

BankDirector

Breakout 4:
**Avoiding Legal Pitfalls
for a Successful
Compensation Program
in 2024**

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#BBTF23

Avoiding Legal Pitfalls for a Successful Compensation Program in 2024

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Speaker Bios



Constance Brewster, Partner

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Constance Brewster advises clients on all aspects of employee benefits and executive compensation matters from design, implementation, compliance and day-to-day administration of qualified and nonqualified retirement plans, welfare benefit plans and executive and other compensation programs to fiduciary best practices and governance. She routinely works with clients on complex corporate transactions and restructurings to address pre- and post- M&A employee and benefit transition issues for clients in highly regulated industries, such as financial services.



Emily Zimmer, Partner

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Emily Zimmer counsels clients on a wide range of employee benefit and executive compensation issues, including issues related to corporate mergers and acquisitions. She routinely advises on the design, implementation, and administration of qualified and nonqualified retirement plans and welfare benefit programs, including wellness programs, health care accounts such as HRAs, Health FSAs and HSAs, adoption reimbursement programs, and educational assistance programs. Emily also provides compliance advice, including with respect to reporting and disclosure requirements, ACA compliance obligations, COBRA benefit continuation rights, and HIPAA portability, nondiscrimination, privacy, and security issues.

Table of Contents

1. 401(k) Litigation
2. Pooled Employer Plans (PEPs)
3. Equity Grant Best Practices: Best Practices to Avoid Risks
4. Increasing Stock Ownership of Employees and Directors

401(k) Litigation

What is it and how can it be avoided?

Regulatory Landscape

ERISA

Governs the conduct and responsibility of plan fiduciaries. Rules are enforced by the Department of Labor (DOL) and private litigation.

- ERISA sets forth strict requirements for plans, employers, and plan fiduciaries, including:
 - Reporting
 - Disclosure
 - Fiduciary Duties
 - Prohibited Transactions

Internal Revenue Code (Code)

Imposes various requirements necessary in order to obtain favorable tax treatment. The Internal Revenue Service (IRS) enforces these requirements.

- Various requirements for favorable tax treatment include:
 - Participation rules
 - Non-Discrimination Rules
 - Distribution Restrictions
 - Contribution and Benefit Limitations

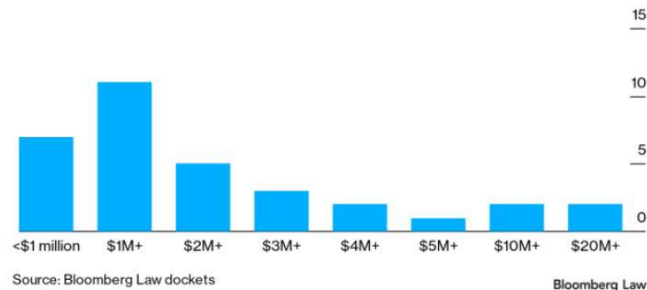
401(k) Litigation Trend

- Litigation against plans is costly and common regardless of the size of the plan
- There has been a significant increase in the number of class action lawsuits alleging mismanagement of 401(k) plans, with approximately 80 new cases filed in 2022
- The types of plans being sued were initially large plans with billions in plan assets, but smaller plans with assets in the millions have been targets as well.

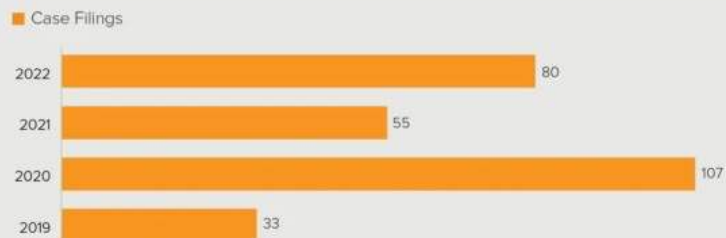
In 2022:

- 24 settlements equaling more than \$160 million
- Settlements amounts from \$900,000 to \$32.5 million
- Many cases settled at relatively early stages

