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HOT TOPICS IN EMPLOYEE BENEFITS

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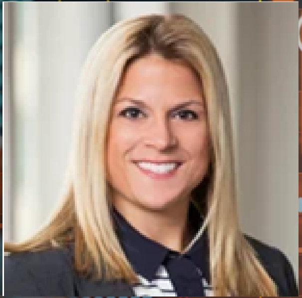

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Agenda

- Gag Clause Attestation
- ESG Update
- Recent DOL Advisory Opinion on Manager Diversity Initiatives and ERISA Plans
- Withholding on Qualified Plan Distributions: Implementing the New Forms W-4P and W-4R
- FTC Proposals to Limit Noncompetes: Impact on Golden Parachute Payments
- Mega-Grants/Retention Grants
- SECURE 2.0 Changes in 2024, Actuarial Equivalence Cases, and Proposed Regulations on Use of Forfeitures

Gag Clause Attestation

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Gag Clause Attestations – Background

- Background – Effective as part of Consolidated Appropriations Act of 2021
  - Plans are prohibited from entering into agreements with a healthcare provider, network or association of providers, third-party administrator (TPA), or other service provider offering access to a network of providers that would directly or indirectly restrict a plan from:
    - providing provider-specific cost or quality-of-care information or data, through a consumer tool or any other means, to referring providers, the plan sponsor, participants, or individuals eligible to become participants;
    - electronically accessing de-identified claims and encounter information or data for each participant, beneficiary, or enrollee in the plan; or
    - sharing information and data with a HIPAA business associate.
  - Note that the agreements may include reasonable restrictions on public disclosure.

Gag Clause Attestation Requirement

- Plans must annually submit a Gag Clause Attestation on CMS’ website by each December 31.
  - Can contractually agree to have a TPA or other service provider attest on plan’s behalf.
- First Attestation due December 31, 2023, covering period from enactment of the CAA on December 27, 2020 through the date of the Attestation.
- Future attestations will be due each subsequent December 31 and will cover the period since the last attestation was completed.
- Go to https://www.cms.gov/marketplace/about/oversight/other-insurance-protections/gag-clause-prohibition-compliance-attestation, where you will find a link to the Attestation, FAQs, instructions and a user manual for submitting the attestation.

Gag Clause Attestations – What Should Plan Sponsors Be Doing to Prepare?

- Confirm whether your TPAs or other service providers will be completing the Attestation on behalf of the plan.
- If not, confirm (preferably in writing) with your TPAs or other service providers that none of your existing agreements contain gag clauses so that you can make the Attestation.
- If they are unwilling to do so, existing contracts should be carefully reviewed to ensure there is no prohibited gag clause language.

Gag Clause Attestations – What Should Plan Sponsors Be Doing to Prepare?

- If a gag clause is discovered, take appropriate steps to amend the contract as soon as possible.
- Take time to complete the Attestation well in advance of the December 31, 2023 deadline; failure to timely file could result in enforcement action, including excise taxes under the Internal Revenue Code or civil penalties under ERISA.

ESG Update

Anti-ESG Movement

- ESG investing is under attack on multiple fronts.

Litigation	Congress	States
• Two federal court cases challenging the DOL's ERISA ESG rule. • In June 2023, first ERISA lawsuit alleging breach of fiduciary duty in offering "ESG Funds" in a 401(k) plan. • In August 2023, a race discrimination lawsuit against several entities affiliated with *Fearless Fund Management, LLC.*	• Both the House and the Senate passed resolutions seeking to repeal DOL's ERISA ESG final rule. President Biden vetoed the repeal. • Republicans in Congress have various bills to amend ERISA to considering ESG factors.	• Dozens of US states have adopted anti-ESG laws applicable to investments by state pensions or other state assets.

Challenges to the ESG Rule in the Courts

- Two lawsuits brought in US federal district courts seek to strike down the ESG rule for being outside the Department of Labor’s (DOL’s) authority.
  - *State of Utah v. Walsh*—filed in the US District Court for the Northern District of Texas in January 2023.
  - *Braun v. Walsh*—filed in the US District Court for the Eastern District of Wisconsin in February 2023.
- *State of Utah v. Walsh* was brough by the Attorneys General of 26 states, along with an energy company and three individuals.
  - The plaintiffs’ claim was that the ESG rule must be invalidated because it was arbitrary and capricious and outside the DOL’s authority, and thus in violation of the Administrative Procedures Act.
- On September 21, the Department of Labor won a motion for summary judgment.

