

# **Pension Derisking: Distributing Annuity Contracts After *Lee v. Verizon***

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**ALI CLE**

**Pension, Profit-Sharing, Welfare, and Other Compensation Plans  
San Francisco, CA  
April 3, 2014**

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# Sources of Risk in Defined Benefit Pension Plans

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- What is Risk? Probability of adverse outcomes; uncertainty; volatility
- Financial Risk
  - Asset value risk
  - Interest rate risk
  - Inflation risk
- Demographic Risk
  - Longevity risk, other (retirement, turnover, etc.)
- PBGC Premium Risk
  - PBGC premium increases counted towards Federal budget



## Derisking Strategies Generally

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- Curtail Growth in Risk: Design Strategies
  - Freeze accruals
  - Freeze plan to new entrants
- Manage Risk: Portfolio Strategies
  - Liability Driven Investment, annuity contracts as pension assets (“buy ins”)
- **Eliminate Risk: Settlement Strategies**
  - **Lump sum distributions**
  - **Annuity distributions**

## Economic Framework: Settlement Strategies Became More Attractive 2013-4

- Asset values increased
- Interest rates increased
- RB 2014 Mortality Table exposure draft released February 2014 by SOA
- PBGC premiums increased – Bipartisan Budget Act of 2013

	Estimated Flat Rate Premium Per Ppt (Single Employer)		Estimated Variable Rate Premium Per \$1000 Underfunding		Variable Rate Premium Cap	
	Prior Law	Bipartisan Budget Act	Prior Law	Bipartisan Budget Act	Prior Law	Bipartisan Budget Act
2013	\$42		\$9		\$400	
2014	49		14		412	
2015	50	\$57	19	\$24	424	\$424
2016	52	64	20	29	437	500
2017	54	<b>66</b>	20	<b>30</b>	450	<b>515</b>

## Political Framework: They Also Became More Controversial

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	Who Opposes	And Why
<b>Lump Sum Payments (especially to retirees in pay status)</b>	Retiree advocates  But NOT actual retirees  PBGC  Treasury?	Retirees' election of lump sum may be ill-informed or irrational  Retirees vulnerable to coercion and manipulation by family members
<b>Annuity Settlements</b>	Retiree advocates  Some retirees - See <i>Lee v. Verizon</i>	State guarantees may be less protective than PBGC guarantees  But see comments of PBGC Director before ERISA Advisory Council

# Legal Framework: Lump Sum Settlements

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- Active employees: Can't distribute absent plan termination
- Former employees not in pay status: Can distribute with notice and consent of participant and spouse
- Former employees in pay status:
  - Treas. Reg. Sec. 1.401(a)(9)-6: lump sum cashout to retirees in pay status not permitted unless an exception applies
  - Two PLRs issued in 2012 clarify that one-time lump sum offer to participants in pay status fits under exception for benefit increases resulting from plan amendment PLRs 201228051, 201228045)
  - Applications since then held up in apparent IRS/Treasury consultation
  - Recent developments
- Amendment is settlor, implementation is fiduciary

# Legal Framework:

## Annuity Contract Settlements

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### ■ Constitutes a distribution:

- Terminates recipient's status as "participant covered under" the plan, to same extent as lump sum payment. 29 CFR section 2510.3-3(d)(2)(ii)
- Active employees: Can't distribute absent plan termination
- Former employees: Permitted without consent

### ■ Amendment is settlor; implementation is fiduciary

### ■ Distributees can enforce under ERISA section 502(a)(9)

### ■ DOL says IB 95-1 "safest annuity available" standard applies

- Lists factors to consider in evaluating safest annuity available
- There can be more than one safest annuity available

■ Courts have declined to apply "safest available annuity" standard, holding that ERISA's normal process-oriented fiduciary duties apply. *Bussian v. RJR Nabisco, Inc.*, 223 F.3d 286, 298 (5<sup>th</sup> Cir. 2000); *Riley v. Murdock*, 83 F.3d 415 (4<sup>th</sup> Cir. 1996)



# Annuity Contract Settlements For Retirees: A Tale of Two Transactions

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## ■ (1) General Motors Spinoff Termination 2012

