

## Governmental Plans

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*National Specialty Practices*



**Question:** We are a public library and have always considered our employee benefits plans to be governmental plans not subject to ERISA. We understand that several years ago there was a lot of litigation about the status of governmental plans and whether or not certain entities should be relying upon the ERISA exemption for governmental plans. What should we consider when reviewing our plans' status as governmental plans?

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**Summary:**

Whether or not plans are properly considered "governmental plans" has been the subject of significant litigation in recent years. Challenges have been raised to plans sponsored by various governmental entities like public hospitals and other health care systems, libraries, schools, etc.

If a plan is determined to be a governmental plan, it is exempt from ERISA requirements. Being exempt from ERISA, however,

is a double-edged sword. While its requirements designed to protect plan participants do not apply, likewise, the protections of ERISA preemption which plan sponsors may appreciate do not apply. Lack of ERISA preemption allows state law claims, including claims for punitive damages, to be brought in lawsuits concerning those plan benefits.



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#### **Detail:**

Governmental plans are exempt from the Employee Retirement Income Security Act (ERISA).<sup>1</sup> Application of that simple statement is trickier than one would think. This is because ERISA does not define key terms in the definition of a governmental plan, and this leaves the question of whether a plan meets the definition open to interpretation and litigation.

ERISA defines a governmental plan as one that is established or maintained by the government of the United States, the government of any state or political subdivision thereof, or by any agency or instrumentality of the foregoing.<sup>2</sup> However, ERISA does not define key terms in that definition including: "political subdivision," "agency," or "instrumentality," nor are they defined by any regulations.<sup>3</sup> As a result, the answer to whether a plan is a governmental plan must be decided in light of numerous Department of Labor (DOL) advisory opinion letters and court cases. The DOL has stated: "[W]hether an entity is a political subdivision, agency or instrumentality of government for purposes of ERISA section 3(32), depends on the facts and circumstances of the relationship between government and the entity whose benefit arrangement's status as a "governmental plan" is in issue."<sup>4</sup> And, in many cases, whether a plan is governmental or not will depend on how the employer is treated under state law.<sup>5</sup> This means that two similar employers in different states may be treated differently such that one employer's plan is considered governmental while the other's is not.

The use of the disjunctive "or" means that a plan can either be established by a governmental entity or maintained by a

governmental entity.<sup>6</sup> It does not have to be both established and maintained. The Internal Revenue Code (Code) has a substantially similar definition of a governmental plan, but uses the conjunctive "and" instead of the disjunctive "or" that is used in ERISA.<sup>7</sup> Nevertheless, the DOL has consulted with the Internal Revenue Service (IRS) concerning its Advance Notice of Proposed Rulemaking: Determination of Governmental Plan Status (ANPRM)<sup>8</sup> that includes definitions of a governmental plan and would apply a facts and circumstances analysis, with many factors, to determine whether an entity is a governmental employer whose plans would be exempt from the Code. The ANPRM includes definitions of key terms under the Code's definition of a governmental plan, including (1) "established and maintained," (2) "United States," (3) "agency or instrumentality of the United States," (4) "state," (5) "political subdivision of state," and (6) "agency or instrumentality of a state or political subdivision of a state." The DOL and the IRS have agreed that it would be advantageous to have coordinated criterion for determining whether a plan is a governmental plan.<sup>9</sup>

Over the years, the DOL has repeatedly found that governmental plans also include plans established and maintained pursuant to collective bargaining between a government employer and a labor union if the plan covers only governmental employees and former employees and it is substantially funded by the governmental employer.<sup>10</sup> Likewise, the DOL has ruled that permitting a de minimis number of private employees to participate in a plan that otherwise meets the definition of a governmental plan will not cause a plan to no longer be considered governmental.<sup>11</sup>



## Agency or Instrumentality

The agency or instrumentality requirement is one of the most frequently litigated questions in governmental plan cases. Some courts have used a six factor test to determine if an employer is an agency or instrumentality:

1. Whether it is used for a governmental purpose and performs a governmental function;
2. Whether performance of its function is on behalf of one or more states or political subdivisions;
3. Whether there are any private interests involved, or whether the states or political subdivisions involved have the powers and interests of an owner;
4. Whether control and supervision of the organization is vested in public authority or authorities;
5. If express or implied statutory or other authority is necessary for the creation and/or use of such an instrumentality, and whether such authority exists; and
6. The degree of financial autonomy and the source of its operating expenses.<sup>12</sup>