Challenges to the ESG Rule in the Courts

- But that does not mean the court likes the ESG rule. In fact, the opinion ends with the following: “And while the Court is not unsympathetic to Plaintiffs’ concern over ESG investing trends, it need not condone ESG investing generally or ultimately agree with the Rule to reach this conclusion.”
- It’s part of a larger reconsideration in the courts about how much deference federal executive agencies should be given.
  - A case on this issue is on the Supreme Court’s docket for this term.
- On October 26, Plaintiffs appealed *State of Utah v. Walsh* to the 5th Circuit.
- *Braun v. Walsh* has not yet been decided in Wisconsin. It is the same claim, but plaintiffs are two 401(k) plan participants.

Other ESG-Related Litigation

- *Spence v. American Airlines*—filed in the US District Court for the Northern District of Texas in June 2023.
- Class action brought by a participant alleging that the American Airlines 401(k) plan offers "ESG funds" that sacrifice investment performance for environmental, social and governance factors.
- The "ESG funds" at issue are (1) largely available through the brokerage window (not part of the main lineup) and (2) not actually ESG funds in any rational meaning of that term.
- American Airlines has filed a motion to dismiss; still no ruling

Recent DOL Advisory Opinion on Manager Diversity Initiatives and ERISA Plans

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Manager Diversity Initiatives

- Last month, a large financial institution ("the company") obtained an advisory opinion from the DOL about the application of ERISA fiduciary rules to a program ("the Program") called the Action for Racial Equity Asset Manager Program.
  - Under the Program, the company will pay some or all of the management fees for diverse managers retained by employee benefit plans sponsored by the company.
  - The Investment Committee will continue to choose managers and is under no obligation to choose managers who qualify for the Program.

Manager Diversity Initiatives

- Questions addressed:
  - Will the Program make the company a fiduciary with respect to selection of managers?
    - DOL says: No
  - Will the Investment Committee breach its fiduciary duties by taking the Program into account in the selection of managers?
    - DOL says: No
  - Will including information about the Program in participant disclosures represent "improper influence" by a plan fiduciary?
    - DOL says: No

But DOL Opinion Must Be Viewed in Context of Recent Supreme Court Ruling

- *Students for Fair Admissions (SFFA) v. Harvard & UNC*—Supreme Court holds affirmative action in college admissions is unconstitutional.
- Implications for race-conscious contracting:
  - We are seeing more challenges to diversity programs under Section 1981—such as diverse supplier program.
  - In early August 2023, a race discrimination lawsuit filed against several entities affiliated with Fearless Fund Management, LLC (Fearless), an Atlanta-based asset manager, alleging violations of 1981 related to the asset manager's grant program, which sought to support Black female business owners.
  - The Fearless claim could signal the type of challenges that might emerge against ERISA benefit plans—including supplier diversity programs—and so the DOL's recent advisory opinion should be viewed through that risk landscape.

Potential Risk Areas

- In light of these potential risks, employers may want to consider if their benefit programs or investment mandates could be viewed as using race-conscious considerations.
- Will race-conscious benefit plan activities be unlawful? It will depend….
  - If extended beyond education, the *Harvard-UNC* decisions could be read as prohibiting such mandates if they are based on race alone.
  - But probably still safe if activity (for example the selection of the manager and/or service provide) is based on a totality of factors and not just the consideration of race.
- Analogous to the legal analysis around permissible ESG investment considerations
- At any rate, this is an emerging and evolving area of the law and ERISA fiduciaries may want to continue to monitor.

Withholding on Qualified Plan Distributions: Implementing the New Forms W-4P and W-4R

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What Are the New Forms W-4P and W-4R?