401(k) Fee Suits Grow in Number, Shrink in Size
Most settlements in cases filed since 2019 worth less than \$2 million



New ERISA Cases Brought Regarding Retirement Plans (2019 – 2022)



Source: [Mondag.com](https://mondag.com/) / Goodwin Procter LLP

401(k) Litigation Trend – Common Allegations

Excessive recordkeeping fees

Choosing a higher-cost share class

Failing to remove poorly performing funds

Excessive expense ratios

Using active investment strategies instead of passive

Failing to understand the totality of the fees (e.g., revenue sharing)

Failing to remove company stock

Money market vs. stable value funds

Standard vs. customized TDFs

Conflict of interest/self-dealing

Excessive investment options (i.e., university cases)

Failure to follow investment policy statement

401(k) Litigation Trend – 2023 Examples

- (1) [Advance Publications, Inc.](#) 401(k) plan participants sued alleging breach of fiduciary duties concerning a \$1.5 billion plan (June 13, 2023).
- (2) [Wake Forest University Baptist Medical Center](#) settled a proposed class action over excessive recordkeeping service fees while offering investments with expense ratios far higher than those in similar retirement plans (May 24, 2023)
- (3) [O'Reilly Automotive](#) beat proposed class action alleging mismanagement of \$1.1 billion 401(k) plan by offering overly expensive funds and high fees (May 24, 2023)
- (4) [Aspirus, Inc.](#) 401(k) plan participants are set to receive a \$1.5 million settlement and \$500,000 attorney's fee award (May 3, 2023)
- (5) [Coca-Cola Bottlers' Association](#) received preliminary court approval for a \$3.3 million class settlement (May 1, 2023)
- (6) [Mutual of America Life Insurance Co.](#) signed a \$2.75 million settlement agreement in a proposed class action challenging the affiliated investment funds and recordkeeping services in its 401(k) plan (April 17, 2023)

Consequences for Fiduciary Breach

Direct Consequences

- Personal Liability
- Liability for Prohibited Transaction
- Liability Relating to Employer Stock Investments
- Criminal Penalty
- Offset of Plan Benefits
- DOL Civil Penalty

Indirect Consequences

- Loss of reputation in community
- Increased fiduciary liability insurance premiums or denial of coverage
- Removal and disbarment from acting as a future fiduciary
- Disclosure of fiduciary breach on personal filings, such as loan applications, securities, licenses, and any job or charitable board application

Mitigating the Risk of Getting Sued

Have a regular benchmarking process for plan service providers (every 3-5 years)

- Recordkeepers
- 401(k) plan investment advisors

Have a great investment lineup

- Appropriate diversity
- Broad range of investment options; but not excessive

Beware of what is included in publicly available information

- Reflect good fiduciary practices on publicly available information, such as Form 5500s (e.g., include in audit report if a benchmarking assessment was conducted)
- Carefully complete Schedule C of Form 5500

Avoid the appearance of impropriety

Strategies to Reduce Potential Damages

Understand what your duties are and comply with them

ERISA fiduciary duties include:

- **Duty of Loyalty/Exclusive Benefit Rule**
- **Duty of Care**
 - Duty of Prudence
 - Duty to Diversify
 - Duty to Monitor
 - Duty to Follow Plan Documents
- **Duties Related to Co-Fiduciaries**

Strategies to Reduce Potential Damages

Identify fiduciaries

- Consider establishing an investment committee
- Consider a third-party investment advisor

Annual fiduciary training

Regularly review all plan fees – meet at least quarterly

- Understand the totality of the fees, including any revenue sharing arrangements
- Continually monitor to see if a less expensive share class is available
- Have a scoring methodology to highlight poorly performing funds and remove those funds as necessary

Document fiduciary decisions and reason for decisions

Adopt policies and procedures to establish a prudent investment process



Strategies to Reduce Potential Damages

Annual review

- Are disclosures appropriate/being followed?
- Are fees in order?
- Is diversity of investments appropriate in light of current events?

