While retirement plans have long been part of the fabric of American society, the legal and financial world has changed dramatically over the past few years. Gone are the days when employers could feel completely comfortable providing guaranteed retirement benefits to their employees and continue to fund such benefits for years into the future.

While employers continue to evaluate how best to provide for their employees’ retirement, the continuation of defined benefit plans has, for some employers, become an issue of serious concern. With the prospect of increasing volatility and lack of predictability in pension plan contributions, coupled with some employer’s interest in providing for a defined contribution-style benefit (in anticipation of attracting a more mobile workforce), employers have begun to consider possible alternatives to the traditional defined benefit pension plan. In evaluating possible alternatives, the discussion invariably moves to consideration of possibly terminating the defined benefit pension plan and purchasing irrevocable commitments (annuities) from an insurance company to meet the plan’s obligation to the covered participants. This article will discuss the strategies associated with the standard termination process and how best to establish the necessary fiduciary record to support the evaluation and purchase of irrevocable commitments for the existing plan obligations.

WHY IS 2012 AND BEYOND SO SPECIAL?

While there may be numerous reasons for employers to consider terminating their defined benefit pension plans, the year 2012 represents the beginning of a new financial era in terms of pension plan terminations. While participant payout rules still require that defined benefit plans terminating under a standard termination process provide for distribution of commercial annuity certificates to participants, the provision of an alternative lump sum benefit will be subject to a new set of rules that will be fully phased in beginning in 2012.

Lump sum payments under a defined benefit pension plan are required to be calculated using prescribed interest rates and mortality tables. New rules enacted under the Pension Protection Act of 2006 provided that the maximum interest rate to be used for these lump sum calculations was to be phased in gradually (over a five-year period) with the result that the 30-Year Treasury rate (in effect in 2007) would change gradually to a corporate bond yield rate such that the change in the interest rate methodology for lump sum payments will be fully reflected beginning in 2012.

In evaluating the possible termination of a defined benefit pension plan, this change in the
interest rate methodology may be quite significant financially. The corporate bond yield rate is generally higher than the 30-Year Treasury rate. So, the change from the 30-Year Treasury rate to the corporate bond rate basis means that the interest rate used in the calculation of the plan’s funded status on a lump sum termination basis increases (as corporate bonds entail risks that the Treasury bonds do not have, thus requiring and generating higher interest rates). This increase in the interest rate means that the payment of optional lump sums (in lieu of more expensive institutional annuities) will be substantially less expensive than if the 30-Year Treasury rate was used. As an example, for March 2011, the corporate bond yield weighted average rate was 6.08 percent while the 30-Year Treasury weighted average rate was only 4.28 percent. This 180 basis point difference (of which only the final 36 basis point change would be reflected in 2012) would generate a significantly lower lump sum benefit, thus making the employer’s costs to fund the pension plan on a termination basis dramatically less, to the extent lump sums are utilized. From a plan sponsor’s perspective, this means that, to the extent that the defined benefit plan was less than fully funded on a termination basis, beginning in 2012, it will cost employers less in additional funding (relative to the costs associated with funding based on the previous Treasury bond rates) to terminate the pension plan in a standard termination, if lump sums are utilized. This potential cost reduction in favor of the employer arises to the extent that many participants, when given the choice, will select a lump sum payment in lieu of an annuity. (Payment of lump sums will eliminate the costs associated with risk loads, profit, and administrative expenses that insurers charge for the issuance of an annuity contract.)

HOW TO GET STARTED—EMPLOYER CONSIDERATIONS

The continuation or termination of a defined benefit pension plan can turn on many factors, not all of which are financial. While there continue to be many very good reasons for employers to sponsor defined benefit pension plans, we are focusing for purposes of this article on those employers who have made the decision to terminate the plan for any number of reasons that may be unique to their organization, industry and financial situation.¹

The financial costs and complexities associated with a plan termination can be quite significant and will no doubt figure prominently in any analysis. From a funding perspective alone, while plan sponsors are generally familiar with the calculation of ongoing plan costs for accounting and tax purposes, they are often surprised at the plan’s funded status on a plan termination basis and usually wholly unfamiliar with the requirements for a “4044” valuation that may be required if the plan is unable to meet the requirements of a standard termination. This valuation and associated allocation methodology, which refers to the section within ERISA that establishes priority categories for the allocation of plan assets,² is critical to the determination of any underfunding associated with a plan termination (to the extent that plan assets are not sufficient to satisfy all plan obligations). Both the analysis of the plan’s funded status on a termination basis and the highly complex 4044 analysis are necessary for a plan sponsor to understand both the likely shortfall and how the Pension Benefit Guaranty Corporation (PBGC) (the federal organization responsible for insuring certain benefits under defined benefit pension plans) would view the funded status of the plan on a plan termination basis. The PBGC is most concerned if plan assets are not sufficient to cover plan liabilities, and what promised benefits might be lost if the plan was to terminate with insufficient assets.
At the outset, employers that may want to consider a plan termination should at least preliminarily determine the unfunded liabilities of the defined benefit plan on a plan termination basis. Following that preliminary review, employers will be in position to determine if a plan termination is something that they will be in the financial position to consider, or if this is something that should be pursued at a later time. To the extent that the employer may want to consider a plan termination, the starting point, and the better practice, requires that the employer and plan fiduciaries begin to establish and document their respective processes to terminate the plan and to consider and purchase any annuity contracts for plan participants and beneficiaries. A well documented approach can serve to mitigate the risk that the employer or plan fiduciaries may become embroiled in participant claims or litigation involving the plan termination.

From a plan sponsor perspective, a disciplined plan governance process is critical to a successful plan termination outcome. The following are some of the more significant considerations that the plan sponsor should evaluate as it begins to move forward with the plan termination.

