ANNUITY LIFT-OUTS

Matthew H. Hawes, Mark J. Simons, and Claire E. Bouffard

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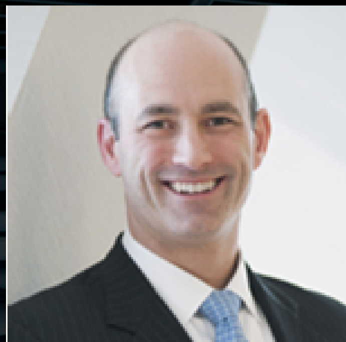
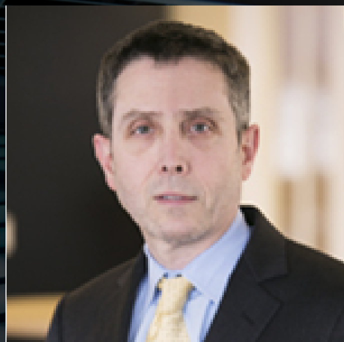
Presenters



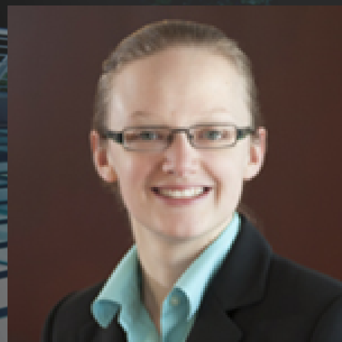
Matthew H. Hawes

Partner, Pittsburgh



Mark J. Simons

Of Counsel, Philadelphia



Claire E. Bouffard

Associate, Pittsburgh

Agenda

- ERISA Overview
- Fiduciary Status and Duties Under ERISA
- Application of Fiduciary Concepts to Lift-outs

ERISA Overview

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What Is ERISA?

- Employee Retirement Income Security Act of 1974
- Enacted in response to high-profile plan sponsor bankruptcies and widespread corruption in the management of employee benefit plan assets
- Imposes fiduciary standards on those with discretionary authority or control over employee benefit plans and their assets (i.e., fiduciaries)
- Includes anti-conflict-of-interest rules and also prohibits transactions with a wide range of parties involved with the plan unless an exemption applies
- Allows plan participants, plan fiduciaries, and the Department of Labor (DOL) to bring suit to enforce ERISA’s provisions

Fiduciary Standards: Comparison

- Standards of Liability
  - ERISA fiduciaries: prudent expert standard
  - Doctors: ordinary negligence standard
  - Police: gross negligence standard
  - Disinterested corporate directors and officers: bad faith, disloyalty, or violation of law

Fiduciary Status and Duties Under ERISA

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ERISA Definition of Fiduciary

- Under ERISA, the term "fiduciary" is broadly defined to include any person who:
  - Exercises discretionary authority or control over management or disposition of plan assets
  - Renders investment advice for a fee
  - Has discretionary authority or responsibility for plan administration
- Includes those named as fiduciaries in governing documents
- Includes those responsible for appointing other fiduciaries
- But a person can be a fiduciary even if not named as such in governing documents—based on function, not title

Examples of Fiduciares and Non-Fiduciaries

Examples of fiduciaries:

- Committees assigned or exercising fiduciary functions
- Individual members of the committees and investment and benefits staff who have discretionary authority or control over the administration and management of the plans
- The trustee (but only to a limited extent in the case of directed trustees)
- Managers of separately managed accounts and collective investment trusts
- Some investment consultants and advisors (more under the new rule)

Examples of Non-Fiduciaries

- The employer as "settlor"/plan sponsor (the extent of fiduciary responsibility is often based on the governance structure)
- Recordkeeper
- "Managers" of mutual funds (or certain private funds)
- Some consultants, lawyers, and auditors

** BUT REMEMBER "FUNCTIONAL" FIDUCIARY STATUS

ERISA – Settlor vs. Fiduciary

- Settlor functions generally include the adoption, amendment, and termination of the plan
- Officers of the plan sponsor may wear both “hats”—having both settlor and fiduciary responsibilities
- In contrast to fiduciary functions, settlor functions can be carried out in the best interests of the plan sponsor without concern for participants’ interests
- Fiduciary expenses can be charged against plan assets; settlor expenses generally cannot

ERISA – Settlor vs. Fiduciary Plan Amendments

- The US Supreme Court has held that amending a plan generally is not a fiduciary act:

"In general, an employer's decision to amend a pension plan concerns the composition or design of the plan itself and does not implicate the employer's fiduciary duties which consist of such acts as the administration of the plan's assets. ERISA's fiduciary duty requirement simply is not implicated where Hughes, acting as the Plan's settlor, makes a decision regarding the form of structure of the Plan such as who is entitled to receive Plan benefits and in what amounts, or how such benefits are calculated."

