

Employee Benefit Plan Language And Sponsor Misconception

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ABSTRACT

The employee benefit plan marketplace is a multi-trillion dollar industry as measured by assets under management. Previous research suggests that even sophisticated plan sponsors and participants are uncertain about the details of their plan. The variety of fee types, (wrap fees, transaction fees, participant fees, and set-up fees) and the use of industry jargon can lead to confusion and misunderstanding. This paper is a case study of an actual deferred compensation plan. We examine the business law aspects of the relationship, particularly how the complexity of the product, coupled with the contract language, could lead to plan sponsor and participant misunderstanding.

Keywords: retirement benefit plans, contract law, plan fees

THE PLAYERS

*A*ssurant, Inc. (Assurant) is a New York based insurance holding company with roots in the US dating to 1977. In that year, N.V. AMEV of the Netherlands acquired Time Insurance Company and began operations under the holding company AMEV Holdings, Inc. With further acquisitions in the US, the firm changed its name in 1991 to Fortis, Inc. In 2004, Fortis, Inc. became a publicly traded company and changed its name to Assurant, Inc. The firm manages a variety of insurance portfolios encompassing health, dental, disability, credit, and warranties. (www.assurant.com).

National Trust Management Services, Inc. (NTMS) is an employee benefits plan administrator based in Warrenton, VA. Plan administrators provide a variety of services to ERISA and non-ERISA benefit plans, including recordkeeping, custodial services, audit, compliance, safe-keeping of assets, and investment advice. Founded in 1999 by Glen V. Armand, he remains the principal in charge. Mr. Armand formed NTMS after a long and successful career in the employee benefits plan administration industry. NTMS is a private firm, solely owned by Mr. Armand. (www.ntmsglobal.com)

THE INDUSTRY/BUSINESS

The employee benefit plan marketplace is massive in scope. In the US alone, thousands of firms offer non-wage benefits to millions of employees. Total Assets are in the trillions of dollars (McHenry Consulting Group). Broadly defined, there are two categories of plans: defined benefit and defined contribution. Each is a deferred compensation plan. Defined benefit plans are plans in which the employer makes all contributions and the employee is promised a stream of retirement income based on salary and years of service. Defined contribution plans are plans in which the employee and employer can make contributions, the employee directs the investments, and no promises are made as to a future income stream. Most plans fall under the Employee Retirement Income Security Act (ERISA) regulations, in which contributions receive tax-deferred status but the plans must comply with non-discrimination guidelines. Plans subject to ERISA are referred to as “qualified plans.”

Many employers, seeking to reward and keep employees, offer key employees additional deferred compensation opportunities not subject to ERISA rules (referred to as “non-qualified plans”). Like a qualified plan, investment gains in non-qualified plans are not subject to current taxation. Unlike qualified plans, employer contributions to an employee’s account in a non-qualified plan are usually treated as taxable income. Also, in non-

qualified plans, the plan administrator can discriminate by restricting employee eligibility and contribution limits.

THE SITUATION

The business relationship between NTMS and Assurant provided for NTMS to administer a non-ERISA benefit plan, wherein Assurant served as plan sponsor and NTMS the plan administrator. NTMS was hired in 2000 by Assurant (then named Fortis, Inc.), to provide a variety of administrative duties, to include:

- Maintenance of accounts and sub-accounts [accounts held at a non-affiliated broker-dealer]
- Provide quarterly account statements
- Process requests for investments and liquidations
- Provide account information to the plan sponsor for tax and accounting matters of the plan sponsor and plan participants

The agreement was modified and renewed in October 2006 for a three year term. The case under review stems from Assurant’s action to terminate the agreement prior to the end of the third year and the resulting dispute over compensation NTMS claimed was owed to it.

The benefit plan administered by NTMS for the benefit of Assurant was a non-ERISA plan falling under section 409(A) of the Internal Revenue Service Code (see Appendix A for an overview of the plan). As a non-ERISA plan, the plan sponsor (the employer, Assurant) can discriminate in the selection of eligible employees. Typically, these plans are structured so as to only provide benefits to senior managers and directors. The employee can make contributions to their investment account. The employer also has the discretion to make contributions to the employee’s account.