- **Differentiate Settlers from Plan Fiduciaries.** When terminating a defined benefit pension plan, the employer takes on multiple roles—knowingly or unknowingly. At the outset, the decision as to whether to terminate a pension plan is considered to be a settlor function. By “settlor function” we mean that the decision is being made by the employer in its role as an employer acting in the best interest of the company and its shareholders. The settlor function is to be contrasted with the employer’s role as a fiduciary. While the decision to terminate the plan is a settlor function, once that decision has been made, the implementation of the decision to terminate the plan becomes a fiduciary decision. As a fiduciary decision, the individuals responsible for the implementation will be considered fiduciaries under ERISA³ and must act solely in the best interests of the participants and beneficiaries in the pension plan. From a plan termination perspective, these dual roles require careful thought and preparation in order to avoid actual or potential conflicts of interest and the risk of breach-

- **Establish Roles and Responsibilities.** In developing the plan termination process, it is critical that each individual involved in the process understand his or her role, and whether that individual is acting on behalf of the employer or the plan participants. (In some cases, senior executives may find themselves representing both the company and plan participants at various times, and making certain that they know which role they are playing can be critical to demonstrating fiduciary compliance.) Those readers who have been through a plan termination can fully appreciate how decisions may change depending on whether the executive is viewing the transaction from the perspective of the employer or the plan participants.

- **Determine Who Third-Party Advisors Represent.** While a plan termination can involve a number of specialists, ad-
visors, and legal counsel, it is equally important that those advisors know whether they are representing the employer or the plan fiduciaries, and that any potential conflicts of interest are identified and addressed in advance of the representation. Just as an employer may wear multiple hats, the third-party advisors must be aware of the party for whom they are providing advice. For example, legal counsel or financial advisors for the employer may provide very different advice, depending on whether they are acting on behalf of the employer or the plan fiduciaries.

- **Manage Information to Be Provided.** In circulating information between the employer and fiduciaries, a process should be developed to make certain that only information that should be considered by the plan fiduciaries is brought to their attention. For purposes of developing a fiduciary record, it is best if issues or financial information of unique importance to the employer are not brought to the attention of the plan fiduciaries in the event that a question may be raised in the future as to whether the employer’s interests were considered by the plan fiduciaries in reaching a decision.4

- **Develop a Written Record.** Of critical importance in the termination process is the need to develop a written record to demonstrate the care and attention given to the various issues that arise and to be in position to demonstrate what actions were taken by the employer in its settlor capacity, and which actions were taken by the plan fiduciaries, and how the plan fiduciaries determined that their decisions were in the best interest of the plan participants.

**Once the Roles and Process Have Been Established**

Assuming the decision has been made to terminate the plan, the roles and responsibilities of the parties have been identified and there is a process established to manage and record information and decisions, the employer and the plan fiduciaries must begin to move forward with the financial, regulatory and administrative analyses that are required to effect a successful plan termination.

While several of these issues may be preliminarily addressed earlier in the process, once the decision has been made to terminate the plan, the parties need to gain a high level of confidence with respect to each of these areas. The plan termination process will necessarily include the following actions, some of which are to be taken by the employer in its role as the settlor, while other actions are to be undertaken by the plan fiduciaries.

- **Create a Timeline and Select a Proposed Plan Termination Date.** Section 4048 of ERISA provides that the termination date of a single-employer plan is, in the case of a plan terminated in a standard termination, the termination date proposed in the Notice of Intent to Terminate selected by the plan sponsor (as provided under Section 4041(a)(2) of ERISA). While there are various points in time during the process where the employer can reconsider whether to continue to move forward with the plan termination, the proposed termination date will drive a number of deadlines (e.g., participant notices, employee communications, activities related to the purchase of annuity contracts, and the distribution of assets). Thus, when selecting the plan termination date, the employer should

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identify and plan on the time needed to accomplish each objective so that it does not run afoul of any deadlines that are determined based on the proposed plan termination date. The plan must continue to comply with all regulatory requirements in the interim (e.g., PBGC premiums are required until all plan assets are distributed).

- **Freeze the Plan.** Although plan sponsors may develop fairly specific timelines for the plan termination process, there is always a possibility of delay. In order to best manage the process, plan sponsors should initially take steps to freeze future benefit accruals under the plan (to the extent that the plan sponsor has not previously taken such step) so that the plan sponsor will not be incurring any additional liabilities under the plan in the event the plan termination date is later than anticipated. (In any event, benefit accruals in the plan will have to be frozen as of the plan termination date.) With respect to “freezing” the plan, this generally means that participants’ existing accrued benefits will remain at their then current values, except for any required interest adjustments, but will reflect the participants’ ability to “grow into” certain pension benefits to the extent applicable. These plan benefits will still be available to participants when they retire, but only in the amounts earned up to the date of the plan freeze.\(^6\) To effect this cessation of future accruals, federal law requires that a plan sponsor provide written notice to participants and other applicable individuals within a reasonable time before the effective date of the plan amendment.\(^6\) From a communication and participant perspective, once a plan is frozen, the actual plan termination may be viewed somewhat favorably by participants in that they may now have access to their benefits, either through an immediate annuity, in the case of those still working for the employer, or through a lump sum payment that may not have otherwise been available to the participants had the plan continued as a frozen plan.

- **Estimate the Funded Status of the Plan.** The funded status of the plan, already frequently calculated under Internal Revenue Service (IRS) and Financial Accounting Standard Board (FASB) bases, should now be calculated based on assumptions that reflect an estimate of the plan’s liability for participant benefits, including the cost of any annuity purchase and lump sums expected to be chosen by plan participants. Plan assets will need to be sufficient to provide the required benefits for all participants or beneficiaries who may elect potential lump sum payments, or who may receive annuity certificates. (To the extent that the plan assets are insufficient to satisfy all benefit liabilities, the plan sponsor will need to be prepared to make a commitment to fund the plan in an amount sufficient to meet all plan obligations.) Due to the financial comfort level that an insurer will want to have before it takes on the liability for a terminating defined benefit pension plan, the cost to fund the annuity purchase is generally much greater than under either the IRS or FASB rules. While the actual difference will be dependent upon the precise demographics of the plan (blue versus white collar, participant ages,
etc.), lump sum experience (if offered), and the assumption differences generated by the plan termination (assumed commencement ages will change), it is very possible that the plan liability that will be eliminated through the purchase of an annuity contract may grow by as much as 20 percent when funding needs are determined on a plan termination basis. The net impact is that, depending on the relevant facts and circumstances, an 80 percent funded plan under an IRS or FAS basis may find its termination funding shortfall growing by as much as 50 percent to 100 percent when evaluated on a plan termination basis.

