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An In-Depth Look at Employee Benefit Plans and Unclaimed Property Laws

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Unclaimed Property Statutes and Escheat

At times, a state takes mere possession of unclaimed property. In other cases, a state claims title to the property (historically, this was through a process known as "escheat"). The distinctions between escheat and possession under an unclaimed property statute are becoming increasingly blurred, with the terms being used interchangeably in some circumstances. Each of these processes has its origin in centuries-old feudal times, when a lord or the king could take property under certain circumstances. Modern due process requirements protect the owners of property, and require a more formal process to establish a state claim.

Normally, any transfer of property held by the state to a rightful owner would be without any change in value from the time the custody was previously taken by the state. Although a rightful owner may reclaim the property. because the state has an interest-free loan of the property, it may not be anxious to make a swift transfer.

ERISA provides even further protections against governmental claims to the property of a covered benefit plan.

ERISA Preemption

ERISA sought to establish a uniform national set of rules for specified types of employers and employee benefit plans. In enacting ERISA, Congress wanted to encourage employers to provide benefits to employees, and to create and protect certain participant rights. At the same time, Congress wanted to avoid the burden, expense and inconsistent results which could occur for both employers and employees if different state laws applied from one jurisdiction to the next. ERISA thus prohibits the application of "any and all State laws insofar as they now or hereafter relate to any employee benefit plan…." The term commonly used for this broad prohibition against state involvement in covered employee benefit plans is "ERISA preemption" of state law. There are very narrow exceptions to ERISA preemption of state law, primarily allowing states to enforce insurance, banking and securities laws of general application. Thus, for example, a state may not be able to regulate a benefit plan directly, but within limits it can regulate an insurance company which insures plan benefits. With limited exceptions for multiple employer welfare arrangements (MEWA), ERISA prohibits a benefit plan which an employer self-insures from being treated as an insurance company, thus preventing state regulation of the plan as an insurance company. Principles are slowly evolving to determine when a statute sufficiently "relates to" an employee benefit plan and may thereby be preempted by ERISA.

For What Types of Benefits Might ERISA Preemption Apply

ERISA preemption of state law can exist only when ERISA applies and a plan is involved. Not all types of employee benefits are covered by ERISA, nor are all benefit arrangements a “plan.” Employer-sponsored retirement plans (both tax-qualified and non-qualified), severance benefits, medical coverage (including dental, vision, drug, health reimbursement accounts, medical flexible spending accounts, and employee assistance plans which provide counseling), life insurance, and long term disability programs are generally (but not always) subject to ERISA. A few less common other types of benefits may be subject to ERISA in some cases. Thus, in any circumstance involving benefit plan assets, it must be determined whether the state is seeking the assets of a type of plan which is subject to ERISA. There must also be a “plan” involved. As a broad simplification, to have an ERISA plan there must be some administrative discretion which will need to be exercised (e.g., regarding eligibility) and some level of ongoing administration. Thus, for example, a one-time lump sum severance pay agreement between an employer and an employee may be an ERISA-type benefit but not a plan, in which case ERISA preemption could not apply. On the other hand, a general severance pay program may constitute an ERISA plan.

ERISA Does Not Apply to Certain Employers

Just as ERISA does not apply to all types of benefits, neither does it apply to all types of employers. The key exclusions from the application of ERISA are for governmental instrumentalities and “non-electing” church plans. Church plans may elect to be subject to ERISA, a rare and generally irrevocable election which should be considered carefully. ERISA preemption of state law thus could not apply unless the employer is subject to ERISA, so that determination is necessary.

The View of The Federal Courts Regarding ERISA Preemption

If both the employer and the type of benefit are subject to ERISA, and if a plan exists, only then may a state's claim to plan assets be preempted by ERISA, but only if the statute sufficiently “relates to” the ERISA plan and only if no exception applies.