- The new Forms W-4P and W-4R are the result of redesigning the 2021 and earlier Form W-4P.
  - The old form was used to make withholding elections for BOTH periodic and nonperiodic payments and eligible rollover distributions.
  - The new Form W-4P allows payers to withhold the correct amount of federal income tax from periodic pension, annuity, profit-sharing, stock bonus plan or IRA payments.
  - The new Form W-4R is used to make withholding elections for nonperiodic payments and eligible rollover distributions.
  - **"Mandatory" use as of January 1, 2023.**
- These forms were revised as part of changes to federal income tax withholding rules under the 2017 Tax Cuts and Jobs Act (TCJA).
- A substitute form is permitted but must effectively reproduce the IRS form to be considered valid.

Form W-4P Purpose and Notice Requirements

The Form W-4P allows a payee to:

- Determine the correct amount of withholding on periodic pension and annuity payments.
- Elect zero withholding.

Notice Requirements

- There is a longstanding requirement in IRC 3405(e)(10)(B) to provide notice to payees about their right to choose not to have tax withheld or to change their previous Form W-4P– the "TEFRA" notice.
  - No more than six months prior to the first payment and not later than the first payment;
  - if not according to the above, then with the first payment; and
  - annually thereafter.
- The regulations allow (but do not require) an election form to be sent out with a withholding certificate, so it may be practical to send out a copy of the redesigned W-4P with the annual notice.

Form W-4R Purpose and Notice Requirements

The Form W-4R allows a payee to:

- Elect a withholding rate on a nonperiodic distribution between 0% and 100% other than the 10% default rate.
- Elect withholding on an eligible rollover distribution greater than the mandatory 20% rate.

Notice Requirements

- For nonperiodic distributions, a payor is required to notify a payee of the right to choose other than the 10% default withholding.
  - Notice is required on a distribution-by-distribution basis, no more than 6 months prior to distribution and is considered timely if included in the benefits application package.
- For eligible rollover distributions, a payor may enter into an agreement to provide for withholding at a rate greater than 20%.
  - The regulations provide that "no request for withholding will be effective between the plan administrator or payor and the distributee until the plan administrator or payor accepts the request by commencing to withhold from the amounts with respect to which the request was made."

Using the Proper Form Is Important to Avoid Liability

- IRC section 3405(d)(2) imposes secondary liability on the plan administrator for withholding and deposit of the tax required to be withheld on periodic and nonperiodic payments.
  - The plan administrator can shift liability to the payor, provided that the plan administrator has directed the payor to withhold such tax and furnished the payor with the information required to do so.
  - A payor that applies a withholding election made on an invalid form is at risk of being held secondarily liable for underwithholding and, separately, for penalties.
    - Where a payor is concerned about the validity of a plan administrator’s withholding forms or the accuracy of the withholding information provided, the payor might consider shifting this liability through a services agreement that “directs” the payor to accept withholding information provided by the plan administrator as valid.

What if a Payee Hasn't Provided the Updated Form W-4P?

- A payee's withholding election remains in effect unless the payee submits a new Form W-4P. There is no requirement for payees to update their withholding elections using the new form.
- A payor must give effect only to the Form revision in effect for a calendar year.
  - The IRS provides a "computational bridge" to enable payors to determine the proper amount of withholding for the current tax year using a payee's 2021 or older Form. See 2023 IRS Publication 15-T.
- The default withholding rule (single with no adjustments) applies when:
  - A payor has no payee election on file.
  - The payee fails to include the correct SSN.

Potential Penalties

- Code section 6662(b)(1) imposes a 20% accuracy-related penalty on the portion of an underpayment of tax required to be shown on a return when the underpayment is attributable to negligence or disregard of rules or regulations.
  - A payor could be subject to this penalty for relying on an invalid Form W-4P to determine the withholding amounts, despite clear rules for how withholding is to be calculated and which Form W-4P is required to be used.

Example

- 100 participants with invalid withholding certificates and $100K in underwithholding.
- Secondary liability: $100K plus a 20% accuracy-related penalty, for a total of $120K.

Limited Relief For Underwithheld Amounts Available through the Form 4669 Process

- Code section 3402(d) provides that a payor will not be held liable for tax that it failed to deduct and withhold if the payor can demonstrate that the tax was paid.
  - A payor can obtain relief from liability for underwithheld amounts by obtaining a completed Form 4669 from each payee for each year relief is requested.
  - The Form 4669 is used to show that a payee has reported and paid taxes owed for a particular tax year. Form 4669 must be signed under penalty of perjury.
- But the payor would remain liable for any penalties applicable to a failure to deduct and withhold.

