

MEMORANDUM

To: Amy Pechacek, Interim Director, ERS
Date: March 8, 2017
Client: Employees' Retirement System of the County of Milwaukee
Subject: Addressing Overpayments in ERS

BACKGROUND

Periodically, a member¹ of the Employees' Retirement System of the County of Milwaukee ("ERS") may receive more benefits than the member is entitled to receive under the Milwaukee County Ordinances and ERS Rules (an "overpayment").² Tax-qualified retirement plan sponsors³ are obligated by law to cease overpayments and restore these losses to the plan (*i.e.*, make the plan whole).

The following reviews the applicable legal guidance, the options for making a plan whole, ERS's current procedures to recover overpayments, and changes the County could make to ERS's procedures.

¹ For purposes of this memorandum, the term "member" also includes beneficiaries of ERS members.

² In this memorandum, the term "overpayment" means both the amount erroneously paid to a member and all applicable interest, as required by the Internal Revenue Service.

³ The County is the Plan Sponsor of ERS.

ANALYSIS

1. Requirement to Make Plan Whole.

a. Fiduciary Duty. The Employee Retirement Income Security Act of 1974 ("ERISA") governs most private retirement plans. ERISA does not directly apply to government plans such as ERS, but ERISA and its related rules and case law provide important guidance for government plan sponsors. Courts will often look to ERISA case law in evaluating claims involving a government plan. *See, e.g., State ex rel. Cannon v. Moran*, 321 N.W.2d 550 (Wis. Ct. App. 1982), *rev'd*, 331 N.W.2d 369 (Wis. 1983). ERISA requires plan fiduciaries to discharge duties "solely in the interests of the participants and beneficiaries." 29 U.S.C. § 1104(a)(1). ERISA further requires that plan assets "be held for the exclusive purposes of providing benefits to participants in the plan and their beneficiaries and defraying reasonable expenses of administering the plan." 29 U.S.C. § 1103(c)(1). These requirements are commonly referred to as the Exclusive Benefit Rule.

Under ERISA, a fiduciary has an obligation to collect money owed to the plan, including overpayments made from the plan. *See, e.g., Dep't of Labor Advisory Op. 77-32A* (a fiduciary is required to "attempt...to collect money owed to the plan, including recovery of erroneous payments made from the plan."). Consistent with the Exclusive Benefit Rule, courts have required plans to recover overpayments to ensure that funds are available to pay benefits to all members. *See, e.g., Northcutt v. Gen. Motors Hourly-Rate Emps. Pension Plan*, 467 F.3d 1031 (7th Cir. 2006) (noting reimbursement of overpaid plan benefits is vital to ensuring sufficient funds remain for the payment of benefits to all other beneficiaries of the plan); *Adams v. Gen. Motors Co.*, 547 F. App'x 661 (6th Cir. 2013) (fiduciaries serve all plan beneficiaries and have a duty to seek the return of erroneous payments so all beneficiaries may receive the promised benefits).

b. The Internal Revenue Code. The Internal Revenue Code (the "Code") mirrors ERISA's Exclusive Benefit Rule and requires a qualified plan to be established by "an employer for the exclusive benefit of his employees or their beneficiaries." 26 U.S.C. § 401(a). Consistent with the Exclusive Benefit Rule, Treasury Regulations require that a qualified plan be "a definite written program and arrangement which is communicated to the employees and which is established and maintained by an employer." Treas. Reg. § 1.401-1(a)(2)-(3). Under these requirements, a plan may pay benefits only as provided for in the plan document.⁴ Payment of benefits exceeding those dictated by the written plan violates the Code and must be corrected to maintain the plan's tax-qualified status. Rev. Proc. 2016-51 § 5.01(3)(c).

It is important for a plan to maintain its tax-qualified status because a retirement plan that satisfies applicable requirements of the Code enjoys favorable tax treatment. If the Internal Revenue Service ("IRS") "disqualifies" a plan for failing to comply with the Code, the plan loses its tax-exempt status. Among other consequences of disqualification, employees' pension benefits may become taxable income, and the pension fund's investment earnings can also be taxed. 26 U.S.C. § 402(b).

