CAMRADATA Analytical Services

The FIDUCIARY'S ROLE *in the* TERMINATION *of Single Employer* DEFINED BENEFIT PLANS: A PRACTICAL GUIDE

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INTRODUCTION: WHY YOU SHOULD READ THIS ARTICLE

De-risking their defined benefit pension plans has become the imperative goal of most plan sponsors. While de-risking takes many forms, the gold standard is termination of the plan and transfer of its liabilities to an insurer by purchase of a buy-out annuity contract.

Once the plan sponsor has decided to terminate the plan, the fiduciary is responsible for implementing the termination in compliance with ERISA and other law. The fiduciary's challenge arises from the structural tension between the fiduciary's ERISA obligations to act only in the best interests of the plan's participants, and the plan sponsor's legitimate business goals. The sponsor wants the termination to be cost-effective and swiftly executed within the sponsor's target interest-rate window. But the fiduciary's obligation under ERISA is for prudent selection of the buy-out annuity — according to the Labor Department, the "safest available" annuity — under a rigid timetable fixed by law and regulated by multiple government agencies. To resolve the tension between these competing goals, to bring the termination to a successful close as efficiently as possible, and to avoid even a perceived conflict of interest, the fiduciary must have a carefully crafted and well thought out fiduciary process.

The fiduciary is personally liable for any imprudent annuity selection. But the in-house fiduciary is typically broadly indemnified by the plan sponsor. A defective fiduciary process thus can leave both the in-house fiduciary and the plan sponsor contingently exposed to plan liabilities for up to six years after the annuity purchase, and even longer in the case of fraud or concealment.

Part I of this article sets forth a checklist of plan sponsor and fiduciary action. Part II expands on the fiduciary's risks and responsibilities in bringing the termination to a close.

I. CHECKLISTS

A. Plan Sponsor Checklist

- Retain annuity placement advisor to determine price point for cost effective termination
- Decide whether to add lump sum distribution options, and for which groups
- Amend plan to freeze benefits
- Determine appropriate funding strategy
- Initiate termination (entire plan, or retiree liabilities only, in "spin-off termination")

B. Fiduciary Checklist

(1) Create the fiduciary structure

- Determine identity and composition of in-house fiduciary
- Decide whether to retain independent fiduciary, and if so, in what role
- Retain annuity placement advisor and other independent experts (federal tax and securities law, ERISA, state insurance law, actuarial, insurance industry expertise)
- Negotiate and execute compensation, indemnification and confidentiality agreements of all outside advisors and fiduciaries
- Establish communication protocols between fiduciary and corporate officers

(2) Select the annuity provider

- Initiate and schedule fiduciary deliberation of factors listed in the Labor Department's Interpretive Bulletin (IB) 95-1 for prudent selection of annuity provider, and determine meaning of "safest available annuity provider" standard
- Initiate and complete data cleanup
- Initiate and review annuity advisor's list of selected annuity providers
- Conduct request for preliminary annuity proposals
- Review proposals and resolve any issues with annuity providers
- Obtain final bids on the basis of preliminary proposals
- Select annuity provider

(3) De-risk plan asset portfolio

- Devise investment strategy, including transition portfolio
- Initiate and complete orderly disposition of illiquid and hard-to-value assets

(4) Furnish all required government filings and participant notifications

- Submit required Pension Benefit Guaranty Corporation (PBGC) filings according to PBGC timetable
- File for IRS determination letter, including submission of required plan amendments
- Submit any required filings to state insurance commissioners

- Furnish all required notices to participants and beneficiaries (notice of intent to terminate [NOIT]; 204(h) notice of plan freeze, notice of plan benefits, etc.)

