict compliance," the recent cases offer some lessons about the types of violations that may cause a plan administrator to lose its deferential standard of review.

Background

Normally, if ERISA plan documents grant the plan administrator (or appropriate claims fiduciary) discretionary authority to interpret the plan's terms, the court will review a denial of plan benefits under the "arbitrary and capricious" standard of review. This means that the court generally gives deference to the plan administrator's determination of benefits during the administrative process. However, a plan administrator can lose this deferential standard of review if it fails to establish or follow reasonable claims and appeal procedures. As a result, the court may apply a *de novo* standard of review, which does not provide deference to the plan administrator's prior findings and benefit determinations.

Generally, a plan that has properly vested the administrator with discretionary authority over benefit determinations will receive the benefit of the "arbitrary and capricious" standard of review if the plan "substantially complies" with the DOL's claims-procedure regulations. In a departure from this "substantial compliance" doctrine, the Second Circuit has adopted a "strict compliance" requirement regarding claims and appeal procedures.

Second Circuit Requires Strict Compliance in *Halo*

In *Halo v. Yale Health Plan*, 819 F.3d 42 (2nd Cir. 2016), the Second Circuit held that "a plan's failure to comply with the [DOL's] claims-procedure regulations...will result in that claim being reviewed *de novo* in federal court" unless the plan administrator can demonstrate that the failure to comply was "inadvertent and harmless." The Second Circuit rejected the district court's application of the "substantial compliance" doctrine, under which the district court held that the Yale Health Plan's denial of benefits was entitled to the "arbitrary and capricious" standard of review. The plaintiff in *Halo* alleged that the administrator of the Yale Health Plan had violated the DOL claims-procedure regulation as to (1) the timing of benefit determinations, and (2) the content of the determination notices. The Second Circuit remanded the case for the district court to apply the "strict compliance" doctrine in its analysis of the applicable standard of review (*de novo*, or arbitrary and capricious).

Salisbury v. Prudential Insurance

On February 28, 2017, the Southern District of New York issued a decision that surprised many plan sponsors and administrators in its application of the "strict compliance" doctrine set forth in *Halo*. In *Salisbury v. Prudential Ins. Co. of Am.*, 2017 WL 780817 (S.D.N.Y. Feb. 28, 2017), the court held that the insurer violated the DOL claims-procedure regulations because it failed to properly establish the "special circumstances" that warranted an extension of time to decide an appeal of long-term disability benefits. As a result, the court conducted a *de novo* review of the insurer's denial of benefits.

The DOL claims-procedure regulations generally require a plan to deny a participant's disability benefit appeal within 45 days; however, the rules allow a 45-day extension if the "plan administrator determines that special circumstances (such as the need to hold a hearing, if the plan's procedures provide for a hearing) require an extension of time for processing the claim."[2] To invoke the extension, the plan administrator must provide the claimant with a written notice of the extension before the first 45-day period ends, and the notice must "indicate the special circumstances requiring an extension of time and the date by which the plan expects to render the determination on review."

Although Prudential provided the plaintiff written notice of the extension before the original 45-day period had expired, the only justification for the extension was that additional time was "required to allow for review of the information in Ms. Salisbury's file which remains under physician and vocational review." Before Prudential even rendered its determination upholding the denial of benefits, the plaintiff filed the lawsuit arguing that Prudential violated the claims-procedure regulations by failing to provide sufficient special circumstances to justify an extension of time.

Citing the "strict compliance" doctrine set forth in *Halo*, the court noted that the standard of review in the case turned on the court's interpretation of the term "special circumstances." Because there was no applicable precedent, the court looked to the preamble of the DOL claims-procedure regulations.[3] In the preamble, the DOL makes the following comments regarding timelines for

determining appeals: (1) time periods for making determinations "are generally maximum periods, not automatic entitlements," (2) an extension may only be imposed for reasons beyond the plan's control, (3) delays caused by cyclical or seasonal fluctuations in claims volume are not considered matters beyond the control of the plan, and (4) delaying a determination without a sufficient "special circumstance" is a violation of the procedural standards.

