DAVIS & HARMAN LLP

MEMORANDUM

TO: James Szostek
AMERICAN COUNCIL OF LIFE INSURERS

FROM: Michael L. Hadley

DATE: December 3, 2014

RE: ERISA Analysis of Mandatory State-Run Automatic Enrollment Retirement Plans

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You have asked me to provide my views on certain issues addressed in a memorandum prepared by Segal Consulting for the National Conference on Public Employee Retirement Systems and AARP, dated November 5, 2014 (the "Segal Memorandum"). The Segal Memorandum considers a range of issues under Employee Retirement Income Security Act of 1974 ("ERISA") and the Internal Revenue Code implicated by a state-run retirement arrangement imposed on private (non-governmental) employers. For convenience, this memorandum refers to such an arrangement as a "Mandatory Automatic IRA Arrangement." Generally under these arrangements, private employers that operate in the state and that do not offer a retirement plan would be required to automatically enroll their employees in the arrangement unless the employee opts out. Commonly, the arrangement purports to utilize tax-qualified individual retirement accounts ("IRAs") as the funding vehicle to receive contributions under the arrangement.

The Segal Memorandum appears to conclude that a Mandatory Automatic IRA Arrangement would not be subject to ERISA because it would fall under an exception in Department of Labor ("DOL") regulations for voluntary IRA payroll arrangements. The Segal Memorandum also suggests that a state mandate that an employer offer a Mandatory Automatic IRA Arrangement if the employer does not offer another retirement plan might not be subject to ERISA's broad preemption provision based the argument that a Mandatory Automatic IRA Arrangement does not mandate the creation of an *ERISA plan*. The Segal Memorandum cites no authority for this proposition. As explained below, ***there are strong reasons to doubt both of these conclusions***.

<u>ERISA Coverage</u>

ERISA coverage generally. With certain exceptions, ERISA applies to any "employee pension benefit plan," which is defined to mean "any plan, fund, or program which was heretofore or is hereafter established or maintained by an employer or by an employee organization, or by both, to the extent that by its express terms or as a result of surrounding circumstances such plan, fund, or program (i) provides retirement income to employees, or (ii) results in a deferral of income by employees for periods extending to the termination of covered employment or beyond."[1] ERISA does not apply to a "governmental plan,"[2] which is a plan a state or local government offers to its employees, but a Mandatory Automatic IRA Arrangement covers private employees and would not be a governmental plan.[3]

Use of IRAs as funding vehicles. A plan that otherwise meets the definition of an employee pension benefit plan under ERISA does not fail to be governed by ERISA simply because the contributions are made to IRAs instead of a single qualified trust. Contributions under ERISA pension plans are funded in a variety of ways, including trusts, group insurance contracts, individual 403(b) contracts and custodial accounts, and IRAs. For example, so-called SEP and SIMPLE IRAs, which use IRAs as funding vehicles, are subject to ERISA.[4]

Safe harbor voluntary IRA payroll arrangements. As described in the Segal Memorandum, DOL regulations provide a safe harbor for certain payroll deduction arrangements in connection with IRAs.[5] In order for a payroll deduction IRA to be exempt from ERISA coverage, the arrangement must satisfy the following:

- No contributions are made by the employer;
- Participation is completely voluntary for employees;
- The sole involvement of the employer is without endorsement to permit the sponsor to publicize the program to employees, to collect contributions through payroll deductions and to remit them to the sponsor; and
- The employer receives no consideration in the form of cash or otherwise, other than reasonable compensation for services actually rendered in connection with payroll deductions.

If a payroll deduction IRA does not meet the safe harbor it will be considered an ERISA plan.

The Segal Memorandum fails to address at least three features of a Mandatory Automatic IRA Arrangement that call into serious question whether the DOL's IRA payroll deduction safe harbor would apply. First, the Mandatory Automatic IRA Arrangement would require that an employer enroll the employee, and deduct contributions from the employee's pay, unless the employee affirmatively elects otherwise. This raises the question of whether the employee's contribution is *completely* voluntary, as the safe harbor requires. An automatic enrollment arrangement also requires administrative procedures beyond those required in a completely voluntary payroll deduction IRA. For example, the employer would need to ensure that each employee is given a notice and a reasonable period to opt out of the automatic enrollment. The

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[1] ERISA § 3(2)(A).

