Q&A with Ivins, Phillips & Barker

Fiduciary Considerations for an Expanding U.S. Pension Risk Transfer Market

Ivins, Phillips & Barker

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Kevin P. O'Brien is a partner in Ivins, Phillips & Barker's Employee Benefits and Executive Compensation practice. He is known for his work on innovative defined benefit plan design, flexible benefits, ERISA fiduciary matters and executive compensation. Kevin is a Charter Member of the American College of Employee Benefits Counsel and has been recognized by *Chambers, Best Lawyers in America and Super Lawyers*.

BCG: *Describe Ivins, Phillips & Barker and the role the firm has played in pension risk transfer transactions.*

O'Brien: We handled our first voluntary plan termination in 1977. We were very active in the spinoff termination cases in the late 1980s and received the first PBGC and IRS rulings supporting the use of participating annuities. We also worked with General Motors in obtaining the first IRS private ruling allowing lump sum offerings to retirees in 2012.

More recently, we advised the IBM fiduciary committee on the fiduciary aspects of settling approximately $16 billion in pension obligations via the purchase of annuity contracts from Prudential and MetLife. This was the second largest annuity closeout in U.S. history. Our work included conducting the RFP for the Committee's engagement of an independent fiduciary to make the annuity selection.

BCG: *Are there any recent legal developments affecting annuity buyouts?*

O'Brien: The legal aspects of PRT transactions have remained stable mainly because there have been no major insurance company failures that would serve to change fiduciary process and behavior. The IRS reopened the possibility of lump sums for retirees in 2019, but we have not seen retiree lump sums outside of full plan terminations.

There has been action at the state level. Virginia recently issued a memorandum noting that some insurers have issued PRT contracts without using State approved forms. We also saw a number of plan sponsors who had to re-issue annuity contracts covering New York participants when the New York State Department of Financial Services challenged PRT transactions that they asserted required New York licensing because of sales activity in New York. New York has now sanctioned four insurers for failure to license PRT annuities in New York. It appears that the issue was missed by all of the outside experts involved in the sanctioned transactions, and these cases highlight the need for PRT annuity advisors to sharpen their review.

Another seemingly unrelated development involves the Labor Department's proposed revisions to prohibited transaction exemption procedures when independent fiduciaries are involved. The DOL has proposed a tighter revenue test for determining independence as well as the prohibition of indemnification protection for independent fiduciaries. Some independent fiduciaries will not take on a case if they are not indemnified for their work. If adopted, any new exemption requirements could flow through to independent fiduciary PRT engagements.

On the legislative side, private equity firm ownership of PRT insurers has come under scrutiny. The new SECURE 2.0 legislation included a provision requiring the Labor Department to review Interpretive Bulletin 95-1 to determine if amendments are needed.

BCG: *Do "buy-in" contracts raise any particular issues?*

O'Brien: There is one significant legal issue that seems to be going unrecognized, and it involves general account "buy-in" contracts. If the general account "buy-in" is not a "guaranteed benefit policy" under ERISA," then an undifferentiated part of the insurer's general assets is deemed to be ERISA "plan assets," which raises a host of fiduciary and prohibited transaction issues. The Supreme Court's opinion in the 1993 Harris Trust case stated that a "guaranteed benefits policy" requires guaranteed benefits to participants and not just a guaranteed return to a plan. A "buy-in" contract generally has a conversion right to a conventional close-out annuity contract, but it is not clear that the conversion right provides a sufficient participant benefit to qualify as a "guaranteed benefit policy."

An independent fiduciary can serve in two capacities -- as a sole-acting fiduciary, or a co-acting fiduciary along with an in-house fiduciary. A sole-acting fiduciary has complete control over the selection process and the ultimate choice of insurer(s).

BCG: *Are you seeing plan sponsors decide on annuity contracts with separate account features? When is it appropriate to go with separate accounts?*

O'Brien: In our experience, annuities with separate account features have become common, especially if a "sole-acting" independent fiduciary is making the choice. Commingled separate accounts and dedicated separate accounts are seen in transactions above $500 million and dedicated separate accounts become more prevalent once a transaction reaches $1 billion. There is no hard and fast dollar threshold, however, and we are aware of a number of single insurer dedicated separate accounts for cases in the $250 million range.

BCG: *To what degree are plan sponsors engaging independent fiduciaries to make annuity provider selection in a sole-acting capacity? And, at what case size has this become more common in today's market?*

O'Brien: We see quite a few cases involving independent fiduciaries making the annuity selection in a sole-acting capacity. Using a sole-acting independent fiduciary is common for transactions at $1 billion and above, but we have also seen sole-acting independent fiduciaries commonly used in transactions in the $500 million range.

BCG: *What are the most important fiduciary considerations when planning for a PRT annuity buyout?*

O'Brien: The key is managing the natural conflict between a company's settlor role and the plan fiduciary's role. The business goal is for a cost-effective and swiftly executed annuity purchase, and the fiduciary's goal is to select a safe and secure annuity. To resolve the competing goals, the plan fiduciary must have a carefully crafted fiduciary process.

The key steps are:

1. Determine the composition of in-house fiduciary.
2. Decide whether to retain independent fiduciary, and if so, in what role.
3. Retain annuity placement advisor and other independent experts.
4. Negotiate and execute compensation, indemnification and confidentiality agreements with all outside advisors and fiduciaries.
5. Establish communication protocols between fiduciary and corporate officers.

The fiduciary process not only involves the structure for selecting the PRT insurer, but also involves decisions regarding the plan's asset portfolio and investment strategy, including the orderly disposition of illiquid and hard-to-value assets. With insurers willing to accommodate asset-in-kind premium payments, the investment work to ensure an efficient transaction cannot start too soon.

BCG: *Are there any particular legal tidbits involving PRT annuity buyouts that you would like to share?*

O'Brien: Yes, there are several items:

1. Be mindful of the ERISA Section 4044 allocation rules when describing the state guaranty protections afforded by an insurance annuity as compared to PBGC protection available under the ongoing plan. Plan retirees stand at the top of the ERISA Section 4044 allocation rules, which means that retiree benefits effectively are fully funded if there is a distress termination. Plan funding would have to fall drastically for retirees to lose that "first-in-line" protection in the ongoing plan.
2. There may be security enhancements that have gone untested so far. Some insurers reinsure PRT annuities through wholly owned affiliates. Plan fiduciaries might want to pursue so-called "cut-through" rights against any affiliated re-insurance. "Cut-through" rights would give plan participants direct rights against the re-insurer, and the re-insurance would not just be a general asset of the issuing insurer to be shared by all of the insurer's creditors in an insolvency.
3. There may be ways to enhance the protections of separate accounts beyond investment restrictions and over-funding the structure. After the insurance company failures in the early 1990s, some separate account GICs in a PRT annuity transaction were structured to give the contract holder first-perfected security interests in the assets of the separate account. This is a possibility that plan sponsors might want to explore.
4. Illiquid assets. There is an existing DOL prohibited transaction exemption that may allow the plan sponsor to buy back plan assets in certain cases.

BCG: *In closing, we will not hold you to this, but what is your forecast for the U.S. PRT market for the next 10 years given the market has experienced historic growth since the unprecedented GM and Verizon transactions in 2012 with 4,000+ transactions and over $270 billion in annuity premiums.*

O'Brien: Great question. The Milliman 100 Pension Funding Index indicated that the largest 100 defined benefit pension plans in the U.S. had an average funded status on an accounting basis of 110% at the end of December. So, using a baseball analogy, I would say early innings. After all, $270 billion represents under 10% of U.S. private-sector DB plan assets according to recent industry estimates.

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