Always follow Investment Policy Statements

Have a rigorous conflict of interest policy and follow it

Have strong cybersecurity practices

Protect the attorney/client privilege in communications with outside counsel

What To Do If You Get Sued

Don't Panic

Contact fiduciary insurer

Contact outside counsel to consider viability of claims

Preserve all evidence

Issue a Litigation Hold – a notification sent to employees instructing them not to delete electronically stored information (ESI) or discard paper documents that may be relevant to a new or imminent legal case.

Avoid discussing case with those who would not be under privilege, including the Plaintiff(s) in the case



Pooled Employer Plans (PEPs)

What are they and what are their legal benefits and liabilities?

What is a Pooled Employer Plan (PEP)?

Congress provided for Pooled Employer Plans (PEPs) in the [Setting Every Community Up for Retirement Act of 2019 \(SECURE Act\)](#)

- A PEP is an individual account plan (such as a 401(k)), established or maintained for the purpose of providing benefits to the employees of two or more employers
- Employers do not need to share a common interest other than adoption of the plan
- Plans help employers, especially small unrelated employers, reduce burdens and costs associated with workplace retirement savings options
- The SECURE Act allowed pooled plan providers to start operating PEPs on January 1, 2021

What is a Pooled Plan Provider (PPP)?

Pooled plan providers manage PEPs.

- A pooled plan provider (PPP) is the named fiduciary of the plan, plan administrator, and the person responsible for the performance of all administrative duties to comply with ERISA requirements
- PPPs must register with the Department of Labor prior to beginning operations
- Approximately 120 PPPs have registered with the Department of Labor

Pros and Cons of PEPs

PROs

- Attractive to small or medium-sized employers that want economies of scale and are willing to cede a large degree of control over their plans
- Reduced administrative costs (Form 5500, audit, bonding, etc. are all done at the plan level)
- Reduced work for the plan sponsor (PPP assumes responsibility for administrative duties and provides the plan document)
- Economies of scale (may offer lower-cost fees that would otherwise only be available to larger plans)
- Reduced fiduciary exposure (but employer retains fiduciary liability for choosing and monitoring the PPP)

CONs

- Limited or no ability to choose recordkeepers
- Limitations on investment choices (PPP chooses investment menu; employer has limited or no flexibility on investment menu)
- Inflexibility in plan design (may have limited ability to structure different benefits than offered by PPP)
 - E.g., annuity forms of distributions

Not All PEPs are the Same

There are key differences among various PEP providers:

- **Fees and how fees are applied**

- PEPs may utilize a flat fee, an added expense load to the assets invested, a participant fee, or a combination of all three
- The size of fees among providers can vary greatly—in one investment consultant's experience, fees differed as much as three times for a prospective plan sponsor

- **Flexibility in their offerings**

- Some PEPs have limited flexibility, for example, no loans, no hardship withdrawals, a standard payroll feed, or a required safe harbor design

- **Fiduciary responsibility**

- PEP providers vary in terms of how much fiduciary responsibility they will assume

Exposure to Lawsuits

PEPs not yet the subject of ERISA lawsuits

- While attorneys have not yet specifically targeted PEPs, they have filed suit against other types of multiple-employer plans. Legal challenges include:
 - Excessive investment fees
 - Poorly performing investments
 - Inadequate monitoring of administrative costs
- A PEP provider is more vulnerable to lawsuits than the plan sponsor due to the differing size of available assets
- Plan sponsors could still be vulnerable to lawsuits for failing to adequately select or monitor the PEP provider

Fiduciary Responsibility

Legal Benefit

PPPs are the PEP named fiduciaries

- However, this does not absolve plan sponsor employees from fiduciary liability

To Mitigate Risk:

- Conduct an RFP to fully analyze and compare PPPs and PEPs
- Develop a process for monitoring
- Document everything

Legal Risk

Sponsors retain fiduciary duties

Selection of a PEP and its provider is a fiduciary act under ERISA. As such, participating employers retain fiduciary responsibility for the selection and monitoring of the PEP provider. Considerations should include:

- *Fee models*: Are PEP fees competitive and commensurate with services provided?
- *Withdrawal*: Are withdrawal fees, penalties or restrictions reasonable?
- *Investment and management of assets*: Unless the PEP has delegated responsibility, employers retain responsibility for the management of assets attributable to their employees

Equity Grant Practices

Best Practices to Avoid Risks

What awards can be granted under the plan?