Example:

- Payor underwithheld by $100K and is assessed a Code 6662 penalty of $20K, for a total proposed liability of $120K.
- Payor obtains Form 4669 showing that payees reported and paid taxes on $10K.
- Payor remains liable for $90K in underwithheld tax plus the $20K penalty, for a total of $110K.

FTC Proposals to Limit Noncompetes: Impact on Golden Parachute Payments

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FTC's Proposed Ban on Noncompete Clauses: Impact on Golden Parachute Payments

- The Federal Trade Commission (FTC) issued a proposed rule on January 5, 2023, which would ban employers from entering into or maintaining noncompete clauses with their workers.
- There are many potential impacts of the proposed rule, and we provide a link to our articles in these slides. We will discuss the impact on the value of parachute payments and on 280G parachute tax penalties.

Section 280G and Parachute Payment Determinations

- Code section 280G
  - Imposes tax penalties on corporations and certain executives with respect to excess parachute payments made in connection with a change in control (CIC).
- Reasonable compensation exemption
  - Section 280G exempts amounts paid as reasonable compensation for services provided after the CIC.
  - Exemption includes refraining from providing services under a noncompete covenant
  - Exemption is often used to reduce the value of parachute payments, and the parachute tax penalties, for purposes of section 280G
- Effect of the proposal
  - Eliminates a significant tool used to reduce the parachute tax penalties, potentially increasing the cost of transactions
  - Contains no provision that would exempt completed transactions

Effect of Proposal on IRC 280G Offsets for Noncompete Valuations

- One of the primary exemptions that companies use to exempt compensatory payments from treatment as a golden parachute payment is by establishing by clear and convincing evidence that such payment is reasonable compensation for services to be provided after the CIC (which includes refraining from providing services due to an **enforceable** noncompete covenant).
- To the extent that noncompete covenants are unenforceable under the FTC's proposal, a major tool used to reduce parachute tax penalties will no longer be available, thus potentially (and substantially) increasing the cost of CIC transactions, prospectively, and maybe retroactively.
- This is particularly an issue for companies that are unable to use private company shareholder votes to cleanse IRC 280G issues with respect to compensation that otherwise would be a golden parachute payment.
- As proposed, the FTC's rule would NOT exempt most CIC transactions. The proposal has a limited exception for the sale of a business, but (unlike a similar exception in California's ban on noncompete clauses), the proposal's exception has a bright-line rule and only applies where the individual is an owner, member, or partner holding at least a 25% ownership interest in a business entity.
- Numerous comments have been filed criticizing the proposal, and, at a minimum, requesting an exemption for executive compensation. The Chamber of Commerce is challenging the whole proposal.

Additional Resources

Read our publications on the FTC's proposed noncompete ban:

- A Practical Guide for Submitting Comments to the FTC's Proposed Noncompete Clause Rule
- FTC's Proposed Ban on Noncompete Clauses May Have Far-Reaching Implications for Executive Compensation
- FAQs on Federal Trade Commission's Proposed Rule Banning Worker Noncompete Clauses
- Federal Trade Commission Proposes Banning Noncompete Clauses for Workers

Mega-Grants/ Retention Grants

What Are Mega-Grants?

- Generally, a one-time stock, option, or mixed grant with a very high value – e.g., more than 10 times an executive's salary or a value of $10M or more.
- Often awarded upon hiring or promoting a new CEO, or in connection with strategic transformation.
- Vesting:
  - typically based on stock price or market capitalization, with required growth multiples of the company's size at grant
  - typically occurs in several tranches
- Reasoning is that shareholders will be rewarded with a substantial increase in stock price while executives are compensated for the outcome.
- Supposed to represent several years' worth of equity awards such that additional awards would not be made to the same executive during the performance period.
- Not new: popular in late 1990s (awarded to CEOs of Oracle, Disney, and others).

Why Are Mega-Grants Potentially Problematic?