- **Review Data Integrity and Plan Compliance.** The quality of the pension plan data must be reviewed prior to performing any benefit calculations or providing participants information regarding their specific benefits. Data is also relied upon to obtain annuity bids from potential insurance companies and can have a material impact on the cost of a group annuity contract. Data issues that may have been a nuisance in prior years must all be resolved in order for a benefit calculation to be developed for every participant. Data issues should ideally be reviewed in advance of any decision to terminate the plan, but certainly before performing any benefit calculations, creating any participant statements, or seeking bids from annuity providers. Participant addresses and other data should also be verified, and a diligent search should be made for missing participants as early as may be possible (see discussion below). To the extent that the data to be relied upon by the insurers changes during the annuity purchase process, such change could jeopardize meeting the asset distribution date. Plan sponsors need to be mindful that any uncertainty with respect to plan data will be borne by the plan, not the insurer, and may increase the costs of any annuity purchase. In addition, with the wind-up of the plan in the foreseeable future, the plan documentation and operational compliance (e.g., benefit calculations, suspension of benefits, minimum required distributions, etc.) should be reviewed as early in the process as may be possible so that any corrective action may be taken so as to mitigate the risk of any post-termination compliance issues arising.

- **Adopt Plan Amendments.** Designing and amending the pension plan in the context of a plan termination will be a settlor (employer) decision and is not subject to the ERISA fiduciary constraints. While the employer will need to amend its pension plan to be certain that the plan terms meet all statutory and regulatory requirements as of the proposed date of termination, there are certain plan provisions that employers may wish to consider in the context of a plan termination that may serve to reduce plan termination costs; while certain of these plan amendments may also serve to increase the insurer’s financial exposure (and thus the ultimate cost of any group annuity contract), the net costs to the employer should improve to the extent that the total liability to be assumed by the insurer is reduced.

- **Lump Sum Feature.** The amendment most often considered by employers in advance of any purchase of an
An annuity contract is to amend the plan to offer lump sum payments to participants who are not presently receiving plan payments. As part of the plan termination strategy and to take advantage of the shift from the 30-Year Treasury rates to the corporate bond rates, employers will want to consider offering a lump sum feature to be effective solely in the context of the plan termination. While there are obvious benefits to the plan sponsor in providing a lump sum option in the context of a plan termination, there are a number of legal and regulatory issues that must be addressed depending on whether the lump sum feature is to be provided to active, terminated vested or retired employees. To the extent that a lump sum feature is to be newly offered, it will require all of the necessary qualified joint and survivor notice and consent rules. In addition, participants must be provided in-formation on the ability to roll over the lump sum, including associated tax consequences. While allowing existing retirees in pay status to receive the value of their future payments in the form of a lump sum is a benefit that can be provided only under very limited circumstances (see, for example, Treasury Regulation § 1.401(a)(9)-6, Question 13, wherein it states that an annuity payment that satisfies Section 401(a)(9) of the Internal Revenue Code may only be changed in connection with, among other things, a plan termination), plan sponsors may prefer not to disrupt the current form of payment to their existing retirees and avoid the complications associated with having to solicit consent to receive a lump sum payment from a retired employee and his or her current and/or former spouse.

- **Disability and Death Benefit Features.** Disability and death benefit plan provisions may result in an increased risk (to the insurer). Some insurance companies will not be willing to offer an annuity contract to defined benefit plans where the disability qualification is based solely on a medical opinion or is determined in the plan administrator’s discretion. Similarly, death benefits may add to the cost of an annuity contract. Some employers may choose to respond to these concerns by either removing the disability or death benefit feature (and other non-protected benefits) completely, or changing them to make them more restrictive. Absent additional facts, plan documentation to the contrary, or prior practices of the employer, disability and death benefits are not generally considered protected benefits under Section 411(d)(6) of the Internal Revenue Code and can be changed or eliminated completely.

- **Position the Plan for An-
nuity Purchases. Insurers generally view one-time lump sum elections as resulting in negative, adverse, or anti-selection. Thus, for example, if lump sums are offered, some insurance companies may use a more conservative mortality table in pricing the liability for participants who do not elect the lump sum. This risk would come into play as insurers will assume that the healthier participants would elect the annuity, which would provide income for life; these participants would thus be assumed (by the insurer) to live longer than the individuals choosing the lump sum, thereby driving the annuity purchase price up. Mortality table assumptions are another key factor in calculating the cost of an annuity. The mortality table an insurance company may use could depend on the mix of participants (male/female or blue vs. white collar), type of industry and size of average monthly benefits. The more detailed information provided to the insurance company on a plan specific basis, the more accurate the pricing will be. For example, if there is a subsidized early retirement provision, the insurance company may price more favorably if actual early retirement experience provided by the employer can demonstrate low utilization of the early retirement benefit.

- Evaluate Interim Investment Strategies. Since the plan termination process may take some time to evaluate and implement, the plan’s investment fiduciaries may want to consider an investment strategy that minimizes the volatility of the plan’s funded status by using long-term bonds or other instruments that replicate the long-term bond price changes used in the liability calculations. In positioning the plan’s investment portfolio, fiduciaries also need to be mindful that annuities are normally purchased with cash, so the plan’s investments need to be evaluated and any illiquid assets addressed at an early point in time so as to be in position to fund the annuity purchase or distribute cash for any lump sum payments. To the extent that plan assets include illiquid investments, the plan’s investment fiduciaries will want to evaluate possible liquidation strategies at an early point in time since it is unlikely that the insurance carriers will want to take such illiquid assets absent a very substantial discount.