(5) Implement lump sum or other design amendments

- Ensure that all benefit elections observe requirements of Internal Revenue Code and ERISA

(6) Extra steps for spin-off termination

- Determine responsibilities for splitting assets between ongoing plan for active participants and terminated spinoff plan for retired participants

II. THE FIDUCIARY'S ROLE IN A PLAN TERMINATION

The ERISA Framework and Its Challenge

The decision to terminate the plan is made by the plan sponsor. The plan sponsor's decision to terminate is a "settlor" act. This means it is not governed by ERISA's fiduciary obligations and is not subject to fiduciary review. The decision may thus be made solely on the basis of financial and other business considerations. In practice, the plan sponsor will decide to terminate its plan only after obtaining information about buyouts and monitoring their pricing either from an annuity advisor or from commercial databases and other information sources.

The plan sponsor may decide to terminate the entire plan, or instead only the retiree liabilities in a spinoff-termination. In addition, the sponsor may decide to add a lump sum option, possibly including a lump sum for retirees in pay status. A high lump sum take rate before the termination will of course reduce the size of the annuity purchase. Moreover, the 2006 Pension Protection Act (PPA) allows lump sums to be valued using corporate bond interest rates, rather than the Treasury bond rate formerly required, making lump sums relatively less costly to the plan. Like any other benefit design change, adding a lump sum is a settlor decision and therefore may be made solely for the purpose of reducing the cost of the termination.

Even though it is a settlor decision by the plan sponsor to add a lump sum, it does add pressure to the fiduciary's task. The decision gives participants a one-time choice between a lump sum and an annuity, contingent on the long-term financial health of the issuer. Any such election is a potential invitation to later litigation by regretful participants. The fiduciary may have to take extra care to ensure that participant communications could in no way be viewed as encouraging the selection of one over the other, or as misstating or concealing relevant facts, and that elections are safeguarded with adequate information for informed participant choice.

Once these settlor decisions have been made, the fiduciary must implement them.

One head, two hats. ERISA's well known "two hat" doctrine allows an agent or employee of the plan sponsor to act as plan fiduciary. But when acting in its fiduciary capacity, the employee must act solely in the interests of plan participants. While incidental benefit to the sponsor is not prohibited, the fiduciary's deliberations may not take the plan sponsor's interests into account, but only those of the plan's participants and beneficiaries.

We have noted that in the case of a plan termination, potential tension exists between the plan sponsor's interests in a cost-effective annuity and the participants' interests in the safest available annuity. When such potentially divergent interests exist, the fiduciary has the duty to ensure that its decision is not conflicted, and indeed is not even perceived as conflicted.

Ensuring loyalty, independence, prudence and care. Several means have evolved by which the potentially conflicted fiduciary can establish that its decision was not influenced by the interests of the plan sponsor. These include (1) an intensive and independent investigation and decision-making process; (2) retention of an independent fiduciary; and (3) establishment of protocols governing communications between the fiduciary and the sponsor's financial decision makers.

The first of these — an intensive and independent investigation — is absolutely necessary, and its importance cannot be overstated. Both prongs are key. The fiduciary's "intensive" investigation must include thorough deliberations of all issues with the assistance of qualified experts. The fiduciary must make its decision independently of any influence of the plan sponsor's business interests. The good news for the fiduciary is that the fiduciary process to create an "intensive" and "independent" investigation needed to show non-conflicted decision making is also the process needed to show the fiduciary met its ERISA duties of prudence and care.

Showing how the fiduciary can build this process, for the purpose of ensuring that the fiduciary has met its duties of loyalty, independence, prudence and care, is the task of this article.

Process may be scaled to size. A practical question exists about how complex an apparatus is advisable to establish the fiduciary's independence and undivided loyalty. In the termination of a small or medium plan, where a safe annuity can be obtained with normal degrees of fiduciary prudence and care, less process may be thought necessary. But in a large termination involving billions or tens of billions of dollars of liability, the annuity purchase puts more pressure on the capacity of any one insurer, is more open to challenge, and may well be harder to defend as adequately safe given the size of the transferred liabilities relative to insurance industry capacity. Some experts estimate that the capacity of the leading insurers is currently perhaps not more than $80 billion. When interest rates and asset values converge to make terminations more attractive, and multiple sponsors compete for annuities, these very large terminations will put pressure on industry capacity and any annuity selection will be closely scrutinized for its adequacy by participants and perhaps the Labor Department. And as a reality of today's legal environment, the acts of large plan sponsors are more likely to be the target of class action lawsuits. In such a mega-termination, the fiduciary may want to create a robust process using extensive measures to demonstrate that the decision met the highest possible standards of prudence, care and independence from the business interests of the plan sponsor.