Hughes Aircraft Co. v. Jacobson, 525 U.S. 432 at 444-45 (1996).

ERISA – Settlor vs. Fiduciary Plan Amendments – Lift-Outs

- Federal courts have specifically relied on the US Supreme Court's view of plan amendments as inherently non-fiduciary in character in the specific context of annuitization lift-outs:
- "Because amending a plan is not a fiduciary function, Verizon was not acting in a fiduciary capacity when it amended the Plan to direct the purchase of an annuity for participants meeting certain criteria."

Lee v. Verizon Communications Inc., 954 F. Supp. 2d 486, 493 (N.D. Tex., June 23, 2013)

Fiduciary – "Two Hats"

- "The statute not only allows you to have a conflict of interest, it compels you to have a conflict of interest. Everyone has a conflict of interest. The default plan administrator [under the ERISA statute] is the company - - - the employer - - - who is both a disqualified person and a party-in-interest. The default named fiduciary [under ERISA] is usually the employer. The definition of fiduciary includes the employer. The question is not whether you have a conflict of interest; the question is whether you are able to act on it."
- "And the assumption is - - - and Congress is saying to you - - - take off your employer hat, put on your fiduciary hat, and act solely in the interest of the employees, and if you can't do that, then go get someone who can."

Frank Cummings, Chief of Staff to Senator Jacob Javits (who has been called the "father" of ERISA).

Fiduciary – “Two Hats” – Lift-Outs

- In the context of a lift-out, the “two hats” concept means that if an in-house (company) fiduciary selects which insurer will annuitize benefits, it must make the selection solely in its capacity as fiduciary - - - that is, solely while wearing its “fiduciary” hat.
  - As Frank Cummings noted, “if you can’t do that, then go get someone who can.” As we will discuss, that may mean hiring an independent fiduciary.
    - This is especially true in “jumbo” lift-out deals, and in plan terminations with a significant reversion, where the settlor wants to avoid even the appearance of a conflicted/self-interested selection of insurer.

ERISA – Settlor vs. Fiduciary

Settlor Actions*

- The decision to amend a plan
- The decision to offer an early retirement window
- The decision to reduce or increase the level of plan benefits
- The decision to merge one plan into another plan
- The decision to terminate a plan

***Note**: Even when the decision may be a settlor function, implementing that decision will constitute a fiduciary function.*

Fiduciary Actions

- The selection (and monitoring) of investment managers or investment options
- Negotiating contracts for services to be paid for with plan assets
- The payment of plan fees and expenses with plan assets (and the expenditure of plan assets generally)
- Participant communications and disclosures

Four Basic Fiduciary Duties

1

Duty of Loyalty (exclusive benefit rule)

- Act solely in the interest of, and for the exclusive purpose of providing benefits to, participants and beneficiaries and defraying reasonable expenses of administering the plan.

2

Duty of prudence (so-called "prudent expert" standard)

- Act with the care, skill, prudence, and diligence then prevailing that a prudent person acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims.

3

Duty to diversify

- Diversify 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.

4

Duty to follow plan terms

- Act in accordance with the documents and instruments governing the "plan" insofar as such documents and instruments are consistent with the provisions of ERISA.

Prudent Process

- Duty of prudence does not require a fiduciary to guarantee outcomes, but it can be demonstrated by the use of a prudent process to make and monitor decisions.
- Sometimes referred to as "procedural prudence"—the ability to demonstrate that the fiduciary followed a prudent process in making a fiduciary decision.
- PROCESS IS KEY – a (well-documented) process is the best defense to claims – fiduciaries need to:
  - Have all information required to make a prudent decision
  - Identify all reasonable alternatives
  - Consider all of the relevant information
  - Use an outside expert to help gather and process the information if special expertise is required
  - Monitor/follow up and adjust as necessary
  - DOCUMENT EVERYTHING in sufficient detail to demonstrate the above