- Locate Missing Participants. The issue of identifying and locating missing participants can become quite burdensome where an employer may have a significant number of vested former employees and beneficiaries who have not commenced benefits under the Plan. A standard termination requires that the plan administrator must provide each participant and beneficiary with his or her benefit as well as other specific plan information. Section 4050 of ERISA provides that the plan administrator of a terminating single employer defined benefit plan may distribute benefits for missing participants only by purchasing an annuity from an insurer or by paying the benefit to the PBGC. Thus, plan fiduciaries must make reasonable efforts and conduct a diligent search to locate missing participants or beneficiaries in order to satisfy their fiduciary obligations under ERISA.11 Section 4050.4(b)(1) of the PBGC regulations provides
that a search is considered a “diligent search” only if the search begins not more than 6 months before the Notice of Intent to Terminate is issued and is carried on in such a manner that if the individual is found, distribution to the individual can reasonably be expected to be made on or before the deemed distribution date. The diligent search is to include inquiry of any plan beneficiaries (including alternate payees) of the missing participant whose names and addresses are known to the plan administrator, and may include use of a commercial locator service to search for the missing participant (without charge to the missing participant or reduction of the missing participant’s plan benefit). ¹²

- **Confirm Plan Expenses Payable from Trust.** Expenses incurred in connection with the employer’s performance of settlor functions would not be reasonable expenses of a plan. Thus, for example, expenses incurred by the plan sponsor in evaluating whether to terminate the plan would generally be viewed as settlor functions and should not be reimbursed from plan assets. The Department of Labor also has taken the position that, while expenses related to settlor activities do not constitute reasonable plan expenses, expenses incurred in connection with the implementation of settlor decisions may constitute reasonable expenses of the plan.¹³ Thus, for example, once the plan sponsor has decided to terminate the plan, expenses incurred by the plan fiduciaries in implementing that decision may be reimbursed from plan assets, provided that the plan document permits such expenses to be reimbursed and they are reasonable and incurred for the benefit of the plan participants.

- **Establish Attorney-Client Privilege.** While the role of legal counsel in the plan termination process is important, the plan sponsor must determine who the attorney is representing—the employer or the plan fiduciaries. From the perspective of asserting any such privilege, the key question is who is the client (and what does the attorney engagement letter specify)? To the extent that the attorney is representing the plan fiduciaries, the attorney’s obligation (and any resulting attorney-client privilege) will run to the plan fiduciaries and, by extension, to the plan participants. The privilege issue can also be affected to the extent that the employer seeks to be reimbursed from plan assets for the work of the attorney. In the event that plan assets are used to pay legal expenses, the courts have generally held that the client in that instance is the plan participants, and that any privileged communications provided by the attorney belong to the plan participants, not the employer.¹⁴

**MOVING FORWARD TO TERMINATE THE PLAN**

- **Process to Manage Settlor and Fiduciary Team Members.** We suggest that plan sponsors hold an initial meeting for all settlor and fiduciary parties involved in a potential plan termination to review the process. This should include the plan sponsor and key management, an ERISA attorney, in-house counsel or a legal consultant familiar with pension law, the plan actuary, the investment consultant, the plan administrator, an annuity placement consultant, and potentially a communication consultant to assist with overall par-
participant communications. Getting everyone in agreement beforehand as to the termination timeline and their respective roles and responsibilities can help ensure a smooth process and transition. Meetings of the subgroups and overall project team should be held at regular intervals for both the settlor team and the fiduciary team to keep the teams abreast of any new regulatory issues, changes in the interest rate environment, benefit calculation issues, and related matters. In addition, the respective teams should separately discuss strategy and manage the information that is provided by each team to the other in the context of the plan termination.

- **Proactively Manage the Plan’s Funded Status.** During the pendency of the plan termination process, the plan sponsor must continue to proactively manage the funded status of the plan. It is important to note that until all obligations have been fully settled through lump sum payments or annuity purchases, asset and liability values and annuity purchase costs will continue to vary on a daily basis until assets are actually transferred to the institutional annuity provider. Estimates of costs or funded status should not be relied upon beyond the date as of which they are determined. To mitigate the risk of significant swings in asset values, there are a number of investment strategies that can increase the likelihood of maintaining the plan’s current funded status or, with sufficient time, may increase the likelihood of reducing the funding shortfall. Consideration should be given to retaining an investment consultant to help plan fiduciaries consider actions that could reduce short-term funded status volatility leading up to the settlement date. Moreover, to the extent that the employer will need to make additional contributions to the plan to satisfy the plan’s liabilities, the timing of such contributions should await receipt of final annuity costs so as to minimize the risk of contributing excess assets that could result in an excise tax on any reversion of assets to the employer.