The contractual relationship between NTMS and Assurant was of standard format. The contract specified the responsibilities of each party. Like any such contract, it specified how the parties would interact and how they would separate. At the heart of this dispute was whether the contract allowed for the custodian, NTMS, to charge a termination fee. Assurant argued that though the language of the contract specified that the custodian, NTMS, could charge a termination fee, it was not clear how that fee would be calculated. All information and data for this case is derived from documentation of the civil proceedings in the case: US District Court for the Eastern District of Virginia, Civil No. 1:08cv928 [LOG/TCB] and from conversations with Glen Armand and counsel for NTMS.

COMMON PLAN ATTRIBUTES

Exhibit 1 below contains information about services that could be subject to a fee. Fees are charged to the plan sponsor, who can absorb them or pass them along to the plan participants (The Standard, 2007). Exhibits 2 and 3 indicate the specific fees for this Assurant plan.

Exhibit 1: Sources of Fees		
<i>One-time fees (paid by plan sponsor)</i>		
* Plan setup		
* Plan conversion		
* Changes in plan services		
<i>On-going fees (paid by plan sponsor and/or plan participant)</i>		
<u>Administration</u>	<u>Investment</u>	<u>Participation</u>
Record Keeping	Mutual fund expenses	Purchases/Redemptions
Custodial	12b-1 fees	Brokerage
Enhanced platform	Sales charges	Advice
Investment Consulting	Asset-based fees	Distribution
Legal/Compliance	Wrap fees	Loans
Audit		

ASSURANT/NTMS CONTRACT-SPECIFIC ATTRIBUTES**Exhibit 2: Core Services Fee Schedule**

One-time plan set-up	\$5000 + \$10 per participant (waived)
Base annual fee (includes custody services)	\$3500 per plan (\$2500 waived)
409(A) reporting and notices	\$3600 per year (waived)
New account set-up fee	\$50 per account
Administration fee	\$50 per participant per year
Wrap fee	28 basis points annually (no load fund only)

Exhibit 3: Event Services Fee Schedule

Mutual fund trades (excludes no transaction fee funds)	\$20 per transaction
Distributions	\$100
Wire transfers	\$20 per transfer
Enrollment meetings	Out of pocket travel expenses
Postage	Waived
All other extraordinary requests	\$125 per hour

Participants made contributions (often via payroll deduction) to accounts administered by NTMS for the benefit of each employee. Employees were offered a menu of mutual funds into which contributions were directed per the instructions of the participant. NTMS provided custody and administration services but rendered no investment advice or fund selection criteria.

THE DISAGREEMENT

The most recent agreement was dated October 11, 2006 for an initial three year term. In the spring of 2008 Assurant (as indicated in court documents) sought to find a replacement to NTMS, effective January 1, 2009. Assurant took this action in secret from NTMS, but by accident NTMS was made aware of the impending change. NTMS inadvertently received a request for information (RFI) from Mercer, the consulting firm hired by Assurant to assist in the search. Assurant intended to notify NTMS *after* a replacement administrator was under contract. As it turned out, Assurant was forced by the circumstances to advise NTMS in late July 2008 that the service agreement would be terminated effective December 31, 2008.

NTMS was obviously not pleased at the turn of events, the method of notification and the termination. In deciding what option(s) they might have, NTMS looked to the service agreement as to the specific terms that applied upon the termination of the contract.

Pertinent Clauses from the Service Agreement

As regards the term and termination of the contract:

- a) The term of this contract is for a period of three (3) years from the date of execution and shall automatically renew at the end of each period for an additional one (1) year period unless terminated by at least sixty (60) days' written notice to the other party prior to the Anniversary date of this Agreement. Neither NTMS nor the Plan Sponsor may terminate this Agreement, unless NTMS and the Plan Sponsor agree to in writing a shorter notice period. Such termination shall take effect as of the end of this Agreement's anniversary date falling on or after the expiration of the 60-day notice period. The Plan Sponsor shall remain liable for any accrued and unpaid compensation due NTMS.

As regards investment responsibilities and restrictions:

- a) The Plan and/or Participant will pay any transaction fees or loads associated with the purchase, exchange or disposition of a mutual fund from his Account.
- b) ... the Plan Sponsor and its participants agree to be bound by the terms and conditions of the related Brokerage Account Application/s and associated agreements, in all of their parts. The Brokerage Account Application and its associated agreements shall be as defined by the broker-dealer as currently in effect and the terms of which shall control over this Agreement.