Consequences of Breach of Fiduciary Duty

- Breach of Fiduciary Duty
  - Personal liability for fiduciary breaches and losses
    - Corporate indemnifications
    - Fiduciary liability insurance
    - Potential limits on exculpation from plan assets
  - Obligation to restore profits received and opportunity costs
  - In the context of an annuitization (including a lift-out), ERISA Section 502(a)(9) allows affected participants, beneficiaries, and related fiduciaries to sue for "appropriate relief, including the posting of security if necessary to assure receipt" of promised benefits
  - Other equitable and remedial relief (e.g., removal from fiduciary position) and additional penalties
    - Monetary penalties to DOL equal to 20% of the recovery amount
    - Criminal penalties for failure to make 401(k) contributions, willful violations of reporting and disclosure requirements, kickbacks, bribes, and embezzlement
    - Reputation risk

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Lift-Outs – Nature and Prevalence

- An insurance annuity "lift-out" is an increasingly prominent liability-based de-risking strategy
  - Involves the transfer of assets and liabilities and all associated obligations and costs to a third-party insurance company
  - The transaction is at the level of the plan and the insurance company and does not (directly) involve participants; no participant consent is required
  - Less complex, and no regulatory filings, as compared to a full plan termination and annuitization
- The Verizon buyout is a significant example that was the subject of protracted litigation

Lift-Outs – Nature and Prevalence (cont’d)

- Pensions & Investments reports that there was a surge in lift-outs in 2022, including the second-biggest U.S. transaction of all time – IBM purchased group annuity contracts to transfer a total of $16B in US pension liabilities
- There were eight other “jumbo” transactions of more than $1 billion each
- Legal & General Retirement America estimated that total volume surged in 2022 by nearly 40%, to $53 billion

Reasons to Lift Out

- Having a large legacy obligation in the form of a defined benefit plan can be a drain on a company's capital and cash, with negative implications for its expansion options, R&D, ability to attract talent, and shareholder return. Does the company want to stay in the business of managing a pension plan?

- Assessing the true cost - - - the "economic liability" - - - of maintaining a defined benefit needs to take into account things such as new mortality assumptions imposed on defined benefit plans that increase liabilities, increasing PBGC premiums, service provider costs, investment management fees, in-house benefits administration costs, etc.

Considerations in Lift-Outs

- General insurer account versus separate account
- In-kind payment versus all cash payment
- One insurer versus multiple insurer
- State guaranty association protections

Fiduciary Implementation of Lift-Outs

- Statutory and regulatory guidance regarding the annuitization of benefits in the context of a plan termination has existed since ERISA was enacted (and even before its enactment).

- In contrast, there is relatively little guidance regarding “lift-outs” from ongoing plans.
  - U.S. Department of Labor Interpretive Bulletin 95-1 notes that “in the case of an ongoing plan, annuities might be purchased for participants who are retiring or separating from service with accrued vested benefits.”

  - As we will discuss, most of the other guidance has come in the form of judicial decisions.

Fiduciary Implementation of Lift-Outs

- Decision to undertake a lift-out should be a settlor function, but implementation of the lift-out will raise fiduciary issues
  - Participant communications
  - Selection of annuity providers
  - Investment strategy
- Fiduciaries should develop a strategy for communicating with participants
  - Provide information relevant to participant decisions
  - Information must not be misleading
- Purchase of annuities
  - Selection of annuity providers is a fiduciary function
  - DOL "safe harbor" for annuity selection (consider the extent to which it's really a safe harbor)
  - Recent case law

Fiduciary Implementation of Lift-Outs (cont'd)

- A participant who is "lifted out" in a buyout ceases to be a participant for purposes of Title I of ERISA when his or her entire benefit rights are, pursuant to DOL Regulation Section 2510.3-3(d)(2):
  - Fully guaranteed by an/several insurer(s);
  - Enforceable by the sole choice of the individual against that insurer(s); and
  - An annuity certificate is issued to the individual.
- A similar rule applies for purposes of determining PBGC premiums. Specifically, an individual is no longer a "participant" once "an insurer makes an irrevocable commitment to pay all benefit liabilities with respect to the individual; see PBGC Regulation Section 4006.6(b)(2)

Fiduciary Concepts and Lift-Outs

- An annuity buyout transaction was challenged in *Lee v. Verizon Communications, Inc.* (5th Circuit, 2015), on numerous grounds
- October 2012, Verizon entered into an agreement to transfer $7.5B in liabilities for 41,000 employees to an insurer through the purchase of a buyout annuity contract – a “lift-out” transaction
- Participants sued, alleging that Verizon plan fiduciaries:
  - Breached their fiduciary duties by transferring liabilities to an insurer not subject to ERISA’s fiduciary duties and PBGC protection
  - Inappropriately depleted plan assets and paid excessive fees to insurer
  - Failed to provide notice and obtain participants’ consent
  - Interfered with participants’ rights to plan benefits
  - Breached their fiduciary duties in the selection of the third-party annuity provider