(1) CREATE THE FIDUCIARY STRUCTURE

The in-house fiduciary. The first step is to decide the identity of the in-house fiduciary. A large or complex defined benefit plan may have two fiduciaries: the plan administrator (typically a committee) and an investment committee, generally comprised of the sponsor's financial officers. It must be decided which of the two is the acting fiduciary — that is, the ultimate decision maker with respect to selection of the buy-out annuity. If instead it is decided that an independent fiduciary will be the acting fiduciary (as discussed below), it should be decided which of the in-house fiduciaries will be responsible for selecting the independent fiduciary. Selecting the independent fiduciary is itself a fiduciary decision. Each fiduciary's compensation should be reviewed to ensure that it provides no incentives — direct or indirect — for effectuating the termination, or meeting any price point or deadline. Such incentives might well be viewed as tainting the fiduciary's independence to a degree not salvageable even by careful process.

Independent experts. To fulfill its duties of loyalty, prudence and care, the fiduciary needs to tap expertise in several areas. In IB 95-1, the Labor Department takes the position that the fiduciary implementing a termination need not hire outside experts to the extent the fiduciary has the requisite expertise. This is rare. Typically, the fiduciary will at the least retain an annuity advisor. Additional independent expertise may be needed in ERISA, tax law, securities law, state insurance law, actuarial practice, and the economics and structure of the insurance industry.

The fiduciary should build in the time necessary to negotiate its advisors' agreements for compensation, indemnification and confidentiality — all key in a transaction with high dollar exposure and high employee sensitivity.

Independent fiduciary. When the in-house fiduciary is potentially conflicted with respect to a transaction, the Labor Department favors hiring an independent fiduciary to make or advise on the decision. In IB-95-1, the Labor Department takes the position that an independent fiduciary may be required for termination of an overfunded plan where the possibility of reversion exists. In today's economic climate, such cases are vanishingly rare. But the same tension exists even in termination of an underfunded plan. The potential conflict between the plan sponsor's interest in minimizing top-up funding contributions and participants' interests in a safe annuity is governed by the duty of loyalty, as is recognized by IB 95-1. Therefore, selecting an independent fiduciary may be desired in all cases.

An independent fiduciary can serve in many kinds of capacities — as advisory fiduciary, acting fiduciary, or co-acting fiduciary. In some cases, the annuity advisor may be willing to acknowledge fiduciary status in an advisory capacity much like an investment advisor. Alternatively, an independent fiduciary may be retained as the acting fiduciary. General Motors, for example, has stated that the selection of Prudential as its buy-out annuity provider was made by an independent third-party fiduciary. Another commonly used model is to have the independent fiduciary act as a co-decision maker, with effective veto power over the decisions of the acting in-house fiduciary.

Communications protocol. The fiduciary should create a protocol governing communications between the plan sponsor's corporate and financial personnel and their advisors, and the fiduciary and its advisors. Rules governing the content and means of communication will help create a record that the fiduciary's deliberations were independent of the plan sponsor's business interests. This may be especially advisable where the in-house fiduciary, rather than an independent fiduciary, is the acting fiduciary responsible for selecting the buy-out annuity.

