This paper considers so-called pension plan de-risking, where a defined benefit plan purchases a group annuity contract to satisfy the plan’s future benefit obligations to retired and deferred vested plan participants, and/or gives such participants an opportunity to receive the value of their future benefits in a single payment. The paper describes the context and history of de-risking, explains why the practice (particularly lump sums) is harmful to participants as a group, and considers theories under which current law provides federal regulators with authority to mitigate some of the harms of de-risking.

Introduction

For a variety of reasons, employers today are less willing than they have been historically to accept the risks—investment risk and mortality risk—of defined benefit plans. Efforts to discharge or minimize such risks have led some employers to terminate plans and other employers to freeze benefit accruals.

In plan terminations, the plan’s liabilities are discharged either through the purchase of an irrevocable insurance commitment to pay plan benefits, through lump sum payments of benefits values to participants who choose them, or, most commonly, through both. Thus, in terminations, the employer, by ending the plan, shifts all risks to one or more insurance carriers and, where lump sums are offered, to participants who choose them.

In some cases, though, plan termination has not been a realistic option for the employer. Sometimes the employer has contractual obligations or labor relations reasons to continue the plan for at least some employees; in other cases, the plan is underfunded, and the cost of funding up the plan so that it can be terminated is regarded as too steep. In many cases where termination is not an effective option, the employer has already frozen benefit accruals for all or a portion of the employees.

In such cases, plan sponsors might use one or more of several strategies to relieve them of some plan-related risks (that is, investment and mortality risk). These strategies—some of whose legality and social-welfare effects will be questioned in this paper—are often referred to as de-risking, for they relieve the employer of future risks related to a portion of the plan’s participant population.

Most of the methods of de-risking are currently expensive because of the low interest rate environment; as a result, an employer must pay what many view as a high premium to immunize itself from plan risk. As explained in this paper, however, one type of de-risking tool, lump sum commutations of benefits to people already in pay status, is less expensive to the employer than other tools but more problematic for participants. A principal goal of this paper is to explore the problems and possible illegality of this tool when aimed at participants already in pay status and to suggest areas that might provide the agencies authority to prohibit or discourage the offer of lump sum payments to individuals in pay status. The paper also describes and analyzes the mechanics, policy aspects, and legality, of de-risking generally and suggests strategies that the
agencies might use to provide stronger protections for plan participants and their beneficiaries than exists under the current regulatory environment.

This paper proceeds as follows: the first section defines de-risking and identifies what is new about it, particularly when compared with a plan termination. The second section describes the adverse effects of certain de-risking strategies on participants. The third section explores the relationship between tax and ERISA Title I legal requirements and the two principal tools employers use to shed risk in ongoing defined benefit plans, payment of lump sum benefits, and the transfer of benefit liabilities to a private insurance company through the purchase and distribution of an irrevocable commitment from the company. This is the section that suggests legal theories that the agencies might use to prohibit or discourage lump sum payments to individuals in pay status and theories to add protections when a plan de-risks through the purchase and distribution of an irrevocable insurance commitment. (A particularly promising approach would be for the agencies to issue guidance creating an enhanced consent procedure for older seniors, who are substantially more likely than other plan participants to suffer diminished mental capacity and thus may not be able to give informed consent to a lump sum distribution.) The fourth section summarizes possible actions that the Federal regulatory agencies might consider to discourage de-risking and to provide greater protection for plan participants whose benefits are being de-risked. The final section briefly concludes.

I. Background: What Do We Mean When We Talk About De-risking?

The term de-risking is a generic (rather than statutory) description of the strategies that employers take to shed the risks of defined benefit plans. This section provides some historical context, identifies and categorizes the varieties of de-risking strategies, describes employer benefits and costs and participant costs and problems, and compares de-risking to plan termination and considers future developments.

A. Context and Types of De-risking Strategies

In an ongoing, non-insured defined benefit plan that pays periodic lifetime benefits to participants, the employer bears two significant risks: investment risk and longevity mortality risk. The employer continues to bear these risks until the last annuity payment is paid to the last remaining participant in the plan. For decades prior to ERISA, these risks were more theoretical than real, because federal law did not mandate funding standards for defined benefit plans and the plan, as a contract, did not require the employer to fund the plan and provided that the plan participants had no recourse against the employer in case of plan insolvency. Thus, the actuarial risk of insolvency rested on the employer only if the employer remained committed to the plan; the employer could unilaterally shift all risk to the participants simply by terminating the plan or even by ending plan funding. When an employer did this, mortality and investment risk were shifted from the plan to the employees. 1 In addition, if the plan were underfunded at the time of plan termination, the participants could also have their benefits immediately cut, in what might be thought of as a retroactive shifting of previous employer-born risk to the employees.

1 If the employer purchased an annuity contract to take on plan liabilities, the nominal burden of the investment and mortality risks lay on the insurance company to whom the plan liabilities were transferred. The employees risk in such cases was limited to the risk of non-performance of the insurance company, and here the employees had some backstop protection from state insurance guaranty programs.
The enactment of ERISA and post-ERISA legislation altered this, creating mandatory funding standards and generally providing that employers could not escape residual liability simply by terminating a plan. Over time, Congress revised the minimum funding standards to require the employer to remedy funding shortfalls over shorter time periods, which resulted in increases in funding volatility. During the same period, the accounting treatment of an employer's pension plan obligations was revised to increase balance and income statement volatility. (The increase in funding and accounting volatility both contributed to employer wariness of continuing defined-benefit plan sponsorship.)

Even after the enactment of ERISA, though, employers retained tools to shed risks in defined benefit plans. The ultimate de-risking tool after ERISA remains, as it was in the pre-ERISA era, plan termination. Under ERISA, an employer can decide to terminate a plan if the plan has sufficient assets to satisfy all plan benefits, which is done through the transfer of the plan's benefit obligations to an insurance company and/or lump sum payments to participants if the plan so provides (and to the extent that the employee either elects to receive his benefits as a lump sum or the benefit is below the threshold at which consent is required, which is currently $5,000). The plan can be amended at termination to add a lump sum benefit option (but, as this paper will argue, perhaps only to people not already in pay status). It should also be noted that an employer can spinoff a part of a plan and terminate either the spun off or the original plan. Whether a plan is fully terminated, or spun off and terminated, the future funding and longevity risks of the affected participants are born by the insurance carrier to whom the liabilities were transferred (or by the participants who receive a lump sum and now have to manage it) rather than the employer maintaining the plan.

A lump sum option in an ongoing plan can also be seen as a de-risking tool, since it relieves the plan, and thus the employer, of risk post-distribution for those employees who elect a lump sum. And some defined benefit plans are funded through level premiums to an insurance company in exchange for guaranteed annuity contracts; in such plans, the insurance company always bears mortality and investment risk (which is priced into the premiums). However, historically, such plans have been used by relatively few and mostly smaller firms.