Fiduciary Concepts and Lift-Outs (cont'd)

- In initial rounds of multi-stage litigation, courts decisively ruled against participants and in favor of Verizon plan fiduciaries
  - December 2012, District Court dismissed request for temporary restraining order
  - June 2013, District Court dismissed all participants' claims
  - April 2014, District Court dismissed additional claims raised in amended complaint
  - August 2015, Fifth Circuit Court of Appeals affirmed dismissal of participants' claims
  - May 2016, U.S. Supreme Court granted certiorari
  - September 2016, Fifth Circuit Court of Appeals affirmed
- Courts' rulings emphasized that:
  - Verizon acted in its settlor capacity in making annuity purchase decision
  - ERISA did not require participant notice or consent for transaction
  - ERISA contemplated transactions (e.g., pension plan terminations) that resulted in participants no longer being covered by PBGC protection
  - No facts or evidence indicating that plan fiduciaries breached their duties in purchasing annuity or inappropriately depleted plan assets or paid excessive fees
- Courts' ruling provided strong endorsement of "lift-out" style buyout transactions, essentially analyzing them as a partial or full plan termination

Fiduciary Concepts and Lift-Outs (cont'd)

- Interpretative Bulletin 95-1: when purchasing annuities for purposes of distributing benefits from a pension plan:
  - "..... [F]iduciaries choosing an annuity provider for the purpose of making a benefit distribution must take steps calculated to obtain the **safest annuity available**, unless under the circumstances it would be in the interests of participants and beneficiaries to do otherwise. In addition, the fiduciary obligation of prudence ..... requires, at a minimum, that plan fiduciaries conduct an objective, thorough and analytical search for the purpose of identifying and selecting providers from which to purchase annuities."
- IB 95-1 issued by DOL in response to several high-profile insurance company insolvencies that occurred in the early 90s

Fiduciary Concepts and Lift-Outs (cont’d)

- IB 95-1 provides that fiduciaries should consider:
  - The quality and diversification of the annuity provider’s investment portfolio;
  - The size of the insurer relative to the proposed contract;
  - The level of the insurer’s capital and surplus;
  - The lines of business of the annuity provider and other indications of an insurer’s exposure to liability;
  - The structure of the annuity contract and guarantees supporting the annuities, such as the use of separate accounts;
  - The availability of additional protection through state guaranty associations and the extent of their guarantees.
- And “[u]nless they possess the necessary expertise to evaluate such factors, fiduciaries would need to obtain the advice of a qualified, independent expert. A fiduciary may conclude, after conducting an appropriate search, that more than one annuity provider is able to offer the **safest annuity available**.”

Fiduciary Concepts and Lift-Outs (cont'd)

- IB 95-1 is confusing in its reference to the "**safest annuity available**":
  - It nowhere defines that term or the identifying characteristics of such an annuity (as the Fifth Circuit observed in *Bussian v. RJR Nabisco, Inc.*, 223 F.3d 286 (2000)).
  - IB 95-1 states that a fiduciary could conclude that "more than one annuity provider is able to offer the safest annuity available" (how, unless the annuities are identical in all respects, which is virtually never the case?)
  - It provides that in very limited circumstances, a fiduciary does not have to select the safest annuity available - - - such as where the safest annuity is only marginally safer but is much more expensive and where the insurer can't administer the plan.

Fiduciary Concepts and Lift-Outs (cont'd)

- Given those issues, the court in *Bussian* concluded that fiduciaries do <u>not</u> have to select the "safest annuity available," but merely need to conduct a review that keeps "the interests of beneficiaries foremost in their minds, taking all steps necessary to prevent conflicting interests from entering into the decision-making process." In other words, process is key, rather than result.

- Take-away: it is pretty much impossible to single out one annuity as the "safest." Rather, fiduciaries need to confirm that each insurer is within IB 95-1's "zone of safety." Once the fiduciaries have done so, they can pick based on other distinguishing factors, such as administrative capabilities and price.