As regards NTMS compensation:

- a) NTMS's compensation for performing its duties under this Agreement will be in accordance with the Core Services Fee Schedule and the Event Services Fee Schedule attached hereto as Exhibits A and B, respectively.
- b) NTMS shall deduct from each respective account or sub account of the plan the Administrative Wrap Fee (AWF) as shown on Core Fee Schedule – Exhibit A. The AWF shall be proportionally deducted from the account once a year based on the greater of the average or highest balance of associated assets during the period. Any account being liquidated or transferred prior to the end of the year shall have the AWF deducted from the proceeds at liquidation.
- c) Further, the Plan Sponsor affirms and agrees that upon termination of NTMS services or requested liquidation of all accounts NTMS shall have the right to deduct all outstanding fees from plan assets.
- d) NTMS shall be entitled to recover the costs of collection of such past due amounts, including reasonable attorneys' fees.

NTMS typically billed plan participants some \$10,000 per quarter from mutual fund trades (plan assets were approximately \$100 million). As it relates to mutual fund transactions (at \$20 per trade), a clause in the service fee schedule indicates some modifications to that fee:

“Excluding transactions that qualify for no transaction fee processing and One (1) mutual fund trade per account for each new payroll deduction cycle deferral limited to a maximum of twenty six (26) payroll deposits transactions per year per participant. This credit is nontransferable.”

That clause was a key to the actions that followed. It was NTMS's contention that over the approximately twenty one months the agreement was in place, NTMS routinely waived certain fees (for all participants) related to “excessive” mutual fund trades. In addition, the firm also claimed that certain wrap fees were also periodically waived. NTMS indicated that such actions on its part were a regular aspect of its business model with all clients – a good will gesture that could be reversed if a client terminated the contract. The result was that NTMS sent Assurant an invoice for over \$800,000. A significant portion was due to transaction costs resulting from the receipt and reinvestment of dividends from mutual fund holdings.

As one could easily imagine, Assurant was not at all pleased with this termination invoice and so refused to pay, claiming the fees were unreasonable and not allowed by the contract. In court filings Assurant also claimed that the contract did not allow/provide for a termination fee that was based on fees that NTMS chose to waive.

NTMS provided its own audit of the transactions and wrap fees and sent that to Assurant. Assurant disputed the charges with NTMS and NTMS filed suit against Assurant for breach of contract and sought both economic and punitive compensation.

Thus, it was left to the court to determine fair and reasonable fees for NTMS's custodial services and whether under the contract NTMS could charge a termination fee, in this case some \$800,000, for previously unbilled but accrued fees. As part of the adjudication process, NTMS hired an outside auditor to analyze the billing (at NTMS's cost). The firm, Cundiff & Associates, gave the following summary report (Exhibit 4) for the period October 1, 2006 through June 30, 2008:

Exhibit 4: Invoiced termination charges			
	<u>Population</u>	<u>Rate</u>	<u>Fees Earned</u>
Participant Maintenance Fee	366	\$50.00	\$18,300.00
New Option Set-up Fee	172	\$50.00	\$8,600.00
Trades Fee	34,594	\$20.00	\$691,880.00
Wires Fee	96	\$20.00	\$1,920.00
Exercises (Distributions)	95	\$100.00	\$9,500.00
Base Fee	NA	NA	\$1000.00
Miscellaneous Fees	NA	NA	\$13,103.43
Less: Trade Credits	NA	NA	<u>(\$13,910.00)</u>
Subtotal	NA	NA	\$730,393.43
Less: Previously Billed	NA	NA	<u>\$98,433.43</u>
Balance Due	NA	NA	<u>\$631,960.00</u>

POSTSCRIPT

In late autumn 2008, Assurant and NTMS reached an out of court settlement. Assurant agreed to pay the fees as determined by the independent audit. The accounts have been transferred to a new custodian effective January 2009.