Moving back from these common practices, which are ordinarily not referred to as de-risking in the sense that the word is being used today, there are two types of de-risking strategies, those that occur "inside" the plan’s asset portfolio and those that occur outside. Inside-plan de-risking can generally take two forms: matching some or all of the plan’s future benefit liabilities to high-quality fixed income securities, which substantially eliminates meaningful investment risk although not mortality risk; or covering some or all future benefit obligations with annuity contracts from insurance companies, which but for insurer-insolvency risk, eliminates both investment and mortality risk with respect to the benefits covered by the annuity. (The annuity is held as a plan asset.) In theory, a plan could also match assets to liabilities and purchase insurance contracts that protect only against mortality risk, although this does not appear to be a practice among defined benefit plans in the United States.  

The other approach to de-risking—the approach that has brought the term its current meaning and accompanying concerns and controversy, is de-risking outside the plan, where investment and mortality risk are shifted from the plan either to an insurance company through the purchase of an annuity contract (distributed to the plan participants rather than held as a plan asset) or to the participant when the participant is offered and elects a lump sum form of benefit. (Because defined benefit plans cannot typically make benefit payments to current employees, unless they have already reached plan retirement age, lump sum offers are made to either or both of deferred vested former employees and participants and beneficiaries already in pay status.) As will be discussed later in this paper, plans that offer lump sum options to those already in pay status have often included an age-cap, presumably because participants above a certain age group have access to better individual mortality risk information and thus would, as a group, cause insurance companies to raise premiums substantially to reflect the expensive adverse selection that would result in favor of lump sums among those with below-average life expectancies.

B. Benefits and Costs of De-risking to the Plan Sponsor

Outside-plan de-risking through the purchase of a group annuity contract is generally thought to be expensive to the employer, because insurance companies typically price contracts using low interest assumptions and a conservative mortality table. In contrast, the use of lump sums as a de-risking device is typically less expensive to the employer than transferring benefits to an insurance company, for four reasons: (i) the Internal Revenue Code permits plans to use a higher interest assumption than the assumptions typically used by insurers in pricing annuities; (ii) the Internal Revenue Code permits plans to use mortality tables that are thought to be less conservative than those used by insurers in pricing annuities; (iii) the plan does not pay the insurer any amounts for future administration of payments to participants, regulatory compliance, or investment management; and (iv) the plan does not pay the insurer to compensate it for its use of capital, i.e., does not have to create a profit for the insurer.

On the other hand, as already noted, when a plan offers a lump sum option, insurance companies can be expected to charge a higher premium per participant since the insurer assumes that those people who are aware of lower-than-average life expectancy will adversely select against the annuity. Nevertheless, virtually all observers of de-risking believe that the employer substantially reduces its costs when it offers a lump sum option in connection with the purchase of an annuity contract. It has been estimated that a lump sum commutation of a benefit is approximately 15 to 30 percent less expensive on average than the purchase of an annuity contract for an electing participant and would be higher but for adverse selection by those who have a terminal illness or otherwise know short life expectancies.

---

3 See e.g., Treas. Reg. § 1.401(b)(1)(i).
4 Adverse selection would also occur for younger groups, but the number of people with information to adversely select would increase as the age of the participants increase.
5 Insurance companies presumably are able to estimate the number of participants who have information that will allow them to engage in adverse selection. Thus, a typical premium will charge the employer an extra fee for participants who choose lump sums up to a cap, the cap being the insurer's estimate of the adverse selectors. Observers believe that offering a lump sum in conjunction with the purchase of a group annuity significantly reduces the employer's costs. As noted above in note 4, most de-risking transactions put an age-cap on the number of participants who are eligible to elect a lump sum, probably because the amount information that would permit adverse selection increases as participants age and are more likely to enter the period of senescence.
Moreover, some employers offer participants a lump sum without purchasing an annuity contract, and this is thought to not only transfer risk to those who elect the lump sum, but to be less expensive than the plan retaining responsibility for payment of the benefit.\(^6\)

From the perspective of the employer, however, inside-the-plan de-risking in some cases can reduce employer cost but in other cases will likely increase employer cost and contingent liability compared to outside plan de-risking.

If the inside-plan de-risking involves the purchase of a group annuity contract from an insurer, both investment and mortality risk are shifted to the insurer at similar cost to purchasing such a contract and then distributing it to the affected plan participants (i.e., outside-plan de-risking). But the plan must continue paying PBGC premiums and bears the risk, arguably trivial, of insurer insolvency. As a result, plan sponsor costs will generally increase when compared to an outside-plan de-risking strategy transferring liabilities to insurers.\(^7\) On the other hand, such an inside-de-risking strategy will not generally upset plan participants or their expectation that their benefits will be paid by the plan and insured by the PBGC.

But a plan investment policy that de-risks by matching assets to future liabilities (and thereby immunizing the liabilities) can be less expensive than transferring assets and liabilities to an insurer--regardless of whether the insurance contract will be distributed to participants or held by the plan--because the insurer typically will base its premiums on a lower rate of return than the plan can realize through investment in high-grade fixed income securities. While the plan will continue to be responsible for PBGC premiums for all participants, the plan generally may still come out ahead on cost (in part because the insurer factors into its premium the insurer’s own costs of participating in the state guaranty funds and administering benefit payments). Of course, in such situations, the plan is not really transferring all risk and is reducing only investment risk, not mortality risk. And even with respect to investment risk, the employer retains the risk that some of the issuers of the securities it holds may become insolvent.\(^8\)

C. De-risking Problems and Costs to Participants

In-plan de-risking has little if any cost to plan participants and in some cases can benefit the participants. First, the plan retains ultimate responsibility for benefits and the benefit remains insured by the Pension Benefit Guaranty Corporation. Second, the plan, by either transferring risk to an insurer or by matching assets to liabilities, reduces the risk of plan failure, which also benefits the participants.

Outside-plan de-risking has clear costs to participants, however, at least for those who select lump sums whose value, as just noted, is less than the value of the annuity benefit. In

\(^6\) The employer who offers a lump-sum only de-risking program can also expect some adverse selection from participants with knowledge that they have below-average life expectancies. But the employer can reduce costs in the aggregate if the take-up rate of the lump sum option is sufficiently high that it more than compensates for the adverse selectors. Moreover, it should be kept in mind that the life expectancy tables authorized by the Internal Revenue Code are outdated and understate group life expectancy.

\(^7\) State guaranty associations will not typically insure contracts that are not distributed to plan participants, but the contract will be guaranteed by the PBGC.

\(^8\) As earlier noted, a plan could also purchase a longevity insurance policy to cover mortality risk, although insurers may be reluctant to sell such insurance for an older population whose characteristics may differ from the general population.
addition, some perceive risk when the plan transfers liabilities to an insurer, but here the costs are more speculative and some have argued that participants are no worse off and in fact may even be better off when a plan transfers liabilities to an insurer rather than keeping them in the plan. The costs and risks to participants in outside-plan de-riskings are discussed in detail in the next section.