Fiduciary Concepts and Lift-Outs (cont'd)

Other key points and takeaways:

Identify and allocate settlor vs. fiduciary roles and responsibilities

Establish and/or update corporate and fiduciary governance committees and structures

Follow corporate and fiduciary governance structure in all decisionmaking

For implementation portions of lift-outs that are fiduciary in nature, establish prudent process that will satisfy procedural prudence requirements, which could include:

- RFIs/RFPs to identify and select annuity or other third-party service providers
- Establishment of comprehensive participant communication strategy
- Process for addressing participant inquiries and/or claims

Lift-Outs: Key Players

- There are generally four main parties in a lift-out:
  - The plan sponsor/settlor
  - An outside consultant
  - The insurance company selected to annuitize benefits
  - The fiduciary - in-house or outside/independent - responsible for conducting fiduciary due diligence and for selecting the insurance company or companies
    - There may also be an “independent expert” if the fiduciary making the selection is an in-house fiduciary
    - An independent expert is an ERISA 3(21) fiduciary (advises on insurer selection but is not the party actually making the selection) rather than an ERISA 3(38) fiduciary (an “investment manager”) that actually makes the selection)
- In certain circumstances, it is more common or even required to use an “independent” fiduciary to make the insurer selection
  - This is typically the case:
    - In “jumbo” transactions, and
    - In an over-funded defined benefit plan with a likely reversion in a plan termination (not a lift-out)

Lift-Outs: Key Players (cont'd)

- Other players include:
  - The plan trustee
  - Internal parties at the company (HR, benefits administration, etc.)
  - Plan actuary
  - Asset manager
  - Outside counsel

Lift-Outs: Typical Timeline

- Project kickoff led (typically) by outside consultant to discuss timeline and workstreams
- Preliminary data preparation
- Preliminary request for proposal (RFP) issued to slate of possible insurer candidates
- Insurers provide preliminary pricing and purchase agreement
  - Typically, insurers provide a sample group annuity contract at this stage; the settlor and fiduciary will provide comments and can request changes, either in the contract itself or (in all but jumbo deals) in a side letter
- Meeting of company/settlor representatives, fiduciary, and consultant to review and discuss the RFP responses
- Fiduciary due diligence of insurer candidates based on DOL Regulation 2509.95-1 and other criteria
- Final census updates
- Final RFP issued to insurers

Lift-Outs: Typical Timeline (cont'd)

- Insurer selection date (final quotes provided by insurers, and purchase agreement with selected insurer(s) is executed)
- Plan is amended to provide for the lift-out and to specify its parameters (who, how much, etc.)
  - This is crucial to ensure that the lift-out constitutes a settlor function immune to challenge as a fiduciary breach
- Deal closes and plan assets are transferred to insurer(s)
- First payment by insurer or for insurer
- Final data reconciliation
- Annuity certificates issued to annuitants

“Top-Ups”

- In the context of a lift-out, a plan sponsor may opt to make an additional contribution to the plan in order to maintain its funding percentage. If a plan’s funded status on a termination basis is strong, the need for a top-up contribution is less compelling.

- In its Form 8-K dated October 17, 2012, in connection with its lift-out (described in prior slides), Verizon noted:

  – “Verizon expects to make additional contributions to the Plan prior to the date of the closing of the transaction so that the Plan’s funding percentage does not decrease as a result of this transaction. The final amount that Verizon will contribute to the Plan will be determined based on several factors, including changes to interest rates and asset valuations between October 17, 2012 and the date of closing.”

Typical Documentation in a Lift-Out

- There are two principal documents that are reviewed and negotiated in, and that govern the terms of, a lift-out:
  - The purchase agreement (contract between the plan sponsor/settlor, fiduciary, and insurer)
    - In jumbo deals, the purchase agreement is a customized agreement that is negotiated like a document in an M&A deal. In smaller deals, the agreement is generally off-the-shelf and can be revised either directly, or via a side letter.
  - The group annuity contract (GAC) (contract between the plan sponsor/settlor and the insurer, with annuitants, surviving annuitants, and beneficiaries as contractual third-party beneficiaries)
    - In jumbo deal, the GAC can be negotiated. In smaller deals, the GAC is pre-approved by state insurance regulators can only be revised via a side letter.

Typical Documentation in a Lift-Out (cont'd)

- In addition, a series of participant communications is necessary to inform participants and beneficiaries of the transfer of liabilities.