2. Options to Make Plan Whole. Plan sponsors and fiduciaries have discretion to determine how to make a plan whole for overpayments. The IRS's Employee Plans Compliance Resolution System ("EPCRS") describes methods to correct plan errors, including overpayments, and to keep plans tax-qualified. Rev. Proc. 2016-51. EPCRS allows plan sponsors to correct overpayments by: (1) recovering the overpayment from the member; (2) contributing the overpayment to the plan; or (3) adopting a retroactive amendment to align the plan document with the plan's operation. Rev. Proc. 2016-51 § 6.06(3). The following reviews these options in more detail.

⁴ ERS's plan document consists of Ordinance section 201.24 and the ERS Rules (Appendix B).

a. Recovery from Members. Plan sponsors often first attempt to recover overpayments from members. The plan sponsor will typically send a letter to the affected member explaining the error and the resulting change to the member's benefit. As part of that letter, the plan sponsor will also request repayment of the overpayment. Rev. Proc. 2016-51 §6.06(3); Rev. Proc. 2016-51, App. B § 2.04(1)(a)(i). If a member is not entitled to future benefits and refuses to repay the overpayment, recovery may be difficult. Plans may ask counsel to send a demand letter and, if the overpayment is large enough, to initiate litigation against the member.⁵ However, if the cost of recovery outweighs the likelihood of recovery, the plan sponsor may choose to contribute the overpayment to the plan. *See, e.g., McMahon v. McDowell*, 794 F.2d 100 (3d Cir. 1986) (a plan fiduciary did not breach its duty by failing to take steps to enforce a claim to the extent the fiduciary reasonably believed that such action would be futile).

If a member continues to receive benefits and refuses to repay an overpayment in a lump sum, a plan may recover the overpayment through offsetting all or a portion of the member's future benefits over a period not longer than the remaining payment period (*i.e.*, usually the member's life expectancy).⁶ Rev. Proc. 2016-51 §6.06(3); Rev. Proc. 2016-51, App. B § 2.04(1)(a)(ii)(A).

As explained above, regardless of the method used to pursue recovery from members, the plan must be made whole for overpayments. Therefore, the plan sponsor must contribute any overpayments not recovered from a member (*e.g.*, the member dies before all repayments are made or refuses to repay the overpayment). Rev. Proc. 2016-51 § 6.06(3); Rev. Proc. 2016-51, App. B § 2.04(1)(a)(i).

⁵ ERS and the Pension Board have successfully argued that recipients must repay overpayments to ERS. *Walker v. Milwaukee Cnty.*, No. 15 CV 006288 (Wis. Cir. Ct. June 20, 2016). However, courts in the ERISA context have limited the remedies under which a plan sponsor may recover overpayments through litigation. *See, e.g., Verizon Emp. Benefits Comm. v. Adams*, No. Civ. A. 3:05-CV-1793-M, 2006 WL 66711 (N.D. Tex. Jan. 11, 2006) (plan could not recover overpayments through use of ERISA section 502(a)(3) action).

⁶ ERS and the Pension Board have successfully argued that a mistake was made and offset is appropriate to recover an overpayment. *Baldwin v. Milwaukee Cnty.*, No. 15 CV 009354 (Wis. Cir. Ct. Oct. 24, 2016).

b. Plan Sponsor Contributes Overpayments. Plan sponsors may also voluntarily contribute overpayments to the plan instead of attempting to recover the overpayment amounts from members. Rev. Proc. 2016-51 § 6.06(3). For example, some plan sponsors have determined as a policy matter that certain overpayment amounts are too small to justify the time, cost and effort to recover from members (*e.g.*, \$100).⁷ In such circumstances, the plan sponsor will then voluntarily contribute those small amounts to the plan.