In one relatively recent case interpreting the agency or instrumentality requirement, a federal district court analyzed whether a plan sponsored by a New York public library was a governmental plan using the six factor test. *Skornick v. Principal Financial Group et al*, (S.D.N.Y. April 18, 2019).<sup>13</sup>

The first factor looks at whether the organization does something that the government would otherwise have to do and whether it is done in a manner similar to how the government would do it.<sup>14</sup> The *Skornick* court found that a library operating as a non-profit entity did not perform an essential governmental function.<sup>15</sup> Under New York law, some libraries are “public” while others are “association” libraries like the one before the *Skornick* court. Association libraries are established and controlled by a group of private individuals operating as an association while a public library is “established for free public purposes by official action of a municipality or district or the legislature, where the whole interests belong to the public.”<sup>16</sup> This factor was important, but not dispositive to the court’s analysis.<sup>17</sup> The court contrasted a situation where a state statute created a mass transit authority for the benefit of all the people of a state (which a court found to be performing an essential governmental function).<sup>18</sup>

The second factor looks at whether the organization’s function is on behalf of one or more states or political subdivisions. The *Skornick* court rejected an argument that a library’s providing free educational benefits to the public is a function performed on behalf of a political subdivision. To find otherwise, the court said, would sweep



large numbers of non-profit organizations outside of the reach of ERISA, something the court did not think Congress intended.<sup>19</sup>

The third factor looks at whether there are private interests involved or whether the states/political subdivisions have the powers and interests of an owner. In the library situation, the state provided funding through a contract and allowed employees to participate in the state’s retirement system. The *Skornick* court found that this type of funding did not equate to ownership where the organization does its own hiring/firing, manages its own budget, and decides which programs to offer.<sup>20</sup>

The fourth factor looks at whether control and supervision of the organization is vested in public authority or authorities. The *Skornick* court found that this factor was in favor of finding governmental status since most of the Board that ran the library consisted of city officials or people appointed by city officials.<sup>21</sup>

The fifth factor looks into what authority was required in order to create the instrumentality. The *Skornick* court found this factor to be neutral.<sup>22</sup> The library was created by state law. But the contract between the library and the city acknowledged the separate corporate identity and existence of the library.



The sixth factor looks at the degree of financial autonomy the entity has and the source of funding of its operating expenses. The *Skornick* court found that while the library relied upon significant financial support from the city, the library exercised a sufficient degree of financial autonomy such that this factor was neutral.<sup>23</sup>

Applying all six factors to the association library situation, the *Skornick* court concluded that the library's benefits plan was not a governmental plan exempt from ERISA.<sup>24</sup> As noted above, the six factor test is not the only test regarding the agency or instrumentality requirement.

Other courts have used a test known as the *Alley* test outlined in the *Alley v. Resolution Trust Corp.* case.<sup>25</sup> The *Alley* test focuses on the nature of an organization's relationship to its employees and its governance of its employees.<sup>26</sup> The court considered factors such as whether the employees were included in the civil service system and whether the employees were subject to personnel rules or restrictions on salaries and benefits usually imposed on federal employees.

Additionally, in the ANPRM, the IRS has created a different list of factors, broken out into "major factors" and "other factors," to determine whether an entity is an agency or instrumentality of a state or political subdivision of a state.

**The major factors are whether:**

- The entity's governing board or body is controlled by a state or political subdivision;
- The members of the governing board or body are publicly nominated and elected;

- The entity's employees are treated in the same manner as employees of the state (or political subdivision thereof) for purposes other than providing employee benefits (for example, the entity's employees are granted civil service protection);
- A state (or political subdivision thereof) has fiscal responsibility for the general debts and other liabilities of the entity (including funding responsibility for the employee benefits under the entity's plans); and
- In the case of an entity that is not a political subdivision, the entity is delegated, pursuant to a statute of a state or political subdivision, the authority to exercise sovereign powers of the state or political subdivision (such as, the power of taxation, the power of eminent domain, and the police power).<sup>27</sup>

**Additional factors are whether:**

- The entity is created by a state government or political subdivision pursuant to a specific enabling statute that prescribes the purposes and powers of the entity and the manner in which the entity is to be established and operated;
- The entity is directly funded through tax revenues or other public sources;
- The entity is treated as a governmental entity for federal employment tax or income tax purposes (for example, whether the entity has the authority to issue tax-exempt bonds under section 103(a) of the Code) or under other federal laws;