D. De-risking and Plan Terminations: What is Different and What Will the Future Look Like?

In some ways, outside de-risking is similar to plan terminations. One de-risking strategy utilizes a so-called spin-off termination, dividing a plan into two plans—typically one for active workers, which is ongoing, and one for everyone else (i.e., retirees and deferred vested participants), which is terminated. Indeed, one of the publicized de-risking transactions—the one used by General Motors—was reportedly a spin-off termination.9

But there are two important differences between the current generation of de-risking and earlier spin-off terminations. First, the motivation is different. Employers formerly used spin-off terminations as part of a strategy to obtain so-called surplus assets in overfunded pension plans, while today they use outside-de-risking, including spin-off terminations, simply to transfer liabilities away from the plan, thus easing future contribution and financial volatility, and sometimes as one step in an ultimate path to a later plan termination.10

Second, it was rare in the earlier generation of plan terminations to offer lump sum benefits to those already in pay status. PBGC regulations seemed to prohibit such offers, although in recent years PBGC has apparently permitted at least some plans to make them. I have discussed this informally with representatives of PBGC and was told that small plans sometimes requested permission to engage in such transactions when annuity premiums were unusually high, and PBGC gave its approval. It has only been recently according to the people I spoke with that large plans have been amended to allow retirees to take lump sum benefits as a de-risking strategy. No one at PBGC has focused, at least publicly, on whether such a practice is legal under ERISA or the Internal Revenue Code. (The same can be said about the IRS and Department of Treasury.)

Because of the low-interest environment and perceived legal obstacles to lump sum offers to retirees, few if any plans engaged in de-risking transactions until two and a half years ago, when three large transactions took place.11 There have been several other de-risking transactions since; at least five have received private letter rulings from the IRS, although as discussed later in this paper, those rulings noted that they did not address a range of issues that could create qualification issues.

Observers have suggested that the pace of de-risking actions might pick up, for several reasons: (1) some people believe that we are in a long-term low interest rate environment, so there is not good reason to wait for interest rates to increase; (2) asset values in plans have increased because of the stock market performance, meaning that less additional employer

---

10 As noted earlier in the paper, employers sometimes have business reasons to temporarily maintain the plan and some plans are currently underfunded, which would prevent a full plan termination.
11 The three were General Motors, Ford, and Verizon.
financial support for a de-risking transaction is necessary; (3) there is a fear that the position of the IRS might become less accommodating of lump sum transactions; (4) the IRS will eventually issue new mortality tables, which will reflect longer longevity expectations; and (5) de-risking is being actively marketed by some consultants and insurers.

II. Costs and Risks to Participants of Outside De-risking Transactions

Outside de-risking transactions generally take one of three forms: (1) the offer of lump sums to a group of retirees or vested deferred participants (the offer does not typically extend to older workers, presumably because of a greater risk of adverse selection); (2) the transfer of liabilities for certain participants to an insurance company with no lump sum option; (3) an offer of a lump sum to a group of retirees or vested deferred employees (again, limiting the pool of offerees to younger retired participants), with a transfer of liabilities to an insurance company for participants who do not accept the lump sum. Ford Motor Co. used the first form of de-risking transaction, Verizon the second, and General Motors the third. In both the Ford and General Motors transactions, approximately a third of the participants who were offered a lump sum accepted it.

This section of the paper first considers the costs and risks to participants of having their benefits transferred to an insurance company and then turns to the costs and risks to participants who are offered a lump sum. The final part of this section considers three issues common to all de-risking transactions: (1) erosion of the PBGC base; (2) the effect on the funding status of the plan after the de-risking transaction; and (3) capacity of insurance companies to accept massive pension plan liabilities.

A. Transfer of Liabilities to an Insurer

There are at least six participant concerns when a plan transfers benefit liabilities to an insurer: (1) that the participants are better protected economically under a plan with PBGC coverage than under an insurance company with state guarantee fund assurance; (2) that a plan will enter into an insurance contract that does not adequately ensure benefits, either because the insurer does not have the strongest claims paying ability or because the insurance arrangement does not use best practices in protecting participants; (3) that the insurance contract will not provide participants with various ERISA statutory protections; (4) that participants may not be able to correct, or at least easily correct, mistakes in benefit calculations; (5) that the transfer will create anxiety and uncertainty among participants, particularly the elderly; and (6) that notice to participants is inadequate, at least when the de-risking is not part of a plan termination with Title IV notice, and that post-transfer notices about material changes in the insurer's financial abilities will depend on state law.

This subsection of the paper will consider each of these points, but it should be said that transfers of benefit liabilities to insurers are routine and noncontroversial in actual plan terminations. Since many de-risking transfers can be structured to include a spin-off termination, the objections outlined here to transfers of annuity contracts could sometimes be accomplished even if such transfers are prohibited outside the termination context. The extra cost of a spinoff
termination to the employer, however, might discourage some such transactions, at least at the margins.

1. Overall Economic Protection of Participants

Some consumer advocates have suggested that participants enjoy stronger benefit security when their benefits liabilities remain in a plan and are guaranteed by the PBGC, rather than transferred to an insurer and protected by state guarantee association protections. (It is important not to conflate these concerns with the second concern: that the plan will not choose an insurer with strong claims-paying ability and/or will not negotiate with the insurer to maximize economic security through the creation of a segregated asset pool not subject to claims by other policyholders of the insurance company.) Insurance companies and other supporters of de-risking transactions, however, have argued that an insurance company, with its expertise at managing risk and with strong state regulation of insurance reserves and investments, is generally more secure than the plan, which is likely invested in riskier assets than the assets in insurance reserves, may not be fully funded, and whose solvency may ultimately depend on the economic health of the plan sponsor. Moreover, state insurance programs will, for some employees, provide higher levels of benefit protection than the Pension Benefit Guaranty Corporation, which is technically insolvent and may eventually exhaust its assets, requiring a reduction in benefit guarantees. The counterargument is that some state insurance funds provide relatively stingy levels of protection, while the PBGC fully guarantees benefits for most participants (with few exceptions, it guarantees benefits up to $61,136 for 2015) and is not likely to be allowed by the United States Congress to fail. In addition, the PBGC has a strong record of taking over benefit payments immediately, while the state reserve funds have sometimes allowed benefit payments to be delayed. Moreover, the state guarantee funds are unfunded and depend on assessments on insurance companies doing business in the state after an insurer’s insolvency. Moreover, different states have different guarantee levels, which can result in disparate treatment of economically similarly situated participants. Finally, state guarantee limits are present-value limits, and the assumptions used to determine present value change over time; at present, interest rates are low and life expectancy tables are more conservative than those used by the IRS, which results in low present values. For example, a 65-year old with a $25,000 annual annuity would likely experience a cut in benefits even in a state with a $250,000 guarantee level.