TEACHING APPROACHES

A suggested approach is to let the students read the case (out of class) after the professor has presented in-class an overview of the employee benefit market, has discussed the types of fees that providers can assess a plan, and discussed the particular details of these two firms. Professors should be sure to emphasize that thorough student preparation will require conducting some research and reading beyond the case. The questions below are the students' guide to further understanding, while the references provided at the end of the case are sources for additional study. Professors may want to use the questions as the foundation for in-class discussion.

SUGGESTED QUESTIONS AND ANALYSIS

- 1) Describe the types of charges an employee benefit plan sponsor and participant may be subject to.
- 2) How might the language of the service agreement been modified to reduce potential lack of understanding of the plan sponsor/plan participants?
- 3) What is a customary and reasonable standard of notifying the plan sponsor/plan participant of a wrap fee charge?
- 4) Should NTMS have indicated on each billing statement the type and amount of charges which were accruing but not billed?

Question 1

As illustrated in "Exhibit 1: Sources of Fees" in the case, fees are broadly categorized into one-time fees and ongoing fees. One-time fees are incurred for administrative services that are needed only once. For example, the initial set-up of a plan is a single event. Other one-time charges are incurred when an existing plan is converted to a new administrator and when a plan sponsor institutes a material change in an existing plan. All three activities require the administrator/custodian to incur a time commitment to administer the necessary paperwork, plus computer system integration and compliance.

Once a plan is set up, many types of costs may be incurred on an ongoing basis. Recurring fees are divided into three categories: administration, investment, and participation. Administration fees cover a variety of activities:

- Record Keeping
- Custodial

- Enhanced platform
- Investment Consulting
- Legal/Compliance
- Audit

An example is compliance. Plans may have to submit records to a particular government agency, such as the Internal Revenue Service or the Department of Labor. Costs of the plan administrator are passed on to the plan sponsor. The sponsor may absorb the costs or pass some or all of the costs onto the plan participants.

Investment fees are a function of the management of plan assets. Mutual fund companies are a common choice to manage these assets. Asset management involves much more than merely a portfolio manager to make investment decisions. The fund company provides a number of other services, such as customer service and a web portal for participant use. In addition, like any firm, fund companies have a variety of personnel, all of whom are compensated; accountants, attorneys, sales representatives, human resource managers, etc. Investment expenses are typically grouped as:

- Mutual fund expenses
- 12b-1 fees
- Sales charges
- Asset-based fees
- Wrap fees

Normally, plan participants bear the burden of investment expenses. These charges might be part of the overall fund expenses or be charged separately.

Participation fees are charges for costs incurred when a plan participant takes a particular action, such as:

- Purchases/Redemptions
- Brokerage
- Advice
- Distribution
- Loans

Each one of these activities results in some human interaction on the part of the asset manager, plan administrator, or plan custodian. Human interaction means a cost is incurred. Plan participants normally bear these costs. Like investment expenses, charges for participation activities may be included as part of the overall expenses in a fund or may be charged separately.

How these costs are structured often adds to plan sponsor and plan participant confusion. Asset management firms might provide administration and custodial services, which can add to the level of confusion or misunderstanding. A plan sponsor and participant may be charged in a variety of ways:

- A per-use (transaction) fee [much like a commission]
- An asset-based fee [a fund company charging a given amount of basis points to manage plan assets]
- A wrap fee, usually covering all expenses [though it does not have to be all-inclusive]

In the case of NTMS, the plan sponsor and participants incurred one-time fees, transaction-based fees, and asset-based fees. The fees from the NTMS were in addition to the mutual fund expenses charged by the investment managers. Plan participants had a lengthy list of mutual funds from which they could select where to place their fund balances. This scenario is not at all unusual.

Question 2

The contract did indirectly stipulate that NTMS could bill for transactions beyond a certain amount for mutual fund trades (part of Exhibit 3). The clause reads:

Excluding transactions that qualify for no transaction fee processing and One (1) mutual fund trade per account for each new payroll deduction cycle deferral limited to a maximum of twenty six (26) payroll deposits transactions per year per participant. This credit is nontransferable.