- **Request a Determination Letter from the IRS.** While a determination letter is not required, a plan termination can adversely affect the qualified status of a defined benefit pension plan.\(^{18}\) While the timing associated with obtaining a determination letter from the Internal Revenue Service with respect to the qualified status of the plan and tax-exempt status of the trust can take up to nine months or more,\(^ {18}\) we strongly believe that having such a determination letter is important and an integral part of any plan termination process. The determination letter (on plan termination) will provide confirmation that the plan and trust were qualified and tax exempt at the time of the plan termination (including all regulatory requirements through the date of termination) and will document that any payments that are rolled over to another qualified plan or individual retirement account have come from a qualified retirement plan. Moreover, as a practical matter, some trustees may require such a determination letter prior to transferring assets to an insurance company, and the insurance company may want to confirm the qualified status of the plan as a condition for offering certain of its annuity products.
Regulatory Filing Requirements. There are a number of participant notices and regulatory filings required for a standard termination. These notices include the Notice of Intent to Terminate (60 to 90 days before the proposed termination date, 29 C.F.R. § 4041.23), Notice of Plan Benefits (completed before filing the standard termination notice (Form 500), 29 C.F.R. § 4041.24), and Form 500, including the actuarial certification (Schedule EA-S) that the plan is projected to have sufficient plan assets to provide plan benefits (after the Notice of Plan Benefits and no later than the 180th day after the proposed termination date, 29 C.F.R. § 4041.25). The PBGC has 60 days following receipt of Form 500 to issue a Notice of Noncompliance. If no such Notice is issued, the plan sponsor may proceed to distribute plan benefits (after the Notice of Plan Benefits and no later than the 180th day after the proposed termination date, 29 C.F.R. § 4041.25). The PBGC has 60 days following receipt of Form 500 to issue a Notice of Noncompliance. If no such Notice is issued, the plan sponsor may proceed to distribute plan benefits (29 C.F.R. § 4041.25). No later than 45 days before the distribution date of any lump sums or annuity certificates, the plan sponsor must issue a Notice of Annuity Information that identifies the insurer(s) that are being considered to provide annuities, and any applicable state guaranty association coverage (29 C.F.R. § 4041.27). Distributions should be completed by the later of (i) the 180th day after the PBGC’s 60 day review period ends, or the 120th day after receipt of a favorable IRS determination letter (29 C.F.R. § 4041.28(a)(1)). Participants must be provided with a copy of the annuity contract or certificate by the 90th day after the distribution deadline (29 C.F.R. § 4041.28(d)). Finally, a Post-Distribution Certification (PBGC Form 501) and Schedule MP for missing participants must be filed with the PBGC by the 90th day after the distribution deadline to avoid penalties. (29 C.F.R. § 4041.29(b); see Figure 1, below.) Once the PBGC receives the Form 501, they will contact the sponsor of any plan with over 300 participants to perform an audit of the plan termination. These filing requirements should also be coordinated with any IRS determination letter request and Notice to Interested Parties.

Purchasing Annuity Contracts for Plan Liabilities

Department of Labor (DOL) Interpretive Bulletin 95-1 confirms that the selection of annuity providers is a fiduciary decision and that the standards applied to fiduciaries require that they select the “safest available annuity” provider unless, under the circumstances it would be in the interests of participants and beneficiaries to do otherwise. A strong fiduciary process is critical to a successful plan termination, particularly with respect to the purchase of annuity contracts that will satisfy the “safest available annuity” provider standards of DOL Interpretive Bulletin 95-1. This importance cannot be overstated and is best demonstrated by two cases involving alleged fiduciary breaches by the plan fiduciaries for two employers’ pension plans. In these separate cases, the fiduciaries for both employers selected an annuity provider (Executive Life Insurance Company) that subsequently was declared insolvent. Despite selecting the same annuity provider, the plan fiduciaries that had a disciplined process (e.g., the plan fiduciaries retained independent experts and evaluated the insurer’s financial data and interviewed other purchasers to confirm administrative capabilities) prevailed in their litigation, while the plan fiduciaries that did little more than review insurance company ratings and...
select the least expensive annuity provider were found to have breached their fiduciary duty to plan participants. Thus, the lesson to be learned—despite similar outcomes (both plans’ fiduciaries selected Executive Life annuity contracts)—having a disciplined and well-documented independent fiduciary review process can mitigate the risk of plan fiduciaries being found to have breached their fiduciary duties based on the information that could have been known at the time of the purchase of the group annuity contract.¹⁹

- **The Department of Labor 95-1 Standard.** The annuity placement process must comply with the guidance provided in the Department of Labor’s Interpreive Bulletin 95-1. This Interpretive Bulletin, issued subsequent to the failure of three large insurance carriers active in the annuity market in the early 1990s, provides guidance on selecting the “safest available annuity” provider and underscores the importance assigned to plan fiduciaries that are charged with annuity selection.²⁰

DOL Interpretive Bulletin 95-1 sets forth a complex, multi-faceted review process that must be followed closely in order to assure compliance. The process is designed to help plan fiduciaries verify that benefits are settled with a “safest available annuity” provider based on all of the information reasonably available at the time the selection was made. It also identifies six factors that a plan fiduciary should consider in selecting annuity providers, but plan fiduciaries must be mindful that this list is not exhaustive of the considerations that the plan fiduciaries must undertake in examining potential annuity providers (see Figure 2). The plan fiduciaries should draw upon appropriate expertise in order to develop the necessary record to support the selection of a possible annuity provider. This record should, among other things, address the six factors outlined in Interpretive Bulletin 95-1 and provide sufficient support such that a reasonable person examining the same available information would consider it prudent and in the best interest of participants to have selected the particular annuity provider at that time:

- **Quality and Diversification of an Insurer’s Investment Portfolio.** When selecting an annuity provider, the plan fiduciary (or independent expert) should conduct an analysis of the quality and diversification of the carrier’s investment portfolio. If the annuity contract is backed by the general account of the insurance company, the analysis should be conducted on the various classifications of assets on the insurer’s balance sheet as well as the quality and allocation of these assets. Further evaluation should be done to ensure the portfolio is well diversified.

- **Insurer’s Size and Ability to Administer the Contract.** The plan fiduciary should also take into account the size of the plan’s assets to be transferred relative to the size of the insurance company’s overall asset base. The insurance carrier should have sufficient size such that absorbing and deploying the plan assets will not have a material impact on its overall invested position, or the insurance carrier must provide a workable plan for investing the plan assets such that the resulting annuity purchase will meet “safest available” criteria. This analysis should consider the insurance car-

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rrier’s financial position both prior to and immediately following the transfer of plan assets. In addition, the selected insurance carrier should have experience in administering group annuity contracts, particularly with plans that are similar in size and characteristics as the one that the plan sponsor is settling.