The federal courts have been unwilling to permit states to require the application of unclaimed property or escheat laws to apply to ERISA plan assets. In an often-cited court opinion involving an Illinois claim to assets which clearly belonged to an ERISA plan, the court stated that under the Illinois unclaimed property statute “The state does not acquire title to the property. It is merely a custodian….In effect, the property is an interest free loan to the state – in perpetuity if the owner never shows up to claim it… The state becomes the plan administrator with respect to those assets…in violation of ERISA's provisions regarding plan administration… it depletes those assets, by taking the interest that accrues on them…[and thus]…the state would actually be reducing [participants'] ERISA benefits…. ERISA's preemption clause, and the case law interpreting it, make clear that a state cannot take over the operation of an ERISA plan, no matter how forcefully it argues that it can do a better job than the plan's trustees and administrators.”

By contrast, an earlier decision by a different federal appeals court held that the state could claim amounts held in an insurance company's (Aetna) reserve account. The reserve account held money to cover checks written by Aetna for ERISA plan benefits which it had insured. Some of those checks were not cashed for years, at which time the state claimed Aetna's assets which backed the checks. Neither the employer which sponsored the insured group medical plan, nor the plan itself, had any claim to any amounts in the insurance company's reserve account, whether or not the benefit checks were ever cashed. Thus, the plan never had possession of those particular funds, and never would under any circumstances. However, all claim-related amounts paid by Aetna, including amounts paid to the state from Aetna's reserve account under the unclaimed property statute, would be taken into account by Aetna in the claims experience rating of the plan, and thus could increase the plan's future premium costs. The court noted that the statute did not require any significant additional “primary” administration by the plan itself as a result of the state claim, nor did it change the plan benefits. The court then concluded that ERISA preemption did not apply, even though there might be some effect on the plan, because any effect would be too indirect and remote. The court went on to note that this was a traditional exercise of state power and, in the court's view, did not pose a significant threat of inconsistent treatment from state to state. Thus, the state could claim Aetna's assets, at least where the effect on the plan itself was indirect and remote, didn't change plan benefits, and did not add significantly to plan administration.

The U.S. Treasury Department and IRS View

The Treasury Department and the IRS regulate and enforce federal tax laws, including the tax laws which apply to some employee benefit plans. Whether or not ERISA applies to a plan is generally irrelevant for tax law purposes, which have a different purpose and focus than does ERISA. However, there are some tax law rules which merit at least consideration when escheat or unclaimed property statutes might apply.

The federal tax laws regarding employee benefit plans are not *required* to be followed, but the tax effects on the employer and/or the employee are worse if they are not followed. The tax laws do not require the vesting of plan benefits over time, other than for tax-qualified retirement plans. Once vested, taxqualified retirement plan benefits may not be forfeited or taken from the participant under the plan itself, except under very narrow circumstances. Tax-qualified retirement plan assets are required to be held in a "spendthrift" trust, under which the benefits are free from the claims of creditors or others outside of the plan, again except under very limited circumstances. Among the exceptions allowing at least the conditional loss of a vested benefit is where there is an "inability to find the participant or beneficiary to whom payment is due." In that case, under Treasury Department regulations a plan is permitted to conditionally forfeit even a vested retirement benefit, "provided that the plan provides for reinstatement of the benefit if a claim is made by the participant or beneficiary for the forfeited benefit. In addition, a benefit which is lost by reason of escheat under applicable state law is not treated as [an impermissible] forfeiture." Thus, the Treasury regulations allow a conditional forfeiture inside of the plan (in which case there may be nothing for the state to claim), and also allow a plan to provide for escheat under state law. Although there is no express requirement in the Treasury Regulation that any escheat to the state must be voluntarily, a plan is not required to include such a provision, so the voluntary nature of any escheat appears effectively to be required. It should be noted that there is no similar express provision in the Treasury Regulation permitting a surrender of a retirement plan benefit to a state under an unclaimed property statute, though again those distinctions have blurred.