[2] ERISA § 4.

[3] *See* DOL Advisory Opinion 2012-01A (April 27, 2012).

[4] *See*, *e.g.*, ERISA § 404(c)(2) (providing special rules for SIMPLE IRAs in applying ERISA's fiduciary provisions).

[5] 29 C.F.R. § 2510.3-2(d).

employer would also need to maintain records of any employee that opted out of having automatic contributions made under the arrangement. This contemplates an administrative apparatus that is more than collecting contributions through payroll deduction.[6]

Second, the Mandatory Automatic IRA Arrangement contemplates that the employer would be making a retirement plan choice on behalf of the employee, although the choice is somewhat subtle. By adopting a Mandatory Automatic IRA Arrangement, the state is forcing the employer to choose between offering another retirement plan or participating in the Mandatory Automatic IRA Arrangement. Thus, the act of not adopting another plan is – essentially – the adoption by the employer of the Mandatory Automatic IRA Arrangement, which means the adoption of an automatic enrollment arrangement.

Third, the Mandatory Automatic IRA Arrangement must provide for an investment into which the employee's contributions will be made. This would either be a default investment (the employee can elect out) or a mandatory investment (all contributions must be invested as directed by the state). In a completely voluntary payroll deduction IRA, with no automatic enrollment, the employee will always be solely responsible for making investment decisions. There is no other person who is making that decision on behalf of the employee. A Mandatory Automatic IRA Arrangement would require someone – either the IRA provider or the state itself – to designate about how contributions will be invested in the absence of affirmative action by the employee. In fact, consistent with the previous point, the employer is essentially *making the decision* to pick the default investment, or appoint someone else to do so, by choosing to adopt the Mandatory Automatic IRA Arrangement.[7] The need to ensure that employers or others that invest retirement savings on behalf of employees are subject to high fiduciary standards is a *key reason* for ERISA's protections.

In short, although DOL has not addressed the issue directly and there is no direct precedent on this issue, it is generally thought that the inclusion of an automatic enrollment feature results in employer involvement that exceeds that allowed under the safe harbor.[8] The

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[6] *See* DOL Field Assistance Bulletin 2007-02 (July 24, 2007) (stating employer may enter into "salary reduction agreements" with employees consistent with a similar safe harbor for 403(b) plans, but not mentioning automatic enrollment); DOL Advisory Opinion 2012-02A (May 25, 2012) (contributions are not completely voluntary if employer makes matching contributions).

[7] Put another way, an employer has decided to use the state's arrangement with whatever default investment that entails rather than adopting, for example, a 401(k) plan with different investments. One reasonable way to look at that choice is that the employer has designated the state's default investment on behalf of the participant.

[8] A similar issue arises with respect to a safe harbor for 403(b) plans in the same DOL regulation. *See* Advisory Council on Employee Welfare and Pension Benefit Plans, Current Challenges and Best Practices for ERISA Compliance for 403(b) Plan Sponsors, 2011 Report, available at http://www.dol.gov/ebsa/publications/2011ACreport1.html ("The Council also considered, but is not recommending, that DOL permit the inclusion of an automatic enrollment feature within the context of an ERISA safe harbor 403(b) plan. The majority of Council members concluded that automatic enrollment would require actions typically performed by a plan sponsor/fiduciary (e.g., designation of a default investment alternative), and consequently, an automatic enrollment option in the plan may not be viewed as voluntary even in light of the participant's right to opt out of the automatic contributions."); McKay Hochman, "On the Subject of Being a Non-

Segal Memorandum does not provide any analysis to allow one to conclude otherwise. In fact, Congressional proposals for a federally-mandated automatic payroll deduction IRA have included a specific exception from ERISA because, otherwise, an automatic enrollment payroll deduction IRA, even one required by law, would be treated as an ERISA plan.[9] Congress can provide an exemption from ERISA coverage; a state cannot.

ERISA Preemption

The Segal Memorandum concludes that if a state offered a payroll deduction IRA product that is voluntary for each employer there would be no issue of ERISA preemption. If the state *mandated* participation by employers that do not offer a retirement plan, the Segal Memorandum states:

> "It is not clear whether such a state mandate would trigger ERISA preemption on the argument that it requires an employer to have a retirement vehicle. One argument against preemption would be that since the state law wasn't mandating creation of an ERISA plan (the payroll-deduction IRA would be designed to fall within the ERISA exception for payroll-deduction IRAs), ERISA preemption would not apply. Whether the DOL and the courts would agree is uncertain."