It is possible to identify individual participants who will receive stronger ultimate guarantee protections when benefit liabilities remain in a plan, just as it is possible to identify individual participants who would receive stronger protections if their benefits are transferred to

---

12 The extra costs include the legal expenses of undertaking a spinoff termination and the potential impact of IRC § 414(l), which provides that no participant will have their benefits reduced because of the plan termination, which essentially requires that plan assets be divided on an actuarially equivalent basis between the remaining and spun-off plan. Unless a plan is fully funded using PBGC actuarial assumptions, which are conservative, the employer will typically have to add assets to the spun-off plan in order to accomplish the spinoff termination. In a pure de-risking transaction, the plan may pay lump sums and use plan assets to purchase insurance contracts using original plan assets, subject only to IRS § 436, which places limitations on an underfunded plan's ability to pay lump sum benefits or to distribute annuity contracts to participants.

13 The PBGC does not enjoy the full faith and credit of the United States and it would require legislation to ensure that the PBGC could meet its full guarantee benefit obligations.

14 On the other hand, total annuity payment under state insurance regulation can exceed nominal guarantee levels because insurance companies can fall below general account requirements and still have sufficient assets to pay all or most obligations under an annuity contract.
an insurer. For example, an older retiree in a plan with an economically strong employer and a well funded plan, whose benefits are fully insured by the PBGC, and who lives in a state with low guarantee levels, would probably receive greater security if liabilities remain in a plan. But a younger retiree who lives in a high guarantee state, whose benefits exceed PBGC guarantee levels, and whose employer is experiencing financial trouble, might receive greater security if benefit liabilities are transferred to an insurance company. Ultimately, it is probably not possible to determine whether a transfer to an insurer is better or worse for participants generally. Part of that answer depends on whether Congress would rescue the PBGC if its assets are at some future point insufficient to support benefit guarantees, and the answer to that question is of course unknowable at present.


Consumer advocates have suggested that plan sponsors engaging in de-risking transactions might not choose insurers with the strongest claims-paying abilities and that they might not be willing to pay an increased premium to the insurer to maximize protection for their retirees. It appears that thus far companies engaging in de-risking transactions have selected insurers that are rated highly by credit-rating agencies, and in at least one of the transactions, participants were protected not only by the insurer's general reserves but by a separate pool of assets. Consumer advocates worry, however, that as de-risking transactions proliferate, and as plan sponsors try to reduce the cost of such transactions, the quality of selected insurance carriers and the level of protection embedded in the insurance contract may decline. There is also concern that some strong carriers may decline to bid on de-risking business and that the most financially secure insurers currently seeking de-risking business may exhaust their capacity to take on additional de-risking transactions, leaving only less secure insurers in the pool of willing companies.

There are also legal concerns. The Department of Labor in 1995 issued an interpretive bulletin, now embedded in the Code of Federal Regulations, which requires fiduciaries to select the safest available annuity when transferring liabilities to an insurance carrier. But some courts have rejected the idea of the safest available annuity, looking only at the reasonableness of the decision to use a particular insurer. Moreover, the Labor Department’s position does not explicitly and perhaps does not even implicitly require that the annuity contract be structured to provide participants with security beyond the insurer's general assets, and it is not clear that a plan fiduciary must consider the asset base protecting the remaining participants in determining how much to spend on an annuity. Furthermore, it may be difficult for participants to challenge an annuity purchase. The ERISA statute of limitations may have already run by the time an insurer fails or is experiencing clear signs of financial difficulty, and bringing a civil action before that time can be problematic, since there may be a standing issue (any allegation of harm is still speculative). Also, a legal challenge would require a level of monitoring and financial sophistication (to go beyond ratings), and financial resources, on the part of participants that is

15 See Riley v. Murdock, 890 F.Supp. 444 (EDNC 1995) (court determined that fiduciary satisfied its fiduciary obligation if its decision to purchase annuity contract was “reasonable,” rejecting plaintiff’s arguments for more probing analysis of safety of insurer). On appeal, the Department of Labor filed an amicus brief asking the Court of Appeals to adopt a “safest available annuity” standard of duty, which the Fourth Circuit explicitly rejected, noting that “no federal court has adopted such a standard, and the circumstances of this case do not merit application of such a demanding standard.” See Riley v. Murdock, 83 F.3d 415 (1996).
probably unrealistic. The Department of Labor does have statutory authority to monitor and contest the selection of annuity providers, but there is no evidence that it is currently using this authority or has the resources to vigorously police the market.

3. ERISA Protections

There are several ERISA consumer protections that participants arguably lose when a plan shifts benefit responsibility to an insurer. Thus, for example, participants may be able to sell future benefits to a factoring company, which the anti-alienation provisions of ERISA and the Internal Revenue Code would prohibit for a benefit held by a plan. While this would seemingly violate IRC § 401(g), which require that an annuity contract purchased by a plan be nontransferable, it is not clear how the IRS would learn of or address a violation other than tax the proceeds. The insurer itself could transfer the liabilities to another company without regard to ERISA’s fiduciary duties (although the participant would generally have to consent to such transfer under state law), or might offer a lump sum commutation of the benefits in the future, not subject to the full array of ERISA’s consumer protections. Creditors may in certain circumstances be able to attach future annuity payments under some state laws.

While there are strong arguments that ERISA’s fiduciary regime requires that fiduciaries negotiating a contract with an insurer attempt to replicate ERISA protections, and while there are Treasury Regulations that require that the joint-and-survivor and present value rules must attach to an annuity contract purchased with plan assets, it is not clear that fiduciaries routinely negotiate for provisions in the annuity contract that attempt to replicate these ERISA requirements. It is also not clear that there is any DOL or IRS post-contract audit of insurance companies for compliance, or that there would be any penalty to an insurer that did not comply with ERISA requirements. It should be kept in mind that the annuity payout period may

16 See GCM 39882 (May 27, 1992)(exchange of annuity contract for dissimilar contract violates 401(g) and results in immediate taxation).

17 See Treas. Reg. § 1.401(a)-20, Q&A-1 (“REA 1984 replaced section 401(a)(11) with a new section 401(a)(11) and added section 417. Plans to which new section 401(a)(11) applies must comply with the requirements of sections 401(a)(11) and 417 in order to remain qualified under sections 401(a) or 403(a). In general, these plans must provide both a qualified joint and survivor annuity (QISA) and a qualified preretirement survivor annuity (QPSA) to remain qualified. These survivor annuity requirements are applicable to any benefit payable under a plan, including a benefit payable to a participant under a contract purchased by the plan and paid by a third party.”); Treas. Reg. 1.401(a)-20, Q&A-2 (“Rights and benefits under section 401(a)(11) or 417 may not be eliminated or reduced because the plan uses annuity contracts to provide benefits merely because (a) such a contract is held by a participant or spouse instead of a plan trustee, or (b) such contracts are distributed upon plan termination.”); Treas. Reg. 1.411(d)-4 Q&A-2(a)(3)(ii)(A) (“The protection provided by section 411(d)(6) may not be avoided by the use of annuity contracts. Thus, section 411(d)(6) protected benefits already accrued may not be eliminated or reduced merely because a plan uses annuity contracts to provide such benefits, without regard to whether the plan, a participant, or a beneficiary of a participant holds the contract or whether such annuity contracts are purchased as a result of the termination of the plan.”) See also Treas. Reg. 1.411(d)-4 Q&A-2(a)(3)(ii)(B) Ex. 2 (Example involves DB plan allowing election between QISA and single life annuity commencing at age 62, with option to defer distribution to any later date subject to section 401(a)(9). “The plan will fail to satisfy section 411(d)(6) unless the optional forms of benefit provided under the plan are preserved under the annuity contract purchased on plan termination. Thus, such annuity contract must provide a participant the same optional benefit commencement rights that the plan provided. In addition, such contract must provide the same election rights with respect to such benefit options. This is the case even if, for example, in conjunction with the termination, the employer amended the plan to permit participants to elect a qualified joint and survivor annuity, single life annuity, or single sum distribution commencing on July 1, 1990.”); Treas. Reg. 1.417(e)-1(e)(1) (“Any annuity contract purchased by a plan subject to section 401(a)(11) and distributed to or owned by a participant must provide that
stretch over three or four decades once the contract commences, so that the protections need to be both explicit and strong, with assurance that there will be penalties for non-compliance.