- General Motors spun off retirees in pay status into a separate plan
- Made lump sum offer
- Terminated plan with respect to participants who did not accept offer
- \$25 billion premium paid to Prudential to cover 110,000 salaried retirees

# Distributing Annuity Contracts to Retirees: A Tale of Two Transactions -- Continued

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## ■ (2) Verizon “Lift Out” December 2012

- October 2012, Verizon board of directors amended plan to require purchase of annuity contract to pay benefits to certain retired participants in pay status
- Amendment directed fiduciary to select annuity provider
- Fiduciary retained independent fiduciary to represent interests of the plan in the selection of annuity provider and the terms of the contract
- October 2012, independent fiduciary “certified” to fiduciary that selection of Prudential and terms of contract satisfied ERISA
- December 10, 2012, Verizon paid Prudential \$8.4 s billion premium to assume \$7.5 billion pension obligation to 41,000 retirees in pay status
- Premium payment included like-kind assets
- Assets held in insurer’s “separate account”— i.e., assets not available to other Prudential creditors; obligations also backed by Prudential general account



## *Lee v. Verizon Communications, Inc.*

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- Participant challenge: *Lee v. Verizon Communications, Inc.*
- Plaintiffs filed motion for preliminary injunction, *denied* December 7, 2012
- Two classes certified in March 2013: transferee (41,000 individuals) and non-transferee class (55,000 participants remaining in plan )
- Amended complaint alleged that transaction violated numerous ERISA duties as to both transferee class and non-transferee class
- June 24, 2013: District court dismissed claims of transferee class, denied standing to non-transferee class, gave both classes leave to re-plead

## Transferee Class: Claims and *Verizon* Holding

Claims	Court 's Reasoning and Decision
Violated ERISA Sec. 102(b) because SPD failed to disclose circumstances resulting in loss of benefits payable by the plan	Dismissed: plaintiffs fail to show loss in amount of benefits, and SPD disclosure is not required to disclose future changes in plan terms, including change in payor
Plan amendment allowing annuity purchase was fiduciary breach	Dismissed: plan amendment is settlor not fiduciary.
Annuity purchase was fiduciary breach because (i) cost unreasonable; (ii) selection of only one annuity provider imprudent; and (iii) Annuity purchased when plan was less than 80% funded in violation of code section 436(d))	Dismissed: (ii) without more than an allegation that \$8 billion premium was unreasonable, Ps fail to state a claim; (ii) by stating that Prudential is the sole insurer, Ps fail to state a claim without also explaining what prudent choice should be (e.g., multiple insurers) (iii) Without explaining how funding level affects plan or constitutes breach, Ps fail to state a claim
Annuity purchase interfered with protected rights in violation of ERISA Section 510.	Dismissed: Ps fail to establish that continued participation in the plan is a protected right



## Non-Transferee Class: Claims and *Verizon* Holding

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### Claims

Verizon breached fiduciary duties and depleted Plan's assets by paying unreasonable premium

Verizon bought annuity when plan less than 80% funded in violation of Code Section 436(c) and ERISA Section 205

### Court's Reasoning and Decision

A loss affecting plan assets is insufficient to convey Article III standing, which requires an injury in fact

For a defined benefit plan, a decrease in the value of plan assets does not necessarily cause injury in fact because benefit amount is fixed; employer bears investment risk and employer must make up funding shortfalls to pay benefit

Even assuming that there was a breach and loss to the plan, Non-transferee Class Ps lack standing unless they can allege that they have not received benefits due, or that Verizon cannot make necessary contributions to the Plan to avoid reduction in plan benefits.

## Annuity Contract Settlements For Retirees: Pros and Cons of the Two Strategies

	<b>Spinoff Termination (GM)</b>	<b>Annuity Purchase (Verizon)</b>
<b>How It's Done</b>	Retiree liabilities spun off into separate plan, satisfied by purchase of annuity contracts in standard termination under PBGC guidance	Plan buys annuity contract and distributes to retirees
<b>What's Similar</b>	Fiduciary standards, IB 95-1 "safest annuity available" standard govern selection of annuity provider Employer liability ended by termination	Same  Annuity contract a "distribution" terminating participant status
<b>Pros</b>	Express guidance covers terminations Prior lump sum offer permitted by statute	No ERISA § 4044 allocation
<b>Cons</b>	ERISA § 4044 allocation required between original and spin-off plan See IRC 414(l)	No guidance expressly covers Prior lump sum – see recent developments