Plan sponsors may consider adding exceptions to a general rule that the plan sponsor contributes certain overpayments to the plan. For example, a plan sponsor may establish procedures under which the plan sponsor will normally contribute overpayments under \$100, but the plan sponsor will not be required to contribute those amounts if the member knew or should have known of the overpayment (*e.g.*, fraud or incorrect information provided to the plan office). If the plan determines the member should have known of the potential for overpayment, the plan sponsor may reserve the right to pursue the member for the full amount of the overpayment.

EPCRS also allows "another person" to contribute the amount of the overpayment to make the plan whole. Rev. Proc. 2016-51 § 6.06(3). The IRS does not define who would constitute "another person," but a plan sponsor might use this option when a third-party caused the overpayment. For example, if a plan's actuary or outside third-party administrator miscalculated benefits, the plan sponsor could pursue the third-party instead of the member for the overpayment. The circumstances under which the County could use this option are likely limited, as its own employees administer ERS, but the County could address such scenarios as part of any revisions to ERS's overpayment procedures.

c. Retroactive Amendment. EPCRS also allows a plan sponsor to adopt retroactive amendment(s) to conform the plan document to the plan's operations. Rev. Proc.

⁷ EPCRS specifically provides that if the total amount of an overpayment is \$100 or less, the plan sponsor does not have to seek the return of the overpayment from the member. Rev. Proc. 2016-51 § 6.02(5)(c).

2016-51 § 6.06(3). This generally must be done through a Voluntary Correction Program ("VCP") submission to the IRS. If the IRS approves the retroactive amendment(s), the overpayments will be corrected, and the affected members will not be required to make any payments to the plan. For example, within the context of its 2007 VCP filing with the IRS, the County corrected the majority of the "buy in" and "buy back" errors using this retroactive ordinance amendment method.

d. Recovery Procedures. As noted above, a plan sponsor has discretion to determine if and when it will voluntarily contribute overpayment amounts to a plan and when it will pursue members for the overpaid amounts. However, a plan sponsor must act on a consistent and uniform basis in its treatment of overpayments (*i.e.*, the plan sponsor cannot "cherry pick" which overpayments to pursue). Rev. Proc. 2016-51 § 1.02. To ensure consistency, plan sponsors should consider developing and implementing consistent procedures for recovering overpayments. Recovery procedures or guidelines provide clarity to plan participants (to set expectations for recoveries) and to the plan administrator.

e. Appeals. If a plan sponsor chooses to recover overpayments from members, a plan sponsor will often allow a member to appeal the benefit change and the request to repay the overpayment. By offering proper appeal procedures (including mandatory certiorari review by a court) plans and review boards may invoke the deferential arbitrary-and-capricious standard of review in litigation. *See e.g., Antisdell v. City of Oak Creek Police and Fire Comm'n*, 609 N.W.2d 464 (Wis. 2000); *Ottman v. Town of Primrose*, 796 N.W.2d 411 (Wis. 2011). Under that standard, the member must prove the review board acted "without a rational basis." *See, e.g., Clark v. Waupaca Cty. Bd. of Adjustment*, 519 N.W.2d 782 (Wis. Ct. App. 1994). Plans can show they acted with a rational basis by implementing recovery and appeal procedures that dictate a clear record of actions taken to review the member's circumstances and of the reasons for the review board's decision.

3. Current ERS Overpayment Procedures.

a. Current Rule 1050. Rule 1050 (copy attached) was adopted by the Pension Board in September 2012 to provide procedures for correcting benefit errors and recovering overpayments. Rule 1050 is divided into two parts, one describing how to correct benefit errors and the other providing procedures for offsetting future benefits to recover overpayments.

i. Correcting Benefit Errors. Under Rule 1050, upon discovery of a payment in error, Retirement Plan Services ("RPS") takes the following steps:

- RPS determines whether a benefit should have been paid under the Ordinances and Rules.
- If the member is not entitled to any future benefits, RPS sends a letter to the member explaining the error and requesting repayment of the overpayment, plus interest.
- If the member is entitled to future benefits, but in a different amount, RPS prospectively pays the member the correct benefit. RPS also sends the member a letter explaining the error and the change in the benefit amount. The letter further notifies the member of the overpayment and RPS's decision to offset the member's future benefits (if applicable and as described below).
- Members may appeal RPS's decision that the benefit was paid in error, using the appeal procedures of Rule 1016 (copy attached).