Maintaining perceived independence is helpful for both fiduciary and non-fiduciary personnel alike. The fiduciary cannot show it met its duties of prudence, care and loyalty untainted by conflict unless it can show deliberations were independent. And if the sponsor's non-fiduciary business decision makers are viewed as controlling the process, they may be viewed as de facto ERISA fiduciaries. As perceived or de facto fiduciaries, their decisions are subject to challenge for ERISA fiduciary breach, and they themselves are subject to personal liability for resulting damages. The case law abounds with such examples. Some show obvious control, such as a memo sent from a company officer directing the fiduciary on how to act. But more subtle examples involve individuals who were held to be the acting fiduciary merely because they briefed the fiduciary committee or participated in its deliberations with no voting role.

The protocol will depend on what kind of fiduciary structure the in-house fiduciary has decided to create. The fiduciary committee typically contains financial personnel closely involved with the sponsor's business interests. At a minimum, rules should govern the content of communications between these individuals and the sponsor's non-fiduciary business decision makers about the termination and annuity selection.

In a very large termination where the in-house fiduciary may have decided to create a particularly robust process, more thought will be needed. The plan sponsor's business decision makers almost certainly decided to terminate the plan only after conducting their own investigation with the assistance of an outside annuity advisor and consulting their own counsel. These same decision makers will probably keep an eye on the process to ensure the termination remains cost-effective. The in-house fiduciary desiring to show maximum independence may have decided to retain its own parallel, but independent, set of advisors and counsel. The fiduciary must plan for how to coordinate and manage communications between these overlapping sets of advisors.

Decision-making record. Longstanding case law has established that the fiduciary is not permitted to rely "blindly" on the advice of its independent experts. To show that it evaluated the experts' advice, and reached its opinions independently, the fiduciary should have a system for keeping records of deliberations leading to those decisions.

(2) SELECT THE ANNUITY PROVIDER

Selecting the annuity provider is the fiduciary's most important decision in implementing the termination.

Applicable standard. In IB-95-1, the Labor Department takes the position that the fiduciary must select the "safest available" annuity, unless the participants' interests would clearly be served otherwise. Only two examples are named of acceptable annuities that are not the "safest available": where the safest annuity provider is unable to process claims, and where the safest annuity is only "marginally" safer and disproportionally more expensive, and the participants benefit from the price difference in the form of enhanced annuities.

The "safest available" standard turns on the objective safety of the annuity, rather than ERISA's longstanding concern for procedural soundness. For this reason, the standard has been rejected by the only two federal courts of appeal to consider it, in favor of the general process-oriented standard of care, prudence and loyalty governing other ERISA fiduciary decisions.

Nonetheless, the procedural steps outlined in IB 95-1 have been embraced by the case law as consistent with the fiduciary's ERISA duties, and should be followed. IB 95-1 states that, in selecting the annuity, the fiduciary is not permitted to rely solely on ratings by insurance ratings services. Rather the fiduciary must evaluate the soundness of the annuity on the basis of at least six factors: (1) quality and diversification of annuity provider's investment portfolio; (2) size of insurer relative to proposed contract; (3) level of insurer's capital and surplus; (4) annuity provider's exposure to liability from its other lines of business; (5) structure of the annuity contract and guarantees supporting the annuities, such as the use of separate accounts; (6) availability of additional protection through state guarantee agencies. In addition to safety and soundness of the annuity, the fiduciary must also take into account the ability of the provider to process claims.

For a number of these factors, their weight and impact on the fiduciary's decision will depend on the size of the termination.

Size of insurer relative to proposed contract. For a very large termination, involving billions of dollars, insurance industry capacity may be a significant concern. The fiduciary in this case might want to consider possible ways of spreading the risk among multiple insurers. Possible options include purchase of commercial longevity insurance and creation of a syndicate of multiple insurers, each of whom would insure a piece of the contract. None of these is mentioned in IB 95-1, but may be viewed as related to the fiduciary's duty under IB 95-1 to evaluate insurer capacity relative to plan size.

Structure of the annuity. A separate account allows assets dedicated to the annuity contract to be walled off from claimants to the insurer's general account. It is typically structured so that the insurer's general account guarantees the benefit payments under the contract. A separate account may be unavailable for a small plan, and is generally more costly than a regular annuity contract.

