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Court's Rejection of ERISA Challenges to Verizon Annuity Purchase Supports "De-Risking" Strategy

Employers who sponsor defined benefit pension plans are currently considering various approaches to "de-risk" (reduce or eliminate) some or all of the plan's liability for benefits to participants. The focus on "de-risking" arises primarily from increased longevity of participants and volatility in investment returns, which create risks that the plan's assets will fall short of its liabilities. To the extent that plan liabilities can be discharged early, these risks are eliminated. Lump sum cash-outs are a form of de-risking. So-called liability-driven investment ("LDI") strategies also are a method of managing risk, though they do not eliminate the associated liabilities.

Another possible approach to "de-risking" plan liabilities is to "annuitize" the benefits of a group of participants without terminating the plan, i.e., to purchase an insurance company annuity to pay benefits owed to all (or a subset) of retired and/or deferred vested participants. Under this approach, the liability for benefit payments is transferred to the annuity provider and the plan (and plan sponsor) are discharged from responsibility. These types of annuities are attractive for a variety of reasons, including the related reduction in PBGC premiums (as the covered retirees are no longer plan participants) as well as potential beneficial effects on the sponsor's financial statements (such as settlement accounting).

Plan sponsors and their advisers considering this approach have been closely following the pending challenge to Verizon's groundbreaking 2012 annuity transaction. A federal court in Texas recently issued a decision – its third since December 2012 – slamming the door on plaintiffs' fiduciary and other challenges. We briefly review the history of the litigation, and the court's most recent decision, below. *Lee v. Verizon Commc'ns Inc.*, 2014 BL 100546, N.D. Tex., No. 3:12-cv-04834-D, 4/11/14. We would be surprised if the plaintiffs do not appeal the decision to the Fifth Circuit.

Verizon I and II

In December 2012, the federal district court initially rejected a putative class action seeking a restraining order on the Verizon Plan's $8.4 billion purchase of a Prudential group annuity contract guaranteeing the benefits of nearly 41,000 Verizon retirees. Lee v. Verizon Communications Inc., 2012 WL 6089041 (N.D. Tex. Dec. 7, 2012). In the action, plaintiffs alleged various ERISA claims, including that the annuity purchase transaction conflicted with ERISA's regulation of plan terminations. In his opinion, Judge Fitzwater denied the motion for the restraining order, finding that the plaintiffs were unlikely to prevail on any of their claims.

In June 2013, Judge Fitzwater again ruled that the 41,000 retiree class plaintiffs had not stated any ERISA cause of action and dismissed the claims. Lee v. Verizon Communications

Inc., 954 F. Supp 2d 486 (N.D. Tex. 2013). The court also rejected a new set of claims – made by the 50,000 remaining plan participants whose benefits were not annuitized as part of the transaction – that Verizon breached its fiduciary duties and depleted the plan's assets by expending such a large sum to effect the annuity transactions.

Among other things, in its second ruling, the court found that –

- A change in the payer of plan benefits – Prudential instead of the Verizon plan – is not the same as a "loss of benefits" – and thus the potential for that change did not have to be disclosed in the plan's SPD.

- Notwithstanding the magnitude of the transaction, in the absence of specific allegations regarding which expenses were inappropriate and why, the court could not "reasonably infer . . . that it was unreasonable to pay Prudential approximately $8.4 billion in total" for the annuities ($1 billion more than the plan's valuation of the liability) in view of the fact that they provided billions of dollars in pension benefits to a large group of plan participants and beneficiaries.

- The class of remaining participants had not established "standing" to sue over the disposition of $8.4 billion in plan assets. Like many other rulings in defined benefit plan litigation, the court rejected "standing" of these participants because there was no allegation that their benefits were not being paid or that "Verizon as plan sponsor cannot make the necessary contributions to the Plan so that reductions are avoided."

Interestingly, in the June decision, the court did not expressly resolve "whether ERISA regulations expressly authorize an annuity purchase that removes a group of participants and beneficiaries from a plan without terminating the plan." However, it observed that "[t]he Transferee Class [the annuitized participants] does not point to any regulation that prohibits it, and the court has found none. But neither does the authority on which Verizon relies expressly authorize an annuity purchase in these circumstances." The court nevertheless granted both the annuitized participants and the remaining participants the opportunity to amend the complaint so as to possibly state valid claims.

Verizon III

While the plaintiffs amended their complaint in some respects, in its April 11 ruling, the court still found their claims deficient and rejected them in their entirety. Most importantly, the court rejected the ERISA fiduciary breach claims.

The annuitized retirees claimed that Verizon should have consulted with and considered the wishes of the retirees and should have required the annuity to be maintained as an asset of the Plan which would have ensured that all retirees retained the protections of ERISA and the PBGC's benefit guarantees. (A plan may purchase an annuity that provides for the payment of benefits to the plan, which in turn remains responsible for payment of benefits to covered participants.) In response to both of these claims, the court simply reiterated its prior ruling that Verizon was not acting as fiduciary when it amended the plan to direct the annuity purchase because "the disputed decisions involve Verizon's role as settlor, not Plan fiduciary."

Plaintiffs' other fiduciary breach claims centered on the fact that the annuity premium paid to Prudential exceeded the Plan's valuation of its liabilities by $1 billion. Specifically, it was claimed that Verizon violated ERISA and the Plan document which require that plan assets be used for the exclusive benefit of Plan participants and to provide benefits under the terms of the Plan and pay reasonable expenses of administering the Plan because that $1 billion was paid to Prudential for expenses, not for benefits and reasonable expenses of administering the Plan, in order for Verizon to avoid paying these expenses. The court continued to view this claim as "conclusory."

Finally, the court rejected the claim that Verizon's decision to purchase annuities from a single provider, Prudential, the day after it amended the plan to provide for it, was a fiduciary breach. The court rejected this claim primarily on the basis that, two months earlier, Verizon retained an independent fiduciary to represent the interest of plan participants and satisfy ERISA fiduciary standards, including the "safest available annuity" requirement of DOL Interpretive Bulletin 95-1. Plaintiffs did not challenge the independent fiduciary's decision as faulty, and the court found their claim that the defendants made a snap decision to select Prudential a "disingenuous suggestion."

In closing, the court stated –

> "at bottom, plaintiffs are disagreeing with the rights of a settlor under ERISA, and such a disagreement must be addressed to Congress through requests for legislative changes to ERISA, not through litigation that complains of the decisions that ERISA empowers a plan sponsor as settlor to make."

<u>Observations</u>

Judge Fitzwater's repeated rejection of the class plaintiffs' fiduciary and other challenges to Verizon's annuity purchase provides helpful support for use of this strategy as a way to defease a segment of plan liabilities. And the process Verizon followed – including retention of an independent fiduciary and amending its plan to clearly direct the annuity purchase – are good steps for interested plan sponsors to follow to minimize the risk of a successful challenge.

Whether Congress will have an appetite to restrict future annuitization transactions – which the court suggests plaintiffs may wish to pursue – remains to be seen. There is also a question whether the DOL may enter the fray through the regulatory process or by other means at its disposal. Notably, the ERISA Advisory Council in 2013 looked at a variety of de-risking strategies and submitted a related report for the Secretary's review. We expect that the DOL will publish that report in the coming weeks. In the meantime, as plans continue to improve their funded status, plan sponsors now have more legal support for annuitization of plan liabilities as a potential tool in the "de-risking" toolbox.