- **Level of Insurer’s Capital and Surplus.** A sophisticated measure of capital and surplus is the Risk Based Capital (RBC) ratio calculated by a formula set forth by the National Association of Insurance Commissioners (NAIC). This ratio considers a carrier’s exposure to both risky and conservative assets and liabilities. It is a very complex calculation considering literally hundreds of variables. It also uses a series of risk factors applied to various assets and liabilities to establish the minimum capital needed to withstand the risk arising from each asset or liability. The four major categories measured for life insurance companies are asset risk, insurance risk, interest rate risk and business risk. These factors are computed to produce what the regulators refer to as Authorized Control Level (ACL) Risk Based Capital.\(^{21}\)

- **Insurer’s Lines of Business and Exposure to Liabilities.** The lines of business for the selected carrier should be well diversified, and a large emphasis on any one line of business should be considered carefully. The provider should have good asset/liability and underwriting disciplines in each of its lines of business. Proper Enterprise Risk Management systems and processes should be in place and reviewed on both a corporate-wide and line of business basis to ensure that risks are understood and accounted for on a proactive basis.

- **Annuity Contract Structure and Use of Separate Accounts.** An additional safety factor to consider is the use of a separate account annuity product. A few insurance companies have developed separate account products for single premium group annuity purchases. This means that annuity premiums are placed in a separate account that will exist within the group annuity contract that is issued, and where the insurance company’s general account policyholders (who will make up the great majority of claims against the insurance company in the event of an insolvency) will have no claim on the separate account assets in the event of insurance company insolvency. The premiums are higher for this separate account product in most cases, although the separate account provides an additional layer of protection to the plan participants and should be a consideration for the plan fiduciaries in evaluating alternative annuity providers. Investment guidelines are set up with the plan sponsor’s approval, and a Plan of Operation must be filed in the state where the contract will be signed. This is generally the state where the plan sponsor is located.\(^{22}\) It is noteworthy that the protections potentially afforded by separate accounts have not been fully tested in an insurance company insolvency.

- **State Guaranty Funds.** Once a liability is settled through a lump sum distribution or an annuity purchase from a life insurance company, the PBGC coverage of that liability under...
Title IV of ERISA ends. While the PBGC guarantees are lost, plan fiduciaries will want to consider the applicability of other possible guarantees. While the primary concern of the plan fiduciaries should be the financial strength of the insurer and its ability to make the required payments, consideration should also be given to any applicable state guaranty funds in the event that an insurer becomes unable to pay benefits as they become due. The implications of an insurance company’s insolvency cannot be predicted with any certainty—in some cases, the insurance industry itself will look to police the process of ensuring that insurance company commitments are honored and, from a historical perspective, may even include the purchase of the insolvent insurer’s business by another insurer. There are a number of issues that can arise in the course of a plan termination. While it is difficult to identify all such issues within the scope of this article, a few additional issues that the plan sponsor should be mindful of as 2012 approaches include the following:

- **Regulatory Agencies/Issues.** To the extent that the employer is in an industry that may be viewed as undergoing significant financial changes, or is subject to close regulatory scrutiny due to prior regulatory issues or activities, consideration may be given to reviewing the plan termination with the regulatory agencies in advance of any formal notices or filings. This pre-filing review will ensure that the agencies are not caught by surprise and may identify certain issues that can be addressed in advance of commencing the plan termination.

- **Collective Bargaining.** To the extent that the defined benefit pension plan is collectively bargained, plan sponsors should review the proposed termination with union representatives and make certain that there are no restrictions in the plan document or collective bargaining agreement that may preclude termination.

- **Review Terms of the Annuity Contract.** It is important that the group annuity contract and any annuity certificates be carefully reviewed to be certain that they provide the same benefits, rights and features that the participants would have received under the defined benefit pension plan notwithstanding its termination.

- **Administrative Support.** The termination of the plan will involve significant time and effort of those individuals responsible for plan administration and related plan compliance. In view of the limited re-
sources that employers may have to devote to all of the plan termination tasks (in addition to their normal responsibilities), some employers may bring in additional support to focus on the discrete plan termination actions (e.g., benefit calculations, missing participant searches, election notices, etc.) that may be required.

- **Communication Strategy.**
  The termination of a defined benefit plan can be expected to have a profound impact on employee morale. Successful plan terminations will normally couple any such announcement with a well designed communication strategy intended to address participant concerns (for active, terminated vested and retired employees), will provide answers to the most frequently asked questions, and provide participants with information on possible alternative defined contribution plan benefits or other alternatives. For example, the overall timing of communicating the availability of a lump sum, particularly for active employees, will need to be carefully considered so that active employees will have sufficient time to consider whether to delay their retirement in anticipation of receiving the lump sum option (to the extent that the lump sum option is not offered to all retired employees). To address this concern for active employees, lump sums could be provided to those employees who retired within one year of plan termination to address those situations where current retired employees may have otherwise delayed their date of retirement had they known that a lump sum payment option was being seriously considered.

- **Top 25 Pre-Termination Restrictions.** The Treasury regulations’ “top 25” pre-termination restrictions are intended to prevent certain highly compensated employees (“restricted employees”) from receiving a distribution of substantially all of a defined benefit plan’s funds with the result being that there would be few assets remaining to provide benefits to the plan’s non-highly compensated participants should the plan subsequently terminate. These restrictions preclude annual payments from a defined benefit plan to one of the restricted employees (generally the top 25 most highly compensated participants) from exceeding the annual value of a single life annuity unless, generally, one of the following exceptions would apply: after making the lump-sum distribution, the defined benefit plan would still have assets equal to or greater than 110 percent of the value of current liabilities (using any reasonable method as permitted under Treasury Regulation § 1.401(a)(4)-5(b)(3)(iv)), where the value of the benefit to the restricted employee is less than one (1) percent of the value of current liabilities, and where the value of the benefit to the restricted employee does not exceed the limitation on the mandatory “cash out” of benefits. If one of these exceptions does not apply, distributions paid from a defined benefit plan in a form other than an annuity to the top 25 restricted employees must be secured by an escrow account or a bond/letter of credit. While plan sponsors will likely intend to fully fund the plan on a termination basis (in the context of the plan termination), payments made to the restricted employees...
in advance of such funding and plan termination will need to have complied with these restrictions.\textsuperscript{24}

- **Capacity of the Insurance Industry.** Over the past five years, the total amount of defined benefit pension plan liabilities settled with annuity placements was under $10 Billion. The insurance carriers in the annuity marketplace today have an estimated capacity of $80 Billion according to an internal Aon Hewitt survey conducted in early 2010. If several very large defined benefit plan sponsors attempt to terminate their plans around the same timeframe, insurance capacity may become strained. To address this issue, non-traditional solutions and alternative structures are being discussed among consulting firms and large financial institutions.