State guarantee associations. For a very large termination, the existence of state guarantee associations may not be a significant factor. The protection offered by guaranty associations flows solely from their legal authority to make assessments on their member insurers; claimants have no recourse to the general funds of the state. In most (or possibly all) states, the dollar amount of assessments is capped at 1% or 2% of annual premiums written or received in the state. Insolvency of a large insurer would significantly impair the ability of the guaranty association to meet its obligations. Moreover, in some states, statutory dollar caps may limit the guaranty fund's liability, or its liability for any one insurer or any one contract.

Can cost be a factor? As a practical matter, most annuity advisors will include annuity cost as a factor in evaluating preliminary and final bids. When is the fiduciary permitted to consider an annuity's cost? At least one federal court of appeals has said that cost is a permitted factor but only after the fiduciary has first determined that the annuity providers are "comparable." IB 95-1 states that there may be "more than one safest available annuity." While not entirely clear, it may be inferred that the Labor Department acknowledges that a group of equally acceptable annuity providers may exist and that, within this group, cost can be a tie-breaker.

Data cleanup. Participant census and benefit data must be updated before the request for preliminary bids is submitted to potential annuity providers. Without good data, an accurate cost estimate is impossible. Accurate census data also is required to prepare the Notices of Plan Benefits that must be provided to each plan participant as part of the PBGC plan termination procedure. This task should be started as soon as possible, since old data may be stored on outdated systems and media, making cleanup costly and time consuming.

Request for preliminary proposals. When insurers submit their final annuity bids in response to the fiduciary's request for proposal (RFP), the fiduciary typically has a window of only a few hours to accept. Therefore, a prior request for preliminary proposals is essential. Insurers' nonbinding preliminary proposals allow the annuity advisor to narrow its field of intensive evaluation to that subset of insurers who respond to the preliminary request. On the basis of this intensive evaluation — which typically takes weeks — the fiduciary can make a determination of likely annuity providers, and can make any needed changes in the final request for bids.

Request for final bids and selection of annuity provider. When final bids are solicited, the fiduciary, with the assistance of its annuity advisor, will select the annuity provider and subsequently transfer assets as a single premium to pay for the contract.

(3) DE-RISK PLAN ASSET PORTFOLIO

The plan's investment portfolio will probably need to be transitioned to lower risk, more liquid assets in anticipation of the pending annuity purchase. If the plan has a written investment policy, the fiduciary should amend it accordingly. The fiduciary should initiate and complete orderly disposition of illiquid and hard-to-value assets. Some of these may be difficult to transfer to a third-party buyer at an acceptable price. If an asset's book value exceeds its fair market value, the plan sponsor may purchase the asset directly from the plan — without triggering the otherwise "prohibited transaction" penalties that would apply — provided that the sponsor follows the terms of PTE 2002-51. The sponsor is permitted to take a deduction for the deemed "contribution" equal to the excess of the asset's book value over its fair market value.

(4) FURNISH ALL REQUIRED GOVERNMENT FILINGS AND PARTICIPANT NOTIFICATIONS

The termination is subject to multiple notice, filing and other requirements imposed by the PBGC and Internal Revenue Service, and, in some cases, the state insurance commissioner.

PBGC Requirements

- Commence search for missing participants. If a participant or beneficiary cannot be found after a "diligent search," the plan must either purchase an annuity from a private insurer in that person's name and provide information on the missing person and insurer to the PBGC, or transfer the value of the person's benefit to the PBGC's Missing Participants Program
- Notice of Intent to Terminate provided to affected parties at least 60 but not more than 90 days before proposed termination date
- Standard Termination Notice (Form 500) filed with PBGC no later than 180 days after proposed termination date
- Notice of Plan Benefits furnished to participants, specifying the amount and form of each participant's plan benefits, no later than Standard Termination Notice filed with PBGC
- Notice of Annuity Information furnished to affected parties at least 45 days before the asset distribution date
- Asset Distribution Date completed by later of (i) 180 days after the expiration of the PBGC's 60-day review period for the Standard Termination Notice, or (ii) 120 days after the plan receives a favorable determination letter from the IRS provided the determination letter was requested by the time the PBGC Form 500 was filed
- Notice of Annuity Contract furnished to participants and beneficiaries receiving benefits in the form of an annuity within 30 days after plan assets are distributed
- Post Distribution Certification (PBGC Form 501) filed with PBGC within 30 days after the last distribution date for any affected party