4. Participant Disagreement with Benefit Calculations

It may be unclear to whom a participant with questions about benefit calculation or form should seek relief: the plan, the insurance carrier, or some combination. Moreover, if the initial appeal lies to the insurance company, it is not clear what type of ERISA claims procedure rules or disclosure standards would apply or whether the annuitant would have some recourse to the plan (since the annuitant is no longer a plan participant).

5. Participant Perceptions

Participants, particularly elderly plan participants, may react negatively to the change and uncertainty that accompanies a transfer of liabilities to an insurer, even if there is no strong factual predicate for their concern. Thus, even if participants are generally as or more economically secure following a transfer of their benefit obligations to an insurer—a question that the paper has already suggested is difficult to evaluate, even for experts—an elderly individual may experience anxiety because of inability to make such evaluations, and this itself is a meaningful negative aspect of de-risking transactions.

6. Inadequate Notice to Participants

There are no clear rules from either the IRS or the Department of Labor on what notice a plan must provide to participants on a de-risking transaction, although there are notice rules when a de-risking transaction occurs as part of a spin-off termination. Some consumer advocates have argued that the failure to conform to PBGC notice requirements is a potential shortcoming of some de-risking transactions, although others have noted that plans that engage in de-risking transactions have, and are likely in the future to, provide participants with equivalent notice. Other consumer advocates have argued that insurers should have to provide annuitants with periodic notices concerning the financial status of the insurer to replicate the ERISA requirement that underfunded plans report their funding status to participants. (State laws may vary in what sorts of periodic or episodic notices insurers must provide to policyholders.)

B. Lump Sum Option Window

As earlier noted, in two of the large de-risking transactions that have already taken place, already retired plan participants (and deferred vested employees) were offered the option of taking a lump sum in lieu of receiving the remainder of their annuity. This is a bonanza for those
who know they have a terminal illness, which permits them to engage in adverse selection by choosing the lump sum option, which is certainly more valuable than a life annuity whose payment period will be cut short by the certainty of an early death. This is the primary group—perhaps the only group, in the view of pension economist Alicia Munnell, among others—that will be financially better off swapping their annuity for a lump sum. Everyone else, or almost everyone else, who selects a lump sum will be forfeiting a substantial portion of their retirement savings and ERISA protections.

It is reasonable to assume that the plan sponsor that permits retirees an election to convert their remaining annuity into a single-sum payment is not doing so because it wants to provide a large financial windfall for former employees with terminal illnesses. And since rational insurance companies will charge higher premiums for a group annuity contract that permits the terminally ill to opt out of the insurance pool, we can assume that the plan sponsor expects to cover the higher premium costs and then some because it predicts that other participants will choose the substantially less costly, and substantially less valuable, lump sum option.

This subsection of the paper will consider three issues: (1) the lower economic value of a lump sum compared to an annuity (for most participants); (2) the retirement-management problems created by lump sums; (3) the problems of election and consent, and some speculation on why employers assume that a significant number of retirees will select lump sum payments despite the economic loss they will suffer. The paper in these subsections also notes some particular problems for women, including special problems for women who are not participants themselves but rather are married to participants.

1. Lower Economic Value of Lump Sum

The value of a lump sum (leaving aside the case of the retiree who is aware that he will have a shorter than average life expectancy and will adversely select against the annuity) will generally be less than the value of an annuity. There are several reasons for this. First, when an employer purchases an annuity, it is purchasing both administrative and investment management services, features for which the participant is not compensated when it selects a lump sum. Second, the discount rate for the annuity is lower than the rate of return a participant can realize on relatively safe investments. While the participant could invest the lump sum in riskier asset classes, this would involve a level of risk that an older person, who generally cannot afford large investment loss, should not take. In addition, the discount rate is pegged to a basket of

19 Relatively young deferred vested participants in some cases may also benefit by taking a lump sum, since they may have less risk aversion than older individuals and may thus be in a better position to take on more risk in return for a higher expected rate of return than is reflected in the lump sum calculation. As discussed below, most older employees cannot bear the risk of an investment portfolio with a higher risk/reward ratio. There may also be some affluent individuals who can bear risk and may prefer a lump sum to shape a more aggressive portfolio. Finally, individuals with high levels of high-interest debt may benefit from a lump sum where bankruptcy is not a realistic alternative, although one can argue that a non-attachable stream of income can be particularly attractive to such individuals.
20 The insurer can presumably make estimates of the number of participants with the ability to adversely select and adjusts the premium upward assuming these individuals will adversely select, but presumably its premium will not make reflect an “adverse selection” charge for the possibility that participants in excess of this estimate will select lump sums.
investment grade bonds. The participant is unlikely to realize this rate of return, however, because the participant will be unlikely to replicate the hypothetical bond portfolio from which the discount rate is generated, in part because the return will be reduced by fees. Moreover, some companies with investment grade credit ratings will nevertheless default, and the lump sum discount rate does not reflect this risk. Finally, if the participant decides to invest the lump sum in an immediate annuity, he or she will find that the annuity they are able to purchase on the individual annuity market will be approximately 28 to 32% lower than the benefit under the plan for a person between 65 and 75 (the reduction will be steeper for women than for men because insurance companies will use gender-biased life expectancy tables).\(^{21}\)

In addition, in cases in which the plan subsidizes the joint and survivor annuity, the lump sum does not have to reflect the value of the subsidy, which will, in addition to the other factors mentioned, mean the lump sum will have lower economic value for plans whose lump sum calculation does not include the value of the reflect the value of the subsidy.

2. Retirement Management, Spousal Protection, and Taxation Problems

An annuity provides a regular stream of income for the life of the participant. This provides the employee with valuable insurance advantages that are hard to replicate without purchasing an annuity contract. It also spares the participant from the time, risk, and expense of managing investments, a particularly difficult responsibility when the participant is also drawing down those assets in retirement. During the draw-down period, because of the constantly declining principal caused by withdrawal of assets, it is difficult to make up for even relatively small market losses without reducing the amount withdrawn from the plan.