ii. Offsetting Benefits to Recover Overpayments. For members continuing to receive benefits after the errors are corrected, the second part of Rule 1050 authorizes ERS to recover overpayments (plus interest at a 5% rate⁸) by offsetting a member's future benefits utilizing the following steps:

- RPS decides the amount of the offset, taking into account the factors listed in Rule 1050.⁹ RPS has stated that in determining the amount of the offset, staff generally works with ERS's actuary to actuarially offset the member's benefit to recover the overpayment over the life

⁸ EPCRS requires interest to be charged on overpayments in order to make the plan whole. Rev. Proc. 2016-51 § 6.06(3); Rev. Proc. 2016-51, App. B § 2.04(1)(a). As part of the 2007 VCP, the IRS required ERS to use a 5% interest rate for overpayments.

⁹ The factors are: (1) the reason for the overpayment; (2) the life expectancy of the member; (3) the amount of the benefit versus the amount of the overpayment; and (4) the financial resources of the member.

expectancy of the member. Rev. Proc. 2016-51 §6.06(3); Rev. Proc. 2016-51, App. B § 2.04(1)(a)(ii).

- RPS sends the member a letter detailing the error and noting that if the overpayment is not repaid in a lump sum, the member's benefit will be offset. The letter also notes the details regarding the offset (*e.g.*, the date the offset will commence and the offset amount). This letter may be the same letter that notifies the member of the error.
- The member may initially appeal the decision to offset and the amount of the offset to the Pension Board. If the member appeals prior to the date of offset provided in the letter, then the offset will not commence unless and until the Pension Board affirms the decision to offset and the amount of the offset.
- The member may also appeal under Rule 1016 up to 120 days after receipt of the offset letter. However, if the member does not initially appeal (as described above), the member's offset will commence as of the date provided in the letter.

The appeal aspects of the Rule were drafted to allow ERS to offset as soon as possible while still providing the member with a meaningful appeal. Because members generally appeal the error, the offset, and the amount of the offset simultaneously, the Pension Board could revise Rule 1050 and Rule 1016 to streamline the appeal process. *See* Section 4, *infra*.

b. Appeal Procedures. As noted above, defined benefit plans often include appeal procedures to allow members to appeal decisions related to benefit errors and requests to repay overpayments. Rule 1016 is ERS's primary appeal rule and allows members to appeal RPS's benefit determinations to the Pension Board. Rule 1050 allows members to appeal RPS's decisions regarding offsets. Further, in response to challenges to the appeals process, the Pension Board adopted Rule 1055 in November 2014 (copy attached). Rule 1055 includes specific safeguards to ensure that Pension Board decisions are impartial. For example, only the Pension Board and counsel are part of the closed session discussions regarding appeals.

Pursuant to these Rules, the steps described below are taken when RPS makes an adverse benefit determination (including a decision to offset a member's benefit). By

following these steps, the Rules provide for, and courts have evaluated Pension Board decisions under, the arbitrary and capricious standard.

The steps are as follows:

- RPS sends a letter to the member explaining the adverse decision.
- If the member appeals the decision (under Rules 1016 and/or 1050), RPS schedules the appeal and the member receives a letter from the Pension Board Chairman with information about the Pension Board meeting and the deadline to submit additional information.
- A summary of the appeal with the facts, the applicable Ordinances and Rules and an analysis of the appeal is sent to the Pension Board directly from Pension Board counsel or Corporation Counsel's office. RPS receives a partial summary with the facts and applicable Ordinances and Rules. This allows RPS to confirm the facts but not influence the analysis.
- At the meeting, the Pension Board hears the appeal from the member in open session and all statements, as well as all documents submitted, become part of the record.
- The Pension Board then discusses the appeal in closed session. Employees of RPS are not allowed to be present.
- The Pension Board reviews RPS's decision under a de novo standard of review and issues its decision in open session. Pension Board counsel and Corporation Counsel's office assist the Chairman and Vice Chairman in preparing a written Pension Board decision.
- The written decision explains the facts as determined by the Pension Board and the Pension Board's conclusions based on the Ordinances and Rules and applicable law. The written decision also becomes part of the record.
- The decision is sent to the member along with a letter from the Pension Board Chairman noting that this is the Pension Board's final decision, which may be reviewed by a court.

