Legal Developments

"De-Risking" Strategies Still Making Headlines

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. Two popular methods of de-risking, purchase of annuities without terminating the plan and lump-sum cashout windows for former participants, have been making headlines recently: (1) the federal court in Texas issued a favorable ruling in support of Verizon's purchase of annuities to provide for the pension benefits; and (2) the Internal Revenue Service has issued another line of private letter rulings permitting lump-sum cashout windows for retirees.

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Under the first approach, the idea is to "annuitize" the benefits of a group of participants without terminating the plan, for example, to purchase an insurance company annuity to pay benefits owed to all (or a subset) of retired and/or deferred vested participants. 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). Under the second approach, retirees (and terminated vested participants) are provided a window during which they may elect to take a lump-sum payment from the plan, eliminating the monthly payments being made (or to be paid) to the participant and his or her surviving spouse.

The *Lee v. Verizon Communications, Inc.* decision [2014 BL 100546, No. 3:12-cv-04834-D (N.D. Tex. Apr. 11, 2014)], and the private letter rulings related to de-risking are described below.

The Decision (and Its History)

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 summary plan description.
- 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 explicitly 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, and the plan 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."

The 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. The claim argued that the $1 billion payment to Prudential was for expenses, not for benefits and reasonable expenses of administering the plan, so that Verizon could 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:

> [A]t 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.

Observations

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 annuitization strategy as a way to "defease" (*i.e.*, eliminate or reduce) a segment of plan liabilities. Furthermore, it demonstrates that 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. This report has been published by the DOL and is available on the DOL Web site. 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. Stay tuned, as we would be surprised if the Verizon plaintiffs do not appeal the decision to the Fifth Circuit.

The Rulings

On May 30, 2014, the Internal Revenue Service (IRS) released four private letter rulings (the 2014 Rulings) that generally support the ability of a defined benefit plan sponsor to offer a lump-sum window to retirees. [Ltr. Ruls. 201422028, 201422029, 201422030, 201422031, and 201424031 (dated March 7, 2014, March 6, 2014, March 5, 2014, March 5, 2014, and March 21, 2014 respectively)] While the IRS ruled favorably on this type of "de-risking" strategy with two, highly-publicized rulings in 2012 (the 2012 Rulings), there were some concerns that perhaps the IRS was rethinking its position, as no subsequent rulings had been issued since that time. The 2014 Rulings confirm that the IRS still considers a one-time lump-sum distribution election for retirees during a limited period of time (a Window) to be consistent with the minimum distribution rules.

Facts. For the most part, the facts of the 2014 Rulings are substantially similar to the facts of the 2012 Rulings, with only minor differences. For example, Letter Ruling 201422029 addresses a plan that covers collectively-bargained employees, where the plan already offers a lump-sum option to non-collectively bargained employees. Letter Ruling 201422028 addresses a retiree cashout under a multiple employer plan. However, none of these minor differences appears to impact the analysis or outcome. In general, the facts that are consistent among the rulings are as follows:

- The plan sponsor proposes to offer a lump-sum payment option to certain participants and beneficiaries currently receiving benefits;
- The lump-sum Window will be offered on a one-time basis, and will be open for between 60 and 90 days (30 to 60 days in one ruling, and 30 to 90 days in another ruling);
- An election to participate in the Window will be subject to spousal consent; and
- Each plan is sufficiently funded such that the Window will not trigger benefit restrictions under Code Section 436.

Holdings. As with the 2012 Rulings, the 2014 Rulings hold that the Windows will not violate the minimum required distribution rules under Code Section 401(a)(9). In particular, the 2014 Rulings interpret Treasury Regulations Section 1.401(a)(9)-6,

Q&A-14(a)(4), which contains exceptions to the general requirement that annuity payments, once they begin, cannot be changed and must be non-increasing. [Q&A-1(a)] One exception allows annuity payments to increase if the payment of increased benefits results from a plan amendment. [Q&A-14(a)(4)] The 2014 Rulings conclude that this exception applies to a plan amendment that allows retirees (and other plan beneficiaries) in pay status to make a one-time election during a limited period to receive their remaining benefit in a lump-sum distribution. The rulings note that the legislative policy of the minimum distribution rules was to "prevent lifetime accumulations which might escape income taxation altogether." They go on to review the regulatory exception for amendments providing for annuity payment increases, and conclude that the Window falls within it.

Letter Ruling 201422031 also concludes that a lump-sum payment during the Window will not trigger excise tax under Code Section 4974, which is imposed on a participant who fails to receive a distribution of all or a portion of his minimum required distribution amount for the applicable year.

Notably, while covered individuals under the 2012 Rulings were offered financial counseling, the 2014 Rulings do not reference this concept (other than Letter Ruling 201424031).

Other Applicable Laws. Although the 2014 Rulings specifically rule only on the application of the Code Section 401(a)(9) requirements, the rulings also make note of various other qualified plan requirements that could be implicated in connection with a Window. These additional rules are important to keep in mind when considering implementing a Window:

- *Benefit restrictions*. Each plan has sufficient funding levels so that the Window would not trigger benefit restrictions under Code Section 436 by reason of the lump-sum distributions.
- *Spousal consent and QJSA/QOSA.* The new distribution under the Window is treated as a new "annuity starting date" for each participant. As such, the election of a new distribution option under the Window is subject to spousal consent in accord with the requirements of Code Sections 401(a)(11) and 417, including consent by the current spouse and, if different, the spouse at the time a person's pension payments began. Under the plans addressed in the rulings, each participant had the ability to elect a qualified joint and survivor annuity (QJSA) or a qualified optional survivor annuity (QOSA), and was provided with the proper QJSA/QOSA disclosures under Code Section 417.
- *Benefit limits.* Each new distribution must satisfy the requirements of Code Section 415 as of the new distribution date, even if the original distribution satisfied the Code Section 415 limits determined at the time the benefit first commenced. This is because, where there are multiple annuity starting dates, the Code Section 415 limits must be applied as of each annuity starting date. [Treas. Reg. § 1.415(b)-1(b)(1)(iii)]
- *Minimum present value.* The lump-sum benefit offered under the Window must satisfy the Code Section 417(e) minimum present value requirements.
- *Eligibility for direct rollover.* The IRS notes that a portion of the lump-sum distribution may not qualify for rollover to an IRA (or other qualified plan) because it represents the minimum required distribution for the year. [*See* Treas. Reg. 1.401(a)(9)-6, Q&A-1(d).]

Therefore, for plan sponsors considering whether to implement a de-risking strategy through a retiree lump-sum Window, the 2014 Rulings provide additional comfort with respect to compliance with the complex minimum required distribution rules.

Conclusion

Given the fact that courts and the IRS are beginning to weigh in on de-risking strategies, we expect to see more and more sponsors considering one or more of these strategies in their ongoing attempts to manage their pension liabilities. While we probably have not seen the end of the court challenges, the recent *Verizon* decisions should provide some comfort to employers considering similar strategies. ■