- Type and level of performance:
  - Shareholder alignment is critical
  - Difficult to project performance over a long period of time
  - Absolute or single performance metrics in a volatile stock market
- Internal and external optics:
  - Executive frustration in mid/later years of performance period when no portion has vested and no additional awards are granted
  - Impact on other executives, lower-level employees
  - Controversial public scrutiny for above-market compensation
- Proxy advisory firms, including Institutional Shareholder Services (ISS) and Glass Lewis, have strict rules that must be adhered to in order to avoid a negative say on pay recommendation or vote against board members, including:
  - Grants cannot replace more than four years of annual grants and the size of the grant on an annualized basis should comport with the size that the issuer would generally grant each year
  - Proxy must explicitly provide that no grants will be made during the performance period
  - Usual pay-for-performance scrutiny is heightened, including completeness of disclosure, transparent and rigorous performance criteria

Retention Grants

- Retention grants have become popular as one-time enhanced or supplemental grants to support retention.
- Companies may want to use retention grants to indirectly replace unearned performance-based compensation.
- Companies often want to use time-based vesting for retention grants.
  - Performance-based retention awards are viewed more favorably by shareholders/ISS/Glass Lewis.
- Retention grants raise significant shareholder/ISS/Glass Lewis scrutiny.
  - Off-cycle retention arrangements are generally viewed negatively.

Retention Grants

- ISS position on granting retention awards where performance awards were earned below target (December 2022 FAQ: Compensation Policies):
  - Investors do not expect boards to reward executives when performance goals are not achieved, whether by lowering or waiving goals (a problematic pay practice) or granting other awards to compensate for the absent incentive payouts.
  - Investors recognize, however, that retention of key talent may be critical to performance improvements and future shareholder value. To the extent one-time awards are granted in the year (or following year) in which incentives are forfeited, companies should explain the specific issues driving the decision to grant the awards and how the awards further investors' interests.
  - Granting one-time awards to replace forfeited incentives and/or to insulate executives from lower pay outcomes will be viewed as a problematic action.
  - Awards should be reasonable in magnitude and be an isolated/nonroutine occurrence. The awards should also be strongly performance-based and have limitations on termination-related vesting.

Some Key Concerns Can Be Mitigated

Shareholder approval

- May be required. Even if not required, may be helpful to mitigate litigation risks.
- Design may affect shareholder approval, e.g., by incorporating post-vesting holding periods and clawback policies or requiring executives to forego annual awards.
- Prepare for shareholder scrutiny by advanced outreach.

Disclosure and Timing

- Helpful to make retention grants at the same time as annual grants.
- Clear justification and tied to strategic goals, need to keep management in place, tied to shareholder interests.
- Use of compensation consultants, thoughtful design.

SECURE 2.0 Changes in 2024, Actuarial Equivalence Cases, and Proposed Regulations on Use of Forfeitures

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SECURE 2.0 Changes in 2024

- Increase small benefit cash-out limit to $7,000.
- Allows emergency savings account linked to 401(k) plans for non-highly compensated employees.
- Allows matching contributions for student-loan repayments.
- Penalty-free withdrawals from retirement plans for certain emergency expenses and withdrawals for domestic abuse.
- Eliminated pre-death required minimum distribution (RMD) requirements for Roth amounts in defined contribution plans to align with Roth IRAs.
- <u>Note</u>: IRS delayed Roth catch-up rule by two years until January 2026.

Actuarial Factors Cases

- More than twenty cases filed so far since 2018; a second wave started mid-2022 continuing into 2023.
- Lawsuits mainly challenge actuarial assumptions – primarily, old mortality tables, or factors with embedded old tables – used to convert between normal and optional annuity forms.
- Lawsuits challenge early retirement reduction factors.
- Plaintiffs claim that plan provisions are based on outdated mortality assumptions and are not “reasonable;” fiduciaries were obligated to override plan provisions; seeking reformation of plan documents and payment of additional benefits.
- Motion to dismiss filed in all cases; denied in many; several settlements.
  - Largest settlement valued at nearly $60 million.