4. Potential Revisions to Rule 1050. As noted above, plan sponsors and fiduciaries have significant discretion in deciding how to make a plan whole due to an overpayment of benefits. Accordingly, the County could retain ERS's current overpayment procedures or request that the Pension Board amend Rule 1050 to change the procedures. The following discusses some options for the County Board to consider.

Because ERS currently offsets all members' future benefits to recover overpayments, the options described below address how the County could voluntarily contribute overpayments to ERS. In considering each option, it is important for the County to consider the potential costs of each option. Different options may result in more expenses for the County depending on the circumstances of the overpayments discovered after a particular option is implemented. Additionally, unless an exception is included, any change the County makes applies to all overpayments (*e.g.*, retirees whose benefits are terminated due to fault or delinquency). If the County decides to contribute overpayments for some members, there could be challenges to that decision.

Once the County has decided what, if any, changes it would like made, counsel can prepare proposed amendments to Rule 1050 and confirm that the modifications requested by the County are acceptable given tax and legal considerations, many of which fall outside of the scope of this memorandum.

Potential County Contribution	Example	Notes
The County would contribute overpayments under a certain amount.	The County implements a dollar threshold of \$100. Member A has an overpayment (including interest) of \$90. The County contributes \$90 to ERS, and Member A makes no repayment.	<ul style="list-style-type: none"> • \$100 is suggested because EPCRS preapproves this as a <i>de minimis</i> amount. Rev. Proc. 2016-51 § 6.02(5)(c). Another amount could be used (<i>e.g.</i>, \$5,000).
The County would contribute the portion of the overpayment accrued outside of a certain time limit.	The County implements a time threshold of 24 months. Member B received an overpayment for three years. ERS pursues Member B for the most recent 24 months of the overpayment. The County contributes the amount that accrued for the first 12 months of the overpayment.	<ul style="list-style-type: none"> • Because interest accrues from the date paid, under this option, the County would pay the 12 months of the overpayment plus the interest that has accrued on the first 12 months of the overpayment.

Potential County Contribution	Example	Notes
The County would pay the amount of the overpayment accrued outside of a certain time limit but only up to a certain amount.	The County implements a time threshold of 24 months and a dollar limit of \$5,000. Member C received an overpayment for three years. ERS would pursue Member C for the most recent 24 months of the overpayment. The County would contribute the amount that accrued for the first 12 months of the overpayment, up to \$5,000. Member C would be responsible for paying the remaining amounts.	
The County would contribute the interest accrued on overpayments.	Member D's overpayment is \$10,000 with \$800 of accrued interest. ERS pursues Member D to recover the \$10,000 overpayment, and the County contributes the \$800 of interest.	
The County would contribute the interest that has accrued on the overpayment, but only up to a certain amount.	The County agrees to pay interest on overpayments up to \$10,000. Member E's overpayment is \$50,000 with \$9,000 of accrued interest. ERS pursues Member E to recover the \$50,000 overpayment, and the County contributes the \$9,000 of interest.	
The County would contribute overpayments reported as part of the pending 2014 VCP.	Member F's \$60,000 overpayment is reported as part of the pending 2014 VCP. The County contributes the overpayment, and ERS does not pursue the member.	
The County would contribute the overpayments reported as part of the pending 2014 VCP up to a certain amount.	The County agrees to pay overpayments reported on the pending 2014 VCP up to \$10,000. Member G has an overpayment of \$15,000 that is reported on the VCP. The County contributes \$10,000, and Member G is responsible for repaying the remaining amounts.	

Attachments.