As noted, it is far from clear – and in my view likely incorrect – that a Mandatory Automatic IRA Arrangement is not an ERISA-governed plan. Even if it is not an ERISA-governed plan, the question of ERISA preemption is much more complex question than the Segal Memorandum suggests. The Segal Memorandum discusses neither the significant case law suggesting that the mandate *would* be preempted nor the public policy underpinnings of ERISA that lead one to conclude that the mandate *should* be preempted.

ERISA preempts any state law that "relate[s] to" any employee benefit plan.[10] The issue of ERISA preemption is too complex to survey in this short memorandum, but at a minimum one should mention a few court cases addressing "pay or play" state laws that essentially force an employer to offer a particular ERISA benefit. In 1992, the Supreme Court struck down a Washington, D.C. ordinance that required employers to provide workers' compensation benefits to their employees and measured the level of required benefits by reference to the existing health insurance coverage provided by the employer.[11] In 2007, the U.S. Court of Appeals for the Fourth Circuit struck down a Maryland law that required employers with 10,000 or more

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ERISA 403(b)," (Summer 2010), available at http://www.pentegra.com/media/20830/pentegra_403bpers_su10_final.pdf.

[9] *See* Automatic IRA Act of 2011, S. 1557, 112th Cong. (2011).

[10] ERISA § 514(a).

[11] *Dist. of Columbia v. Greater Wash. Bd. of Trade*, 506 U.S. 125 (1992). The Court rejected the argument that a state law that relates to an employee benefit plan survives preemption if "employers could comply with the law through separately administered plans exempt [from ERISA]."

Maryland employees to spend 8% of their total payrolls on employees' health insurance benefits or pay the shortfall in spending to the state.[12] In contrast, the U.S. Court of Appeals for the Ninth Circuit upheld a San Francisco ordinance requiring employers to pay a tax, but giving employers a dollar-for-dollar credit for any amount paid by that employer for health care for its employees.[13] It is not clear that the Ninth Circuit opinion can be reconciled (even though the court tried to do so) with other court decisions on this issue. In any event, what is clear is that it is a mammoth understatement to say that the ERISA preemption implications of a Mandatory Automatic IRA Arrangement are "uncertain."

One must also consider the public policy purpose behind ERISA's broad preemption provision. The "threat of conflicting or inconsistent state and local regulation of employee benefit plans" was cited repeatedly as a reason for the enactment of ERISA[14] and courts have often noted the need for a uniform regulatory regime in examining preemption cases.[15] The Mandatory Automatic IRA Arrangement could impose conflicting obligations on employers with employees in multiple states. For example, one state might require an employer to adopt the Mandatory Automatic IRA Arrangement if the retirement plan offered by the employer for employees in that state does not meet certain minimum criteria, while another state requires adoption of its mandatory Automatic IRA Arrangement only if the employer does not offer any other retirement plan. If one imagines a patchwork of similar rules across individual states, then one of the core reasons for ERISA's preemption provision comes to light: giving employers administrative uniformity in offering benefits to employees in different states.

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[12] *Retail Industry Leaders Ass'n v. Fielder*, 475 F.3d 180 (4th Cir. 2007).

[13] *Golden Gate Rest. Ass'n v. City and Cnty. of San Francisco*, 546 F.3d 639 (9th Cir. 2008).

[14] *See* 120 Cong. Rec. 29,933 (1974) (statement of Sen. Harrison A. Williams, Jr.); *see also* 120 Cong. Rec. 29,942 (1974) (statement of Sen. Jacob K. Javits); 120 Cong. Rec. 29,197 (1974) (statement of Rep. John H. Dent) (describing preemption as "the crowning achievement of this legislation").

[15] *See Fort Halifax Packing Co., Inc. v. Coyne*, 482 U.S. 1, 9 (1987) ("The most efficient way to meet these responsibilities is to establish a uniform administrative scheme, which provides a set of standard procedures to guide processing of claims and disbursement of benefits. Such a system is difficult to achieve, however, if a benefit plan is subject to differing regulatory requirements in differing States.").