- **Award types authorized by plan**

- Restricted Stock
- Profits Interests
- Restricted Stock Units (Phantom Equity)
- Stock Options (NQSOs and ISOs)
- Stock Appreciation Rights
- Does plan permit unrestricted stock awards?
- Some states limit the types of equity awards banks can grant
- Regulators limit the types of equity awards de novo banks can grant

- **Plan limits**

- Maximum shares authorized under plan
- Plan recycling provisions
- Annual per person limits
- Non-employee director compensation limits

- Shares registered on Form S-8 (public companies only)

Who has authority to grant award?

- **Board**
- **Compensation Committee (if delegated in plan or by Board)**
 - Compensation Committee must recommend or approve awards (*NYSE/NASDAQ companies only*)
- **CEO/CFO/CHRO (if delegated in plan or by Compensation Committee)**
 - Typically limited to specific number of shares
 - Short-swing profit rule: Should be limited to non-Section 16 insiders (*public companies only*)
 - Should be limited to non-executive employees (*NYSE/NASDAQ companies only*)

Who can receive award?

- ISOs may only be granted to employees
- Former employees and directors typically cannot receive awards (*unless serving in consultant or advisor role*)
- Does plan permit awards to **directors of subsidiaries or advisory directors**?
- Does plan permit awards to **consultants or advisors**?
- Is the proposed award consistent with stated **purpose of plan**?

What does the committee or board need to decide?

- Grant [date](#)
- [Who](#) is receiving the award (name, title, group number)
- [Number](#) of options, SARs, shares, RSUs or PSUs granted (or formula)
- [Exercise price](#) and [expiration date](#) for options, SARs
- [Vesting terms](#), including specific performance criteria and payout calculations for performance-based awards
- [Dividend treatment](#)
- [Treatment upon termination](#) (forfeit or accelerated vesting)
- [Treatment upon Change in Control](#)



When can an award be granted or amended?

- **Shareholder approval to adopt or amend an equity plan is required:**
 - If company listed on [NYSE/NSDAQ](#) (with limited exceptions)
 - If [state law](#) requires shareholder approval for equity plans of banks
 - If plan contains [ISOs](#)
- **Duration of plan**
- **Prior to termination of employment or board service**
- **Form S-8 registration prior to issuance of shares of a public company**
- **Consider blackout periods and material inside information when timing grants**
- **Remember: before awards are granted or compensation plans are adopted or amended, determine who has the authority to approve the action**

Know what you have and estimate what you will need!

Share Counting

- State corporate law purposes
- Plan compliance purposes
- Dilution

Recycling Provisions in Plan

- Gross versus net share counting
- Forfeited or expired awards

Performance-Based Grants

Estimates of Future Needs

Don't Forget About 409A!

Code Section 409A governs the timing of deferral elections and the time and form of payment of deferred amounts under a **nonqualified deferred compensation plan or arrangement (“NQDC”)**

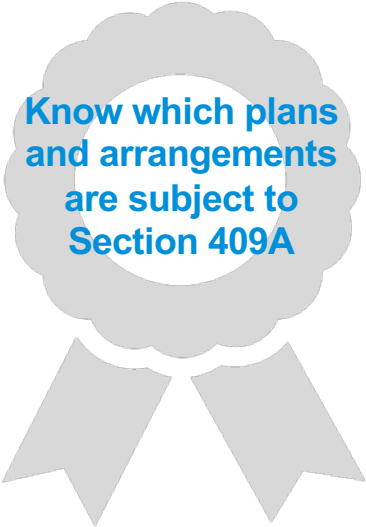
- Depending upon terms, certain equity awards may be NQDCs

Failure to comply with Section 409A can result in **severe penalties.**


- Deferred compensation becomes taxable to employee
 - Deferred amount is subject to additional 20% tax penalty plus a potential premium interest tax
- Employer also subject to penalties for failure to properly withhold taxes or report violations to IRS
 - Plus any claims from employees resulting from employer failures

Don't Forget About 409A!