The court found that the explanation Prudential provided in its extension notice (the plaintiff's file "remains under physician and vocational review") cannot constitute a valid "special circumstance" because virtually all appeals for disability benefits would require physician and vocational review. The Court rejected Prudential's argument that the plaintiff's file contained thousands of pages of medical records and several days of surveillance because this information was not included in the extension notice that was provided to the claimant. The court noted that Prudential's improper extension did not fall within the *Halo* exception for "inadvertent and harmless" violations because Prudential purposefully sought the extension (*i.e.*, the violation could not be inadvertent). Thus, the court held that the *de novo* standard of review would apply to the court's review of Prudential's disability benefit determination.

Lastly, it is important to note that neither party originally raised the "strict compliance" doctrine or cited to *Halo* in their briefs. The *Salisbury* court issued its opinion without providing the parties with the opportunity to submit additional briefs to address the "strict compliance" standard. In fact, in its analysis of the "inadvertent and harmless" exception, the court first-stated that the exception would not apply because Prudential did not include *Halo* in its brief (*i.e.*, Prudential failed to meets its burden of proof), before the court determined the exception on its merits.

Takeaways

It is unclear whether other circuits will follow the Second Circuit and adopt more stringent claims compliance standards. Furthermore, even other district courts within the Second Circuit have applied the "strict compliance" doctrine with less devastating effects than *Salisbury*. Nevertheless, *Salisbury* serves as a good reminder of the potential scope of the "strict compliance" doctrine and its effects on the applicable standard of review. Plan sponsors and administrators, particularly those administering benefit plans within the jurisdiction of the Second Circuit, may want to review their administrative claims and appeal procedures for the following issues:

- Extensions for time to determine a claim or appeal should only be requested under limited circumstances that are out of the plan's control;
- Requests for extensions based on voluminous appeals should be carefully considered in light of the DOL's position regarding cyclical and seasonal fluctuations in claims;
- Notices of extensions should describe:
  - The specific reason(s) why an extension is necessary (*e.g.*, stating that the claim is still being reviewed is not sufficient)
  - Any issues that have made the claim or appeal more difficult to review
  - The date by which the administrator expects to render its decision
  - Any additional information that the claimant should submit and an explanation of why the information is necessary (if the extension is due to the claimant's failure to provide the necessary information);
- Claims and appeal determination notices must comply with the DOL claims-procedure regulations regarding required content (*e.g.*, reference to the specific plan provisions on which the determination is based, time limits for bringing a lawsuit, etc.);
- Claims and appeal determination notices should specifically address any objections raised by the claimant; and
- Requested plan documents and claim files should be furnished to the claimant (or authorized representative) timely.

See following page for footnotes

[1] The DOL published the final regulations on December 19, 2016. The final regulations, which apply to all claims for disability benefits filed on or after January 1, 2018, require plan sponsors and administrators to make significant changes to current disability adjudication procedures. Specifically, disability benefit plans will be required to strictly adhere to the new regulations, except for "de minimis violations that do not cause, and are not likely to cause, prejudice or harm to the claimant so long as the plan demonstrates that the violation was for good cause or due to matters beyond the control of the plan and that the violation occurred in the context of an ongoing, good faith exchange of information between the plan and the claimant." Note: the exception is not available if the violation is part of a pattern or practice of violations. (See https://www.gpo.gov/fdsys/pkg/FR-2016-12-19/pdf/2016-30070.pdf)

[2] See 29 CFR 2560.503-1

[3] See Employee Retirement Income Security Act of 1974; Rules and Regulations for Administration and Enforcement; Claims Procedure, 65 FR 70246-01 (November 21, 2000)

MARCH 2017

FIRM NEWS

On April 6, **Robert Gower** was a panelist for an ABA webinar entitled *An Independent Accountant's Role in the Annual Form 5500 Process*.

On May 10, **Benjamin Spater** will speak on fiduciary considerations attendant to Socially Responsible Investing at a luncheon co-sponsored by Trucker Huss. The discussion will familiarize plan sponsors with the SRI landscape as it stands today and factors to consider when evaluating an SRI for their retirement plans.

The Trucker ✦ Huss *Benefits Report* is published monthly to provide our clients and friends with information on recent legal developments and other current issues in employee benefits. Back issues of *Benefits Report* are posted on the Trucker ✦ Huss web site (www.truckerhuss.com).

Editor: Shannon Oliver, soliver@truckerhuss.com