Moreover, an older retiree with several hundred thousand dollars will be seen by some unscrupulous financial advisers and out-and-out scam artists as bearing an irresistible gift. And that retiree, especially if burdened by diminished mental capacity, may begin to consume beyond sustainable levels. And in some cases, financially stressed relatives will borrow (or worse) from the retiree. It should also be said that the negative management impact of a lump sum will generally be most severe for a female beneficiary, who has a longer life expectancy than her husband and is more likely to be alive when the assets are exhausted.

In addition, a participant who does not roll over all of his or her distribution will be subject to income taxation, and because of the bunching in a single year, could be taxed at a higher marginal tax rate than the participant would ordinarily bear. If not rolled over, the assets would be subject to the claims of creditors, and even if rolled over, the assets would be easily accessible to the participant, who may draw on the IRA to yield to creditor demands. Moreover, in some states creditors can reach assets in IRAs prior to bankruptcy. In addition, the participant's spouse loses important spousal protections, because the participant is permitted in an IRA to withdraw much or all of the account without spousal consent. Also, in some states

\(^{21}\) The estimates were prepared by comparing lump sum values under ERISA as of January of this year for a 65 year old, a 70 year old, and a 75 year old, and then using an annuity calculator for fidelity, assuming that the individual took a straight life annuity and resided in the state of New York. The author’s personal experience with Fidelity is that it serves as broker for a number of insurance companies, all of which are highly rated for claims paying ability but are not necessarily the highest rated. For a 65-year old man, an annuity purchased from Fidelity would be approximately 28% lower than the plan annuity and for a similarly aged woman the annuity purchased from Fidelity would be approximately 31% lower than the plan annuity.
payments from a retirement plan are exempted from state income taxation but withdrawals from individual retirement accounts are not.22

3. Election and Consent Issues

The participant, of course, has to elect to receive a lump sum benefit and a married participant can do so only if his or her spouse consents. We know that many participants, in ongoing plans, opt for lump sum benefits when they leave employment or retire, even though annuity benefits are typically worth more. Thus, we know that participants often make disadvantageous lump sum elections, but this is, unfortunately, a part of our current defined benefit system.

For a variety of reasons, the problems of poor decision-making, can be more profound for retirees already in pay status than for other participants. First, people already in pay status are older than the average plan participant and are more likely to suffer some diminished capacity.23 Moreover, the lump sum option in a de-risking transaction is a window benefit, available only for a short period of time, which puts additional pressure on the participant. Older people, particularly those with diminished capacity, may also be subject to pressure from children (who may see a possibility of access to additional money if a lump sum is selected, or a larger inheritance) and from investment advisers who stand to profit if the participant takes a lump sum and then pays them, directly or indirectly, to manage the lump sum. An older spouse may not be in as strong a position to object to the lump sum option. In addition, in some plans retirees and their spouses have already considered and rejected a lump sum option and now will have to revisit that decision, which can be particularly unfair if mental capacity has diminished between the time of initial benefit commencement and the offer of a new lump sum benefit window.

So why do employers expect so many retirees to make decisions against their own economic interest and in favor of the employer’s economic interest? Here again the answer is multi-factorial.24 Behavioral economists have shown that individuals have difficulty accurately discounting future payments and thus will overvalue lump sums. Moreover, some retirees will be concerned that if they unexpectedly die early, they will have “forfeited” their benefit. Retirees may be pressured by creditors to take a lump sum. And as already noted, financial advisers who work on commission have a financial interest in recommending that a participant forgo the

24 Some have argued that choice is always good and that the lump sum option permits people to maximize their welfare by selecting the choice that makes most sense to them. But as explained in the text, this argument is inconsistent with the way many people make choices. In fact, the only situation in which it is clear that a participant in pay status will maximize his or her welfare by selecting a lump sum is if they know they are near death and thus will receive little benefit to a continuing annuity. But if this were the only case in employers and insurance companies assumed participants would elect a lump sum, the insurance company would increase the premium substantially because of the loss of short-lived participants in the insured pool. It is improbable that employers would be willing to pay those higher premium charges, so it is reasonable to assume that the employer and the insurer predict that a sufficient number of people will select the lump sum against their interest. It is also worth noting that few employers would presumably be willing to bear an extra cost to give participants who know they are about to die a financial windfall.
annuity in favor of a lump sum, children and other relatives may pressure the retiree to take a lump sum, and some retirees will be experiencing diminished mental capacity and simply not be able to make good decisions. It is no wonder so many retirees make bad choices, and no wonder that employers anticipate that they will make bad choices. Offering a lump sum option to retirees can be a form of corporate elder abuse.

C. Other Policy Issues in Outside-Plan De-risking Transactions

1. Erosion of PBGC Premium Base

The PBGC single employer plan program, which has a long-term deficit, currently has only two sources of positive income: investment income and future premiums. Plan premiums are a multiple of the number of plan participants, which include those in pay status. When a plan de-risks through the distribution of a group annuity contract or payment of a lump sum, it has fewer participants and thus will pay lower premiums. This will at least somewhat impair the PBGC’s ability to continue to pay guaranteed benefits over the long term.

2. Effect on Plan Funding

When a plan is split into two plans, it is subject to section 414(l) of the Internal Revenue Code, which requires, in effect, that plan funding of each plan can be no less than it would have been had the spin-off not occurred. In de-risking transactions, the remaining part of an underfunded plan will generally have fewer assets than it had before, which results in less funding security of the participants whose benefits remain in the plan.  

3. Insurance Company Capacity

Some consumer advocates have raised the question of whether insurance companies, individually or even in the aggregate, have the capacity to absorb the liabilities of the growing number of defined benefit plans that might seek to de-risk over the next several years. There have also been questions about whether there are sufficient investment-grade fixed income securities and United States debt obligations available to allow insurance companies to take on such liabilities and satisfy state regulation with the quality of investment reserves.

III. Legal Aspects of De-risking

This section of the paper addresses the various ERISA and tax regulation (and in one case, age-discrimination rules) that create the legal context in which de-risking activities occur. The section is structured in two parts: the first considers the legal rules applicable to a plan offering a lump sum to a person already in pay status. The second section considers the legal rules applicable to a plan transferring benefit liabilities to an insurer and then distributing the contract to the covered participants. In each of these parts the paper considers whether there are arguments that the de-risking tool, i.e., either lump sum payments or transfers to annuity contracts, is prohibited, and also discusses the legal limitations, requirements, and considerations that might bear on using a de-risking tool if the tool is not prohibited. The paper argues that the Department of Treasury has authority to prohibit the offer of lump sums to people already in pay

25 A plan is not permitted to make lump sum payments, however, if its funding status falls below 60% and is subject to limitations if the funding level is between 60 and 80 percent. IRC § 436(d).
status and that the IRS should in any event stop issuing letter rulings opining on the permissibility of offering lump sums to those already in pay status. In addition, there are numerous questions concerning lump sum offers to retirees that the Department of Treasury and the IRS should clarify and the IRS should audit plans for compliance. Moreover, the Department of Labor also has the ability to provide important protections to participants offered lump sums, apart from the Department of Treasury and IRS.