Group Annuity Contract – Key Issues to Consider

- Misstatements
  - Traditional approach
  - Cut the cord
- Anti-assignment (by insurer) provision
- Confidentiality
- Annuitants as third-party beneficiaries

Group Annuity Contract – Key Issues to Consider – Misstatements

- The "cut the cord" approach is generally used in jumbo deals and is intended to limit the plan sponsor's liability after the initial data reconciliation and true-up process is completed.
  - Changes in data due to updated/corrected dates of birth, dates of death and gender do not result in an increase or decrease in benefit payments - - - the insurer takes the gain or loss and does not seek an additional premium payment from the plan sponsor, nor does it refund any premium already paid (as applicable).
- The "traditional" approach is a perpetual provision allowing for changes (and related premium adjustments) after the true-up process is completed.

Purchase Agreement

Key Issues to Consider in a Purchase Agreement

- **RBC ratio representation from the insurer**
- **Anti-assignment representation from the insurer**
- **Prohibited transaction exemption representation from the insurer pact of the problem to the target populations**
- **Signatories to the agreement (fiduciary for fiduciary issues, settlor/company for other issues, and the insurer)**

Our Global Reach

Africa
Asia Pacific
Europe
Latin America
Middle East
North America

Our Locations

Abu Dhabi
Almaty
Beijing
Boston
Brussels
Century City
Chicago
Dallas
Dubai
Frankfurt
Hartford
Hong Kong
Houston
London
Los Angeles
Miami
New York
Nur-Sultan
Orange County
Paris
Philadelphia
Pittsburgh
Princeton
San Francisco
Seattle
Shanghai
Silicon Valley
Singapore
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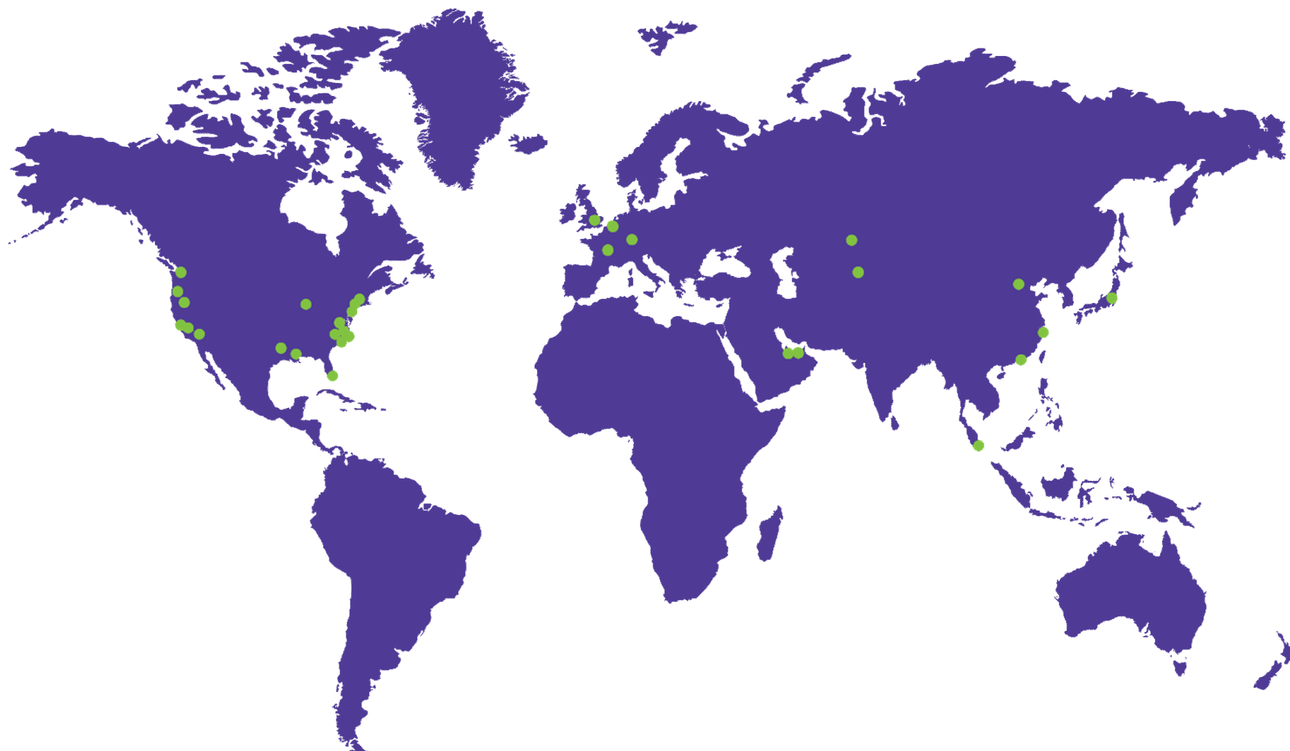

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