Ways to Reduce Risks under Section 409A:



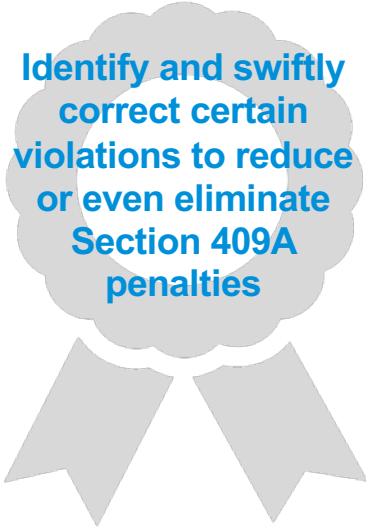
Know which plans and arrangements are subject to Section 409A



Think of Section 409A whenever an employee terminates



Review Section 409A compliance on an annual basis



Identify and swiftly correct certain violations to reduce or even eliminate Section 409A penalties

Increasing Stock Ownership of Employees and Directors

Increasing Stock Ownership of Employees and Directors

Traditional Equity Grants

- Stock options, restricted stock, RSUs, PSUs
- Unrestricted stock (only if authorized by plan)

Company Policies for Stock Ownership

- Stock ownership guidelines for directors and officers
 - Monitor compliance and enforce consequences for non-compliance
 - Review levels in light of market volatility
- Retention requirements beyond vesting for equity grants
- Can strengthen equity grants by encouraging strategies that produce results beyond vesting date

Director Elections to Receive Stock in Lieu of Cash Director Fees

- Elections should be made only during open trading periods
- Shares require formal grant by board or compensation committee
- Shares need to be granted under equity plan (*remember* – in most cases, must be approved by shareholders)
- Confirm plan permits grant of unrestricted stock to directors

Increasing Stock Ownership of Employees and Directors

Dividend Reinvestment Plan (DRIP) / Dividend Reinvestment and Stock Purchase Plan (DRSPP)

- Additional purchases can be funded by payroll deduction (DRSPP)
- No SEC registration if use third-party administrator and shares come from market purchases (*non-exempt public companies*)
- If shares come from the company, need to track shares used against shares authorized and registered
- Elections and sales from plan only during open trading periods

Increasing Stock Ownership of Employees and Directors

Employee Stock Purchase Plan (ESPP)

- Purchases can be funded by payroll deduction
- If stock to be sold at discount, must comply with IRC 423
 - Shareholder approval of plan within 12 months
 - No more than 15% discount to FMV
 - Almost all employees must be allowed to participate
 - 5% shareholders may not participate
 - \$25,000 limit per year per employee
- SEC registration required (*non-exempt public companies*)
- Need to track shares used against shares authorized and registered
- Elections and sales from plan only during open trading periods

Employee Stock Ownership Plan (ESOP)

- Method for making profit sharing and other employer contributions in stock with all of the protections and tax advantages of a qualified plan
 - Additional regulatory requirements
 - Additional fiduciary obligations

Increasing Stock Ownership of Employees and Directors

Company stock fund offered through a 401(k) plan

- Requires SEC registration even if all shares come from market purchases (*non-exempt public companies*)
- Purchases funded by payroll deduction
- Need to track shares used against shares authorized and registered
- Elections, intra-plan transfers and sales from plan only during open trading periods
- May not be possible for companies with limited liquidity
- Imposes additional fiduciary obligations

Questions and Contact Information



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Thank you!

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