There is a technical argument that de-risking through liability transfers to insurance companies outside a plan termination is prohibited unless the participant consents. In light of the history of defined benefit plans transferring liabilities to an insurance carrier or using an insurance carrier to provide plan benefits, these arguments may not persuade a court. In any event, such a rule would not apply to employers who are able to engage in a spinoff termination as a part of a de-risking transaction. As a result, most of the paper’s discussion on liability transfers focuses on the legal principles, particularly the application of fiduciary law, that relate to a plan fiduciary’s selection of an annuity provider.

Before turning to focused discussion on the lump-sum and liability-transfer de-risking tools, it may be useful to discuss a basic legal issue that applies to both tools: the appropriateness of the decision to use either of these tools under ERISA’s fiduciary regime.

Indeed, someone who takes a quick look at ERISA’s fiduciaries provisions may be surprised to learn that de-risking transactions, particularly those that include lump sum options, are permissible. Section 404(a) of ERISA provides that fiduciaries of ERISA plans must act for the sole benefit of participants and their beneficiaries and at least lump sum de-risking transactions are arguably designed to impair the welfare of participants and beneficiaries in order to reduce a sponsor’s costs. Why then are they permitted?

The answer can be found in the judge-made settlor-fiduciary doctrine, which holds that amending a plan—and a de-risking transaction is done pursuant to plan amendment—is not a fiduciary action at all, regardless of its impact on participants. Rather, it is a so-called settlor action, made by the plan sponsor in its business capacity as the designer of an employee benefits plan. The decision to de-risk is thus a settlor function and does not need to be made in the best interests of the plan participants. Instead, under one view of the doctrine, the decision can be explicitly made to harm the interests of participants rather than to advance them.

But the actions of plan officials to implement as opposed to adopting a plan amendment are fiduciary acts and are subject to all ERISA standards of fiduciary conduct. Thus, the key questions in de-risking transactions for an ERISA fiduciary are these: what decisions and actions are implementation decisions rather than settlor decisions, and what does implementation require in a de-risking transaction? It is in the answers to these questions that the Department of Labor must locate its authority to regulate de-risking transactions.

As just indicated, the choice of an annuity provider is not a settlor function, but rather is an implementation decision. Similarly, the fiduciary’s negotiation with the insurer over the annuity’s features and contractual provisions are implementation decisions. It is within the

---

Department of Labor’s authority to issue guidance both on how to select an insurer and on the contractual provisions that a fiduciary must ensure are included in the annuity contracts that the fiduciary negotiates on behalf of the plan.

It is also within the Department’s authority to issue guidance that provides that a fiduciary implementing a decision to offer retirees a lump sum has a fiduciary responsibility to minimize the possibility that the retiree will make an imprudent decision. To do this might require a robust level of disclosure and might also in some circumstances require that the plan provide retirees with independent fiduciaries to give them advice on whether to take a lump sum or continue receiving their monthly benefits. A fiduciary may also have a duty not to implement a compressed window period for choosing a lump sum if the fiduciary determines that the compressed window period will result in participants being pressured into making poor choices.

In an ideal regulatory environment, the disclosures and other protections required of the fiduciary would be sufficiently effective to substantially reduce the number of people who imprudently choose a lump sum option. In such a world, the plan sponsor’s cost-benefit analysis of whether to offer the lump sum option might result in no such option being offered, since presumably most of the people who did elect would do so because they anticipated dying earlier than average life expectancy.

A. Offer of Lump Sum Payments to Individuals in Pay Status

In 2012, the IRS granted private letter rulings to two plans (widely reputed to be the salaried-employee plans of Ford Motor Co. and General Motors) that considered whether a pension plan could offer a lump sum commutation of a benefit in pay status during a window period (of at least 60 days) without violating Section 401(a)(9) of the Internal Revenue Code. Prior to this time, it was unclear was this was permitted from an ongoing plan, although as earlier noted, some terminating plans were amended to offer a lump sum benefit form to individuals already in pay status as part of the termination process. The two rulings were limited in scope to the section 401(a)(9) issue, although the IRS presumably would have not issued the rulings if it believed that the lump sum were prohibited by another provision in the Internal Revenue Code. In 2013 and 2014, the IRS issued additional private letter rulings which explicitly limited the ruling to section 401(a)(9) issues and noted that the ruling did not purport to consider other requirements of the Internal Revenue Code.

1. Are Lump Sum Offers to Participants in Pay Status Permitted Under the Internal Revenue Code?

This part of the paper considers Code and regulatory provisions that can be interpreted, individually and collectively, to bar a lump sum commutation of a benefit already in pay status. The provisions are (1) section 401(a)(9) and the regulations thereunder (which do not permit an acceleration in benefit payments once payment starts, except under certain prescribed conditions, including benefit improvements, the category that lead the IRS to conclude in several private rulings that lump sum offers to those in pay status is permissible); (2) section 417 of the Internal Revenue Code, which requires that certain information and spousal consent to an alternative

---

form of benefit be provided before the annuity starting date (the IRS impliedly takes the position that there can be more than one annuity starting date for a benefit under the plan, a position questioned in this section); (3) section 401(a)(13), which prohibits alienation or assignment of a benefit; and (4) Treas. Reg. 1.401-1(b)(i), which provides that (i) a pension plan is established and maintained by an employer primarily to provide systematically for the payment of definitely determinable benefits to his employees, over a period of years, usually for life, after retirement, and (ii) can provide for the payment of only incidental death benefits.

i. Section 401(a)(9).

Section 401(a)(9) of the Internal Revenue Code provides that a qualified plan trust must provide that benefits must commence or be paid over the lives of the employee, no later than the employee’s “required beginning date,” which is generally the April 1st after the calendar year in which an employee attains age 70.5. The purpose of section 401(a)(9) is to prevent a plan participant from using a qualified plan to create a tax-favored asset to transmit to heirs rather than as a source of retirement income. While this purpose has little to nothing to do with the policy propriety of paying a lump sum benefit to someone already in pay status, the IRS issued regulations under section 401(a)(9) that are arguably inconsistent with the payment of a lump sum to a defined-benefit plan participant already in pay status, except on plan termination.

In particular, the regulations permit participants and beneficiaries to change the form of future payments only in three situations: (1) when a participant is being paid a period-certain annuity; (2) when a participant marries after retirement; and (3) when a plan terminates. Thus, in de-risking transactions that do not involve a spin-off termination, a plan cannot permit a participant in pay status to change the form of benefit payment, whether or not the participant consents to the change. But in certain circumstances a plan can increase annuity payments, and the change in a benefit from an annuity benefit could be viewed as an increase in the annuity amount from the monthly annuity to the lump sum and this, as will be discussed below, was the basis of the IRS revenue rulings permitting a lump sum offer to participants in pay status.