- **Nonqualified Plans.** To the extent that the employer may also sponsor an excess or nonqualified plan, the termination of the defined benefit plan will necessitate that the employer evaluate how such termination will impact the nonqualified plan. To the extent that the nonqualified plan is to be modified, the employer will need to evaluate the restrictions imposed by Section 409A of the Internal Revenue Code (governing nonqualified deferred compensation plans).

- **Excess Assets.** While far less common today, to the extent that a defined benefit plan has excess assets, consideration should be given to possible approaches to avoid a reversion to the employer along with possible excise taxes, and such evaluation should consider the use of possible replacement plans.

- **Consider Replacement Plan Strategies.** If the plan was not already frozen, then some consideration of potential replacement benefits, both qualified and nonqualified, may be appropriate. This would entail a review by the employer of its retirement income goals, and how the elimination of the defined benefit plan will impact the employer’s ability to attract, retain, and motivate employees. An analysis of what income workers are expected to need at retirement, and what they can expect once the plan has been frozen or terminated is an important piece of information to be used in the development of the new plan. Similarly, the benefits provided by competitors—both within the same industry and within the same geographic locale that the company competes for talent in, need to be reflected. Ultimately, the form and value of any future retirement strategy will be based on the company’s ability to pay, the competitive market forces, the relative mix of pay and benefits the company wants to provide, and the degree to which the company wants to emphasize certain goals—such as profit sharing, age-equity, participation in retirement savings, or even the relative importance of service.

In conclusion, while interest rates available in 2012 and thereafter may make the plan termination process more attractive from a financial standpoint, the development of a disciplined termination process and confirmation of the respective roles and responsibilities for all of the parties is a critical first step to a successful plan termination. Moreover, as we have seen, there are numerous issues that must be considered by the plan sponsor and the plan fiduciaries in their respective roles. To the extent that each develops a strong record
and utilizes third-party resources when appropriate, the process should run smoothly, and the risk of adverse claims or litigation should be minimized. Ultimately, actuarial, legal, financial, insurance, plan administration, and plan termination expertise is necessary—along with a corporate commitment to understand the impact this action will have on employees, stock price, and cash reserves. Properly planned and executed, a plan termination can be quite successful and can position the business for a productive future.

**Figure 1 - The Termination Process**

![Termination Process Diagram](image-url)
NOTES:

1There are a number of ongoing costs associated with sponsoring a defined benefit pension plan, including actuarial, legal, administrative, corporate, investment, PBGC premiums, and others expenses. These costs can generate contribution or expense requirements of up to 3% or more of the plan liability every year. While employers may choose to freeze their defined benefit plans (i.e., cease providing any further benefit accruals) in anticipation of a plan termination, these expenses and related costs will continue despite the lack of any corresponding benefit increase for plan participants.


2Under Section 404 of ERISA, a fiduciary is required to discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries and (A) for the exclusive purpose of: (i) providing benefits to participants and their beneficiaries; and (ii) defraying reasonable expenses of administering the plan; (B) with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and with like aims; (C) by diversifying the investments of the plan so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so; and (D) in accordance with the documents and instruments governing the plan insofar as such documents and instruments are consistent with the provisions of Titles I and IV of ERISA. 29 U.S.C.A. § 1104 (2011).

To the extent that the defined benefit plan may have excess pension assets and the potential for an employer reversion, special care should be taken where fiduciaries selecting the annuity provider have an interest in the sponsoring employer which might affect their judgment (in terms of making a decision that may serve to maximize the employer’s reversion). The potential conflict of interest may create the possibility for a violation of ERISA’s prohibited transaction rules (dealing with plan assets for one’s own interest). Department of Labor Interpretive Bulletin 95-1 indicates that, as a practical matter, many fiduciaries have this conflict of interest and therefore will need to obtain and follow independent expert advice calculated to identify those insurers with the highest claims-paying ability willing to write the business. 29 U.S.C.A. § 2509.95-1; 29 U.S.C.A. § 1106(b) (2011).

A freeze will generate the need for some economic analysis whether it is followed by a plan termination or not. From an accounting perspective, the freeze will generally constitute a curtailment under ASC 715-30 (formerly FAS 88). This will generate accounting implications that need to be reflected. Should the freeze be followed by a total plan termination, the curtailment will be followed by a complete settlement (also accounted for under ASC 715-30). The net impact is that all the accrued gains or losses that would have been recognized in the future, including the likely loss associated with plan termination, now need to be recognized, since the plan will not have future opportunities to expense those items. The financial impact associated with a plan freeze, especially if it also entails a plan termination, can be dramatic, especially for plans whose asset sizes rival their market capitalizations.

6Except as otherwise provided in the regulations, a Section 204(h) notice must be provided at least 45 days before the effective date of any plan amendment intended to significantly
reduce the rate of future benefit accrual under the defined benefit plan ("Section 204(h) amendment"), and at least 15 days before the effective date of any Section 204(h) amendment in the case of a small plan (i.e., a plan that the plan administrator reasonably expects to have, on the effective date of the Section 204(h) amendment, fewer than 100 participants who have an accrued benefit under the plan). Special rules apply to amendments that may reduce early retirement benefits or retirement-type subsidies in connection with certain plan transfers, mergers, or consolidations. Treas. Reg. § 54.4980F-1, Q-9 (2011).