Proposed Regulations on Use of Forfeitures

- Under the IRS's informal guidance from 2010, generally, forfeitures must be allocated or used within the same year.
- Under the IRS's proposed regulations, defined contribution plans must state that forfeitures of unvested benefits be used no later than 12 months after the close of the plan year in which the forfeitures were incurred.
  - Transition relief for forfeitures incurred before 2024 – treated as incurred in first plan year beginning on or after January 1, 2024.
- Proposed regulations permit forfeitures to be used for payment of plan administrative expenses, reducing employer contributions, and increasing benefits in other participants' accounts.

Our Global Reach

Africa
Asia Pacific
Europe
Latin America
Middle East
North America

Our Locations

Abu Dhabi
Almaty
Beijing*
Boston
Brussels
Century City
Chicago
Dallas
Dubai
Frankfurt
Hartford
Hong Kong*
Houston
London
Los Angeles
Miami
Munich
New York
Nur-Sultan
Orange County
Paris
Philadelphia
Pittsburgh
Princeton
San Francisco
Seattle
Shanghai*
Silicon Valley
Singapore*
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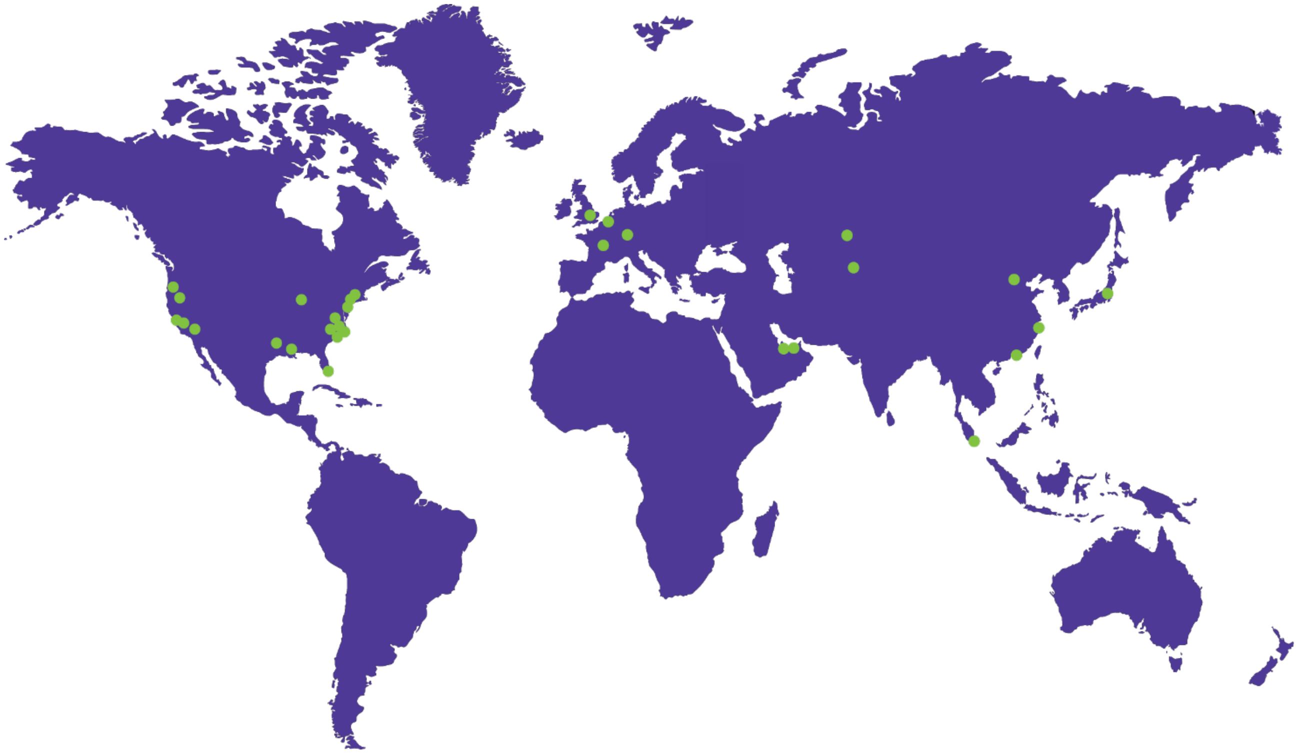

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