U. S. Department of Labor

In Advisory Opinion Letter 94-41A, the DOL noted that a Texas unclaimed property statute would directly affect core plan functions and reduce trust assets, and concluded that because the statute did not fall within the exception allowing states to regulate insurance, banking or securities, it could not be applied to take custody of plan assets. Similar conclusions were reached by the DOL in Advisory Opinions 78-32A (Illinois statute), and 79-30A (California statute).

By contrast, in 1983 Advisory Opinion 83-39A, the DOL concluded that the New York Abandoned Property Law was not preempted by ERISA, in circumstances similar to that involved in the Aetna court decision discussed above, where the assets really belonged to an insurance company and the effect of the plan was negligible.

In 1995, the DOL issued a letter to the National Conference of Commissioners on Uniform State Laws, expressing concern that the states were trying to apply the Aetna decision too broadly in developing a model law for unclaimed property. The DOL noted that the proposed law would "significantly interfere with the administration" of ERISA plans if applied directly to a plan, requiring additional records, notices to missing persons and to the states, interest payments, and potentially large penalties and fines. In addition, the DOL noted that turning over custody of plan assets to the state would result in the state holding those assets outside a trust and administered contrary to ERISA. Furthermore, the DOL argued that there was "serious doubt" about the earlier Aetna court decision, because the U. S. Supreme Court had since indicated that any state law is preempted if it relates to an ERISA plan, even if "the effect is only indirect."

The DOL has made it clear that ERISA preemption can apply to any type of ERISA plan. The same principles should apply to both pension and welfare plans, though state involvement in third-party-insured welfare plans should allow more state involvement, both because the assets may be insurance company assets and because a state is generally allowed to enforce insurance statutes of broad application.

If the positions in both Advisory Opinion 83-39A and the 1995 letter to the National Conference of Commissioners on Uniform State Laws remain valid in the view of the DOL, then the Department's general view would be that ERISA preempts all state laws which "relate to" any ERISA plan. However, preemption of state law won't occur where the assets sought by the state are not actually plan assets, provided the statute does not significantly affect the plan, its benefits, its assets or its administration. The DOL has "serious doubt" that even indirect effects on a plan are permitted.

Circumstances Matter

The DOL initially made it clear in Advisory Opinion 94-41A that it did not necessarily agree with the Treasury Department position that escheat of pension plan assets should be permitted. Of course, the focus of these agencies is dramatically different. Where they apply, the tax laws are focused on plan coverage and reasonably equivalent benefits. The DOL is concerned with fiduciary responsibility and the protection of plan assets. As a result, even between federal regulatory agencies there has not always been clear agreement on what is permitted.

However, even the DOL recognizes that sometimes, under some circumstances, someone else has to take control of plan assets. What happens when a plan terminates, benefits need to be distributed to close down the plan and its associated trust, and some participants are missing or nonresponsive? What if the employer will no longer exist, or there will not be any remaining trust to hold the assets separate from the company assets? For tax-qualified account balance plans (like 401(k) plans), if the employer or an affiliated entity has another similar tax-qualified retirement plan, then for tax law purposes if the participant does not consent to a distribution the plan benefit generally must be transferred directly to that other plan of the employer or its affiliate. Such a transfer would keep the assets in a tax-qualified plan and, coincidentally for purposes of this article, in another ERISA-covered plan. ERISA preemption would then continue to apply to those assets in the successor plan.

If there is no other plan of the employer or of some affiliate, then for terminating defined benefit pension plans, there are procedures under which trust assets can be transferred to the Pension Benefit Guaranty Corporation (PBGC), a wholly-owned subsidiary of the United States government and existing by virtue of ERISA. The PBGC then assumes the ultimate liability for payment. There is no known instance where a state sought unclaimed benefits from the PBGC, but if it arose the PBGC would presumably deny the claim, based either on ERISA preemption or sovereign immunity.