# Putting It All Together: Derisking Options

	Lump Sums Permitted? (With Consent)	Annuity Contract Permitted? (No Consent Required)
Active Employees	<p><b>Without Plan Termination: NO</b></p> <p><b>With Plan Termination: Yes (expensive)</b></p>	<p><b>Without Plan Termination: NO</b></p> <p><b>With Plan Termination: Yes (expensive)</b></p>
Terminated Vested (not in pay status)	<b>YES</b>	<b>YES (but may be expensive)</b>
Retirees in Pay Status	<p><b>Without Plan Termination See Recent Developments</b></p> <p><b>With Plan Termination: YES spinoff termination typical</b></p> <p><i>ACTUARIES MAY RECOMMEND: Lump sum offer to one group; annuity settlement for different group</i></p>	<p><b>Without Plan Termination - YES</b></p> <p><b>With Plan Termination: YES spinoff termination typical</b></p> <p><i>ACTUARIES MAY RECOMMEND: Lump sum offer to one group; annuity settlement for different group</i></p>



## ERISA Advisory Council Response to Verizon

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- ERISA Advisory Council
  - 15-member advisory group established by statute to advise Labor Department
- Pension derisking hearings June and August of 2013
- Witnesses representative from participant advocacy groups, retiree associations, insurers, and others
- Recommendations presented verbally to Labor Department in November, written report expected in 2014



## Some Witness Testimony About Annuity Distributions

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- Participant Advocates: Causes loss of PBGC guaranty and other ERISA protections. DOL should consider adding IB 95-1 factors, e.g.,
  - Reinsurance, to make annuity no less safe than PBGC insured benefit
  - Funded status of remaining plan
  - Qualified plan-like protections in contract
  - Minimum standards for state guaranty
- A new ERISA fiduciary standard being proposed?
- PBGC Director Joshua Gotbaum: no real risk difference between state guarantees and PBGC guarantee
  - Other indications of PBGC thinking: *Compare* PBGC request for public comment on purchase of irrevocable commitments before plan termination, 74 Fed. Reg. 61074 (Nov. 23, 2009) *with* PBGC no-action notice, 75 Fed. Reg. 82095 (Dec. 29, 2010)

# ERISA Advisory Council Recommendations: Annuity Contract Settlements

Recommendation	Comments
<b>(1) Enhance IB 95-1 “safest annuity available” standard</b>	
<b>Clarify IB 95-1 applies even absent plan termination</b>	Most practitioners believe this is already the case
<b>Consider safe harbors under IB 95-1</b>	Unclear. Is safe harbor better for participants than general fiduciary duty?
<b>(2) ERISA 502(a)(9) guidance clarifying:</b>	
<b>Consequences of fiduciary breach in annuity selection</b> <b>“Appropriate relief” under 502(a)(9)</b> <b>When “posting security” required</b>	Standing issues?  Underlying ERISA debate: What’s the fiduciary duty? The injury?

## ERISA Advisory Council Recommendations: Other

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Recommendation	Comments
<b>(3) Require enhanced disclosure for lump sum windows:</b>	Generally enhanced versions of disclosure standards under IRS regulations
<b>(4) De-risking education &amp; outreach to plan sponsors, e.g.,</b>  <b>De-risking options available</b> <b>Distinction between settlor/fiduciary</b>	
<b>(5) Collect data on de-risking</b>	



## State Insurance Law Developments

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- National Conference of Insurance Legislators scheduled to review proposed “Pension De-Risking Model Act” at its Spring 2014 meeting
  - State Commissioner approval of any “derisking transaction” as condition of implementation
  - Reinsurance required
  - Mandatory disclosure
  - Opt out option required
  - Lump sum option required
- Do they regulate insurance for purposes of savings clause?
- New York State Assembly Bill 8161A – introduced August 30, 2013



## Lessons from *Verizon*

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- Consider Pros and Cons of prior lump sum distribution
- Pay attention to process – both distributees and remaining plan participants
- Consider what elements of IB-95 may have become best practices, e.g., independent fiduciary?
- Keep track of changes in standing law
- Keep track of developments at Labor Department, IRS, State law