The potential problem is that unless the plan sponsor and plan participants are aware of the actual number of trades taking place over each quarterly billing cycle, they may easily lose track of the actual cost of transacting trades in their accounts. Also, the language of the clause could be written to more clearly indicate to which mutual fund trades the mutual fund fee applies. Specifically, all transactions, even dividend distributions, are subject to inclusion under this clause. For accounts held at a mutual fund company, the cost of these transactions are bundled in the overall fund fee. But, as these accounts were held at a brokerage firm, each mutual fund trade (including receipt and reinvestment of dividends) resulted in a transaction fee. Assurant's reaction to the termination fee suggested they may not have been fully cognizant of this and were "surprised" upon receipt of a termination invoice.

As NTMS regularly chose to waive certain types of fees, having the custodian provide, at least annually, an accounting record for each account (or in the aggregate for all accounts) of the fees that were waived but accrued would potentially reduce or eliminate sponsor/participant misunderstanding.

Question 3

In the securities and investment advisory business, it is a long-standing requirement for agents to notify a customer (prior to opening an account) of wrap fees to be incurred or potentially incurred (Goldenberg and Stone). This entails information as to the size of the fee and the frequency at which it is to be applied. At least quarterly, the agent (or custodian or plan administrator) must send to each accountholder a statement that shows a variety of information about the account, including all fees and expenses charged to the account in that reporting period. It is not customary that prior to the sending of the quarterly statement and the imposition of the wrap fee that a customer would receive prior notification of the impending charges. It is sufficient and within the guidelines for the notification to be the quarterly statement on which the fees and expenses are specified. Based on conversations with NTMS and personal knowledge of the broker-dealer, quarterly statements were being sent to each accountholder and the wrap fee (if it was charged that period) was disclosed on the statement.

Question 4

Listing this information on every quarterly statement might have reduced the surprise that Assurant indicated on receipt of the termination invoice. There is a growing chorus asking for more and better disclosure of fees in employee benefit plans (AARP, 2008). Current regulations do not require complete and regular disclosure of all fees and expenses. New regulations from the Department of Labor will require, beginning in 2009, more detailed reporting of fees and compensation. The new requirement applies to ERISA plans but not to non-ERISA plans, such as the one in question between Assurant and NTMS. Statements could be modified to show the total number of transactions each period, separated into two groups: those transactions for which a charge was applied and those transactions for which the fee was waived but accrued.

WHEN TO USE THIS CASE

Depending on the emphasis of the instructor, this case will fit into several different courses. For example, a Principles of Investments course may have a chapter on mutual funds and fund fees. If the instructor chose, she could expand the standard material to include the more encompassing detail of this case. In a Portfolio Management course (often combined with investments) this case will fit neatly when the instructor chooses to focus on the more practical aspects of money management, not only the financial theory of investment management. For example, when I teach Portfolio Management, the course divides rather neatly into two components. The first component

includes the standard theory of mean-variance optimization, working through the Markowitz model, CAPM, and the Arbitrage Pricing Theory. The second component is a series of exercises in managing a portfolio: equity, fixed income, cash, and alternative investments. I include administrative matters, such as fiduciary responsibilities, investment policy statements, and measuring manager performance. This “practical” portion of the course provides a good fit for this case. In a Business Law course, the instructor would have several options. The case could be the basis for a discussion of contract law. In addition, the case, coupled with the actual contractual agreement, might be used for a discussion of best practices for written communication of seemingly complex legal arrangements.

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AUTHOR INFORMATION

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APPENDIX A

An overview of the Assurant 409(A) employee benefit plan. There are also two grandfathered plans with slight variation in detail.

Eligible Employees

- Executives selected for participation with at least \$125,000 of base salary or \$200,000 of annual compensation.
- Outside directors

Deferral Amount

- Up to 50% of base salary
- Up to 100% of bonus and commissions
- Up to 100% of director fees

Employer Contributions

- Discretionary contributions may be awarded for certain individuals

Vesting

- Employee deferrals: fully vested at all times
- Discretionary contributions (if any): vesting schedule established when granted and may differ by individual

Interest Crediting

- Based on deemed investment options

Deferral Options

- Class-year elections
- In-service (minimum of two years)- can elect fixed dates in 25% increments
- To termination of employment
- Re-deferrals allowed 12 months before scheduled distribution date with a minimum re-deferral of 5 years of separation from service, if sooner

Distribution Options

- Lump sum or 5, 10, or 15 annual installments

NOTES