IRS Requirements

- Notice of benefit freeze [204(h) Notice] provided to participants within IRS's required window before the effective date of the amendment
- Notice to Interested Parties posted no more than 24 days and no less than 10 days before the filing with the IRS of an application for a determination letter
- Determination Letter Request (IRS Form 5310) filed with IRS no later than Form 500 filed with PBGC; IRS will generally respond with a favorable determination within 270 days

State Insurance Commissioner Requirements

- Establishment of a separate account with an insurer (if that is what the fiduciary decides to do) may require state insurance commissioner filings
- In some cases, the insurance contract must be reviewed by the state before it can be executed

(5) IMPLEMENT LUMP SUM OR OTHER DESIGN AMENDMENTS

If the plan sponsor offers a pre-termination lump sum payment option, participants' elections to receive it must be administered in accordance with IRS requirements. Until recently, IRS spokespersons took the position that their own regulations prohibit offering a lump sum to retirees in pay status. But Ford Motor Company made headlines recently by announcing that it has decided to offer lump sums to retirees currently receiving annuity payments. General Motors made a similar announcement, stating that it would offer lump sums to some retirees in pay status in connection with a contemplated spin-off termination of retiree liabilities. The fiduciary must ensure that participants' elections satisfy the IRS's rules and timetables.

(6) EXTRA STEPS FOR SPIN-OFF TERMINATION

The plan sponsor may be unwilling to terminate its plan for active employees, or to undertake the cost of terminating the entire plan. In this case, the plan sponsor may initiate a so-called spin-off termination. This requires division of the plan into two plans, one for active participants and terminated vested participants not in pay status, and the other for retirees. The retiree plan is then put through the termination according to the steps outlined above. The IRS, the Labor Department and the PBGC blessed the idea of a spin-off termination back in the 1980s, so this is familiar ground for the regulators.

In splitting the assets between the two plans, a decision has to be made as to both the amount and composition of the assets allocated between the two. The decision as to the amount of assets allocated between the two plans is largely driven by statute, and is not a fiduciary decision. The courts uniformly have held that a plan spin-off is an acceptable exercise of the settlor power, immune from fiduciary review, as long as the ERISA and Code rules are followed regarding the amounts allocated in the spin-off [Internal Revenue Code section 414(l)].

Who is responsible for deciding which investments go to which plan is a more difficult question. This decision must of course be made, and there are reasons for preferring that more liquid assets be allocated to the retiree plan scheduled for termination. There are strong arguments for the position that this decision too is settlor, but the fiduciary should of course make this determination.

CONCLUSION: GETTING STARTED

If the plan sponsor intends to terminate its plan at some point in the future, the sponsor needs to get informed early in the process. The sponsor should begin researching the pension risk transfer (PRT) market, available products and providers, and pricing. As soon as practical once the plan sponsor's decision is underway, and certainly before taking significant steps to implement it, the fiduciary should begin constructing the well-considered fiduciary process needed to bring about a successful, efficient termination immune from legal challenge.

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About Ivins, Phillips & Barker

Ivins, Phillips & Barker is the leading law firm in the United States exclusively engaged in the practice of federal income taxation and employee compensation and benefits. Ivins, Phillips & Barker has particular expertise in the termination of defined benefit plans, and advised General Motors on the plan qualification aspects of their retiree lump sum option and plan termination.