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- The entity's operations are controlled by a state or political subdivision;
- The entity is determined to be an agency or instrumentality of a state or political subdivision thereof for purposes of state law. For example, the entity is subject to open meetings laws or the requirement to maintain public records that apply only to governmental entities, or the state attorney general represents the entity in court under a state statute that only permits representation of state entities; and
- The entity is determined to be an agency or instrumentality of a state or political subdivision thereof by a state or federal court for purposes other than [Code section 414(d)].<sup>28</sup>

The ANPRM was issued in 2011. Unfortunately, nothing further has been issued in the many years since. No "proposed regulations" have been published, which are a precursor to "final regulations." Thus, clarity in the area of defining governmental plans (from just the IRS perspective) is still years away.

This above discussion of the singular phrase "agency or instrumentality" highlights the fact that whether a plan is a governmental plan or not requires a complicated, fact intensive analysis. Other undefined terms in the ERISA definition of a governmental plan have been litigated in similar fashion. Therefore, it is impossible to announce a short, quick rule to apply when faced with the question of whether a plan is governmental or not.

### ***Atrium Lawsuit***

In November of 2018, a class action lawsuit was initiated against a health care system headquartered in North Carolina.<sup>29</sup> The lawsuit alleged that Atrium Health, formerly known as Carolinas Healthcare System, erroneously claimed that its pension, 401(k) and health plans were governmental plans exempt from ERISA. The complaint alleged that the pension plan was significantly underfunded. According to the lawsuit, the plans at issue were not governmental plans because they were established by the Charlotte-Mecklenburg Hospital Authority (Authority), which is not a "political subdivision" or an "agency or instrumentality" of a governmental entity.

The District Court dismissed the case in 2019, after finding in relevant part that the Authority met the governmental plan definition as a "political subdivision" (declining to reach the alternative argument that the Authority was not an "agency or instrumentality" of a government entity).<sup>30</sup> The court applied the facts of the Authority's background, composition, tax-exempt status and registration as a municipal body to the standard for a "political subdivision"

based on the test established by the Supreme Court in 1971 in *NLRB v. Natural Gas Utility District of Hawkins County*.<sup>31</sup> Under *Hawkins*, the Supreme Court described "political subdivisions" as "either (1) created directly by the state, so as to constitute departments or administrative arms of the government, or (2) administered by individuals who are responsible to public officials or to the general electorate."<sup>32</sup> The court found that the Authority met both prongs after noting that one would have been sufficient; the first was met because the Authority was "created by the state of North Carolina through a delegation of its authority pursuant to the [Hospital Authority Act],"<sup>33</sup> and the second because, like *Hawkins*, public officials appointed the board and may be removed by the entity's governing members.<sup>34</sup>

This lawsuit is an example of another recent challenge to an employer's claim it is sponsoring governmental plans exempt from ERISA.



## Implications of Governmental Plan Status

If a plan is found to be a governmental plan, then it is exempt from ERISA and its many disclosure and reporting requirements. This means that governmental entities have greater flexibility in their plan design, structure and operation. Much of the litigation has focused on governmental retirement plans because of ERISA's funding and vesting requirements for those plans. Governmental retirement plans are not required to follow those onerous funding and vesting requirements like private employers are (this is part of what is alleged in the Atrium case above). However, there are implications for group health plans and other welfare benefit plans as well. For example, a governmental plan is not required to have a summary plan description or to follow ERISA's strict claims procedures rules. ERISA's civil penalties and broad fiduciary duties do not apply. And, Form 5500s are not required for governmental plans. Governmental plans are also exempt from ERISA's COBRA provisions, but the almost-identical COBRA provisions of the Public Health Service Act still apply to state and local governmental plans.<sup>35</sup> While some of these things sound favorable, there are disadvantages to being exempt from ERISA.

## Disadvantages of Being Exempt from ERISA

ERISA preempts (supersedes) state laws governing employee benefits to allow uniform administration of benefits for employers operating in multiple states. ERISA requires claimants to follow the plan's claims and appeals process and to exhaust those procedures before filing a lawsuit. Lawsuits are brought in federal court, not state court. State claims including misrepresentation, fraud, breach of contract, etc., some of which give rise to punitive damages, are not permitted. ERISA limits remedies to the value of the benefit not provided. Jury trials are not permitted, and the decisions made by the plan administrator are generally subject to an "abuse of discretion" standard of review that is favorable to plan administrators. Governmental plan participants, however, are free to bring their lawsuits in state court and to file state law claims, including claims for punitive damages, and they have the right to demand a jury trial.