For defined contribution plans like 401(k) or profit sharing plans, the PBGC has no statutory authority, so a transfer of assets to the PBGC is not a possibility under current law. At the same time, because the DOL knows that there may still be "missing participants" after adequate efforts to find them, it has indicated that the assets should be sent to an IRA established in the participant's name, when possible. If that isn't possible, the employer "may consider establishing an interest-bearing federally insured bank account in the name of the missing participant or *transferring missing participants' account balance to state unclaimed property* *funds….*[W]e do not believe that the principles set forth in Advisory Opinion 94-14A, which dealt with a plan fiduciary's duty to preserve assets held in trust for an ongoing plan, prevent a plan fiduciary from voluntarily deciding to escheat missing participants' account balances under a state's *unclaimed property statute* in order to complete the plan termination process." Thus, after decades of ERISA's application, the DOL has indicated that at least where there is no other option the plan fiduciaries may "voluntarily" send plan assets to the state if establishment of an IRA or bank account in the participant's name is not possible. For years after passage of the Patriot Act, it was difficult to establish accounts in the name of a participant without the participant's signature. However, with the passage of time and additional guidance from the federal government, this is now a fairly easy process. Of course, if assets are transferred to a bank account or IRA the benefits would no longer be plan assets and the state could clearly claim the bank account or IRA eventually as unclaimed property.

Plan Design Matters

As discussed above, sometimes the permissible application of an escheat or unclaimed property statute depends upon whether the assets are to be transferred to the state voluntarily. Under ERISA, for a plan to make a voluntary transfer of assets to a state by escheat, the plan document would have to provide for such a transfer. As permitted under Treasury Regulations, plans are allowed to provide for an escheat of benefits payable to missing participants (though the DOL may disagree under some circumstances). More commonly, a plan would provide instead for a forfeiture within the plan, which would not appear to be an issue for either the DOL or IRS.

If a forfeiture occurs within the plan and the participant or beneficiary later appears, the benefit is required to be reinstated within the plan. It is not clear what would happen if the plan later terminated without a successor plan to assume the normal obligation to re-establish the benefit if the participant appeared. Although a successor plan would assume the contingent obligation to restore the benefit, it does not appear that the employer would have any obligation to restore the account balance based on the termination of the plan, in order to allow a transfer to an IRA or a bank account. If there is no continuing obligation of some plan to restore the benefit, and no transfer to an IRA or bank account, then the participant could actually be in a worse position than if the state had taken the assets.

It is common today for plans to force retirement plan distributions of small account balances after a participant leaves employment. Balances of $1,000 or less can be sent to the participant, and balances of up to $5,000 can be transferred to an IRA. While there may be some dispute as to whether a state can claim assets underlying an insurance company check for insured welfare plan benefits, pension plan assets should be free from state claims if checks remain uncashed. However, where an IRA is established to receive pension plan funds, the assets cease to be ERISA plan assets and state law can apply to those assets, including unclaimed property laws.

So, Where Are We?

We believe that states will be increasingly aggressive in seeking unclaimed property. When plan assets are involved, there appears to be an uneasy truce under which the states view the question of ERISA preemption as unsettled, posing the possibility of expensive litigation. In some cases, a state may request the assets, but drop the issue upon resistance from a plan representative. Given the position of the DOL and the IRS, if the assets being sought are either trust assets under a tax-qualified plan or true assets of any ERISA plan, the plan fiduciary who turns over assets to the state is exposed to personal liability for any loss to the plan for having done so.

Where the assets being sought are third-party insurance company assets, with the plan having no right to the assets whether or not a benefit claim is made, the state can in some circumstances collect those assets from the insurance company, with little or no involvement by the company or the plan (though insurance rates may increase). Where the assets being sought are benefits under a self-insured employer-sponsored ERISA benefit plan, whether as a result of an uncashed check or otherwise, ERISA preemption should prevent any successful state claim.

For a non-ERISA benefit arrangement, ERISA preemption of state law is not an issue, and a state can assert a claim after the required waiting period.