7Very accurate data can reduce the purchase price of a group annuity contract by as little as 10 basis points or as much as 1 percent of the purchase price depending on the liability duration.

8The defined benefit plan terms should also be carefully examined in the context of a plan termination to confirm the treatment of participants who previously separated from service, were paid their partially vested accrued benefits, and have not yet incurred a break in service at the time of the plan termination. See GCM 39310 (April 4, 1984).

9These notice and consent rules include, among other things, notice of the relative value of the available optional forms (including the lump sum), offering an immediately payable annuity to all lump sum-eligible participants, and of course receiving the consent of the participant and spouse, if married. Participants must also be informed of their right to defer benefit commencement and any related consequences. These notice requirements must be provided within the normal time periods required under applicable law.

10In preparation for the annuity purchase process, plan sponsors may consider having their annuity place-ment consultant get “real-time” preliminary pricing from qualified insurance companies in the marketplace. This will provide a good indication of the plan’s liability at any given point in time. The employer should be mindful that if lump sums are offered, the insurance premium for any benefits not paid as a lump sum may be much different from when preliminary pricing was obtained from the insurers. As noted above, this could significantly affect the universe of bidders and their pricing assumptions and methodologies.

11The Department of Labor, in the context of a defined contribution plan, notes that the effort to locate missing participants is a plan fiduciary function under ERISA. DOL Field Assistance Bulletin 2004-02 (September 30, 2004).

129 C.F.R. § 4050.4(1). The Social Security Administration has a correspondence forwarding process whereby it will forward communications from the plan to the missing participants. Under IRS Revenue Procedure 94-22, moreover, the Internal Revenue Service will forward letters to lost participants or beneficiaries.


14In the ERISA context, there is a fiduciary exception to the attorney-client privilege when it comes to matters of plan administration, and courts have held that “an employer acting in the capacity of ERISA fiduciary is disabled from asserting the attorney-client privilege against plan beneficiaries on matters of plan administration.” See, e.g., In re Long Island Lighting Co., 129 F.3d 268, 272, 21 Employee Benefits Cas. (BNA) 2025, 39 Fed. R. Serv. 3d 614 (2d Cir. 1997). This exception to the traditional view of the attorney-client privilege is more limited in the context of plan fiduciaries acting in contemplation of litigation. See, e.g., Tatum v. R.J. Reynolds Tobacco Co., 247 F.R.D. 488, 43 Employee Benefits Cas. (BNA) 2304 (M.D. N.C. 2008).

15IRS has proposed examination guidelines for its examiners of employee plans to use when examining plans that have terminated without a determination letter. The guidelines focus on qualification defects likely to arise in plans that terminate without a determination letter. Internal Revenue Service Manual 7.12.14.1 (January 1, 2003); see also IRS Announcement 94-101, I.R.B. 1994-35 (August 12, 1994).

16Plan asset distributions may be delayed pending receipt of a favorable IRS determination letter provided that the determination letter request is filed prior to filing the Form 500 with the PBGC. 29 C.F.R. § 4041.25(c).


1829 U.S.C.A. § 2509.95-1

19Compare Bussian v. RJ Nabisco, 223 F.3d 286, 25 Employee Benefits Cas. (BNA) 1120 (5th Cir. 2000) (holding against the employer for failing to structure or conduct an independent and impartial investigation to select an insurer that would be best positioned to provide participants’ benefits) with Riley v. Murdock, 890 F. Supp. 444 (E.D. N.C. 1995), judgment aff’d, 83 F.3d 415 (4th Cir. 1996) (wherein the court found no fiduciary breach where pension committee retained independent advisors, conducted a thorough investigation of each insurer, and consulted with other employers that had purchased annuities from such insurers); see also, In re Unisys Savings Plan Litigation, 173 F.3d 145, 22 Employee Benefits Cas. (BNA) 2945, 22 Employee Benefits Cas. (BNA) 2972, 51 Fed. R. Evid. Serv. 279, 51 Fed. R. Evid. Serv. 307 (3d Cir. 1999) (where the defined contribution plan fiduciaries were found to have acted prudently when selecting Executive Life guaranteed investment contracts).

20It is critical to note that the Department of Labor states with regard to plan fiduciaries that “[u]nless they [the plan fiduciaries] possess the necessary expertise to evaluate such factors, fiduciaries would need to obtain the advice of a qualified, independent expert.” 29 U.S.C.A. § 2509.95-1.

21The ACL RBC is reported annually in insurance companies’ statutory financial statements, which are publicly available. Insurers are also required to file a report, including the specific RBC ratio, containing the details behind these numbers to the NAIC and the appropriate state Insurance Commissioner. This report, however, is confidential and not publicly available. Regulations prohibit insurance carriers from publishing the RBC ratio for marketing purposes. It is not intended as a ranking tool but rather is used to indicate whether any action needs to be taken if minimum capital requirements are not met.

22In the event of a shortfall of as-
sets in the separate account, most states require that a reserve fund be set up within the general account to cover the shortfall. In the case of excess assets in the separate account, states may require that the funds be moved to the general account, either quarterly or annually. Depending on the state, state guaranty protections should apply to these separate accounts.

The insurance laws of various states have established guaranty funds to protect policyholders of insurance companies that may operate in that state and that may ultimately become insolvent. These funds are meant to safeguard certain classes of policyholders in the event of nonperformance by an insurance company. In the event that a state insurance commissioner determines that an insurer is insolvent, the mechanism used to protect policyholders is the state guaranty association. In general, the coverage limit for annuities is between $100,000 and $500,000 (present value of annuity benefits), depending on the state. Additionally, while the guaranty fund may be helpful in the case of single insurer forced into insolvency or receivership, it is unlikely that there would be sufficient funds or industry support to protect policyholders in the case of a contagion, such as that caused by an event that would adversely affect all insurers.

Treas. Reg. § 1.401(a)(4)-5(b); Rev. Rul. 92-76, 1992-2 CB 76.