## Conclusion:

Governmental plans are exempt from ERISA. However, there are complicated factual assessments to be performed when determining if a plan falls within the ERISA exemption for governmental plans. There is no "one size fits all" explanation and counsel should be involved in helping determine if a particular organization's plans can fall within the ERISA exemption.

### References

- 1 - ERISA §4(b)(1).
- 2 - ERISA §4(b)(1) and 3(32).
- 3 - DOL Advisory Opinion 2004-01A (January 27, 2004).
- 4 - DOL Advisory Opinion 2005-21A (December 21, 2005).
- 5 - See, e.g., DOL Advisory Opinion 1994-03A (February 7, 1994) (where political subdivisions jointly established a community hospital authority pursuant to a state statute, and the hospital authority operated and maintained a hospital, the hospital's plans were governmental plans); DOL Advisory Opinion 2005-01A (February 14, 2005) (Georgia state health plan created pursuant to state statute would still be governmental plan if employees of Georgia's Agricultural Commodities Commissions (created by state statute pursuant to state constitution) were permitted to be covered by the health plan).
- 6 - *Graham v. Hartford Life & Accident Ins. Co.*, 589 F.3d 1345 (10th Cir. 2009); *Gualandi v. Adams*, 385 F.3d 236, 242 (2d Cir. 2004).
- 7 - See Internal Revenue Code §414(d).
- 8 - Advanced Notice of Proposed Rule-making, <https://www.govinfo.gov/content/pkg/FR-2011-11-08/pdf/2011-28853.pdf>.
- 9 - Advanced Notice of Proposed Rule-making, <https://www.govinfo.gov/content/pkg/FR-2011-11-08/pdf/2011-28853.pdf>.
- 10 - DOL Advisory Opinion 2005-17A (June 22, 2005); DOL Advisory Opinion 2002-11A (October 17, 2002).
- 11 - DOL Advisory Opinion 2005-21A (December 21, 2005); DOL Advisory Opinion 2005-17A (June 22, 2005).
- 12 - *Rose v. Long Island R.R. Pension Plan*, 828 F.2d 910, 918 (2d Cir. 1987).
- 13 - <https://docs.justia.com/cases/federal/district-courts/new-york/nysdce/7-2018cv04324/493853/42>.
- 14 - *Skornick v. Principal Financial Group et al*, S.D.N.Y. April 18, 2019, <https://docs.justia.com/cases/federal/district-courts/new-york/nysdce/7-2018cv04324/493853/42>.
- 15 - *Skornick* at p.6.
- 16 - *Skornick* at p.7.
- 17 - *Skornick* at p.7.
- 18 - *Rose*, 828 F.2d at 916.
- 19 - *Skornick* at p.9.
- 20 - *Skornick* at pp.9-10.
- 21 - *Skornick* at p.12.
- 22 - *Skornick* at p.12.
- 23 - *Skornick* at p.13.
- 24 - *Skornick* at p.16.
- 25 - 984 F.2d 1202 (D.C. Cir. 1993).
- 26 - 984 F.2d at 1205 n.11.
- 27 - Advanced Notice of Proposed Rule-making, <https://www.govinfo.gov/content/pkg/FR-2011-11-08/pdf/2011-28853.pdf>.
- 28 - Advanced Notice of Proposed Rule-making, <https://www.govinfo.gov/content/pkg/FR-2011-11-08/pdf/2011-28853.pdf>.
- 29 - *Shore v. Charlotte-Mecklenburg Hospital Authority (D/B/A/ Atrium f/k/a/ Carolinas Healthcare System)*, (M.D.N.C. November 19, 2018) <https://s3.amazonaws.com/si-interactive/prod/plansponsor-com/wp-content/uploads/2018/11/20114803/ShoreAtriumComplaint.pdf>.
- 30 - <https://www.ncmd.uscourts.gov/sites/ncmd/files/opinions/18cv961moo.pdf>.
- 31 - *NLRB v. Natural Gas Utility District of Hawkins County*, 402 U.S. 600 (1971).
- 32 - *Hawkins* at p.400.
- 33 - *Shore* at p.571.
- 34 - *Shore* at p.580.
- 35 - PHSA §2201.