Before turning to that discussion, however, it should again be noted that plans can in many circumstances de-risk using a spinoff termination, which involves the termination of a plan. As just noted, the section 401(a)(9) regulations expressly permit a participant to elect a new form of benefit in a plan termination. Use of a spin-off termination, however, can increase the cost of a de-risking transaction and consequently, employers will generally want to avoid that approach to de-risking. But the fact that section 401(a)(9) permits a plan to offer a lump sum option to participants in pay status means, in effect, that it will not bar the use of lump sum offers if the plan sponsor is willing to incur the expense of a spin-off termination.

As noted in the first paragraph of this section, the 401(a)(9) regulations also permit annuities to increase under certain circumstances, and arguably the conversion of an annuity into a lump sum can be characterized as an increase in the annuity itself. The regulations indicate

---

28 IRC § 401(a)(9)
29 Treas. Reg. § 1.401(a)(9)- 6-Q&A13.
30 See note 12, infra, and accompanying text.
five circumstances under which an annuity can increase, one of which arguably might apply to converting an annuity into a lump sum: a plan amendment that increases benefits. \textsuperscript{31}

The IRS letter rulings permitting plans to offer lump sums to participants in pay status have each been based on the view that an amendment to a plan creating a lump sum option (within a specified window period) does not cause the plan to violate section 401(a)(9) because it is an acceleration of a benefit that is improved by a plan amendment. \textsuperscript{32}

The conclusion that such an amendment is a benefit increase is debatable. In addition, it is something of a semantic stretch for the rulings to take the position that a lump sum option is an increase in an annuity benefit rather than a new benefit form, a proposition that the rulings assume without examination.

As just suggested, it is debatable whether the offer of a lump sum payment is a benefit improvement. The lump sum, whose calculation must use specified mortality and interest assumptions prescribed by Section 417(e)(3), has a value that is by statutory definition the same as the remaining annuity payments. One can question, then, how offering a new benefit form of equivalent value to the existing benefit is a benefit increase. The counter-argument is that adding choice, even of an identical benefit, is a benefit increase, or at least enhances the welfare of the participant by providing him or her with an additional option.

In the real world, rather than the theoretical zone of equivalency created by section 417(e)(3), a lump sum will of course have more or less economic value to a particular participant depending on circumstances. The primary circumstance in which the lump sum has greater economic value is the situation in which the participant has a much shorter life expectancy than assumed by the mortality tables dictated by section 417(e)(3). To such participants, the addition of the lump sum can be fairly characterized as a benefit increase. But for reasons discussed earlier in this paper, for most participants the continued annuity will have much greater economic value to the participant than the lump sum. And as also pointed out earlier, the plan sponsor, if behaving rationally, will amend the plan to offer a lump sum to participants as part of a de-risking strategy only if it believes that the take-up rate among participants who will get less value from the lump sum than a continuing stream of annuity payments will more than compensate the plan for the losses incurred by people who are able to adversely select in favor of a lump sum because of their assessment that their life expectancy is lower than reflected in realistic mortality tables. In the real world, then, the aggregate effect of adding a window lump sum benefit is that it decreases the value of total plan benefits paid by the plan, rather than increases the value. The IRS ruling policy should not endorse what is essentially a fiction: that a benefit amendment whose purpose is, and whose aggregate impact will be, to reduce the value of benefits paid by the plan to its participants, is nevertheless a benefit improvement.

\textsuperscript{31} See 1.401§ (a)(9)-6-Q&A14(A)(4).
\textsuperscript{32} Interestingly, the private rulings do not expressly hold that the amendment is a benefit increase, but rather note that the regulations permit an annuity benefit to be increased by plan amendment without violating section 401(a)(9). The ruling than goes on to indicate that the lump sum option was created by a plan amendment, without specifically saying that the amendment was a benefit increase. But commentators on the private letter rulings have assumed that the rulings were premised on the lump sum offer as a benefit increase. See Rosina Barker, Pension De-risking: Distributing Annuity Contracts After Lee v. Verizon (2013), supra at note 4.
This position, though, has two problems, one theoretical and one practical. The theoretical problem is that the purpose of section 401(a)(9) is to ensure that participants use the tax deferred savings for retirement and not simply to build an estate by indefinitely keeping assets in tax-favored plan solution. The position in the IRS letter rulings does not undermine that purpose, although it does undermine an important protective feature of the regulations, namely protecting people in pay status from being offered a lump sum. But that latter protection is unrelated to the purposes of section 401(a)(9).

The practical problem is that the regulations themselves allow the addition of a new form of benefit on plan termination. Thus, employers who are in a position to use a spin-off termination to effect plan de-risking could use such an approach even if the IRS changes its view that an amendment creating a lump sum window is a benefit increase.33

ii. Section 417 Notice Requirements and the Annuity Starting Dates

Section 417 of the Internal Revenue Code and its regulations requires that a participant may waive the normal form of plan benefit within a 180-day period ending with the benefit's “annuity starting date” and instead choose an optional form of benefit (which includes a lump sum payment of the value of the benefit). The participant must be provided information on the optional forms of benefits, including a comparative valuation of the different forms of benefits, no later than a reasonable time period before the annuity starting date. If the participant is married, the participant's spouse must consent in writing to the choice of the optional form of benefit and acknowledge the effect of such an election. Section 417(a) does not provide for a participant to make an election after the annuity starting date. Thus, if a benefit can only have a single annuity starting date, there can be no change in the form of the benefit once the benefit has commenced.

Section 417(f)(2) defines the term "annuity starting date" as "(i) the first day of the first period for which an amount is payable as an annuity, or (ii) in the case of a benefit not payable in the form of an annuity, the first day on which all events have occurred which entitle the participant to such benefit." The IRS in its regulations has interpreted this definition as follows: "the annuity starting date is the first day of the first period for which an amount is paid as an annuity or any other form."34

This language can plausibly be interpreted to provide a single annuity starting date for a particular plan benefit. It is important here to note that a lump sum is a form of benefit, not the benefit itself. From this perspective, the definition of the annuity starting date applies to the participant’s accrued benefit and describes the date by which the participant must elect the form

33 An employer who wanted to de-risk using only lump sums would probably not be able to use a spin-off termination strategy because the plan could not terminate without transferring the annuities of the non-electing participants to an insurer. The spin-off strategy in any event subjects the employer to additional expense and also subjects the employer to the requirements of section 414(l), which requires that participants in both the remaining and the spun-off plan suffer no reduction of benefits in the event of plan termination (considering only plan assets, not PBGC guarantees).
34 Internal Revenue Service, Employee Benefit Plan Audit Guidelines, Explanation 3, Joint and Survivor (2014) at 3.
in which she will take the benefit. The statute makes no provision for a subsequent annuity starting date for a benefit once that benefit has commenced.\[^{35}\]

The view that section 417 contemplates only a single annuity starting date for a particular plan benefit is consistent with a special set of rules dealing with a married plan participant who has not been married for a full year before his or her annuity starting date. In such circumstances, a plan may treat the participant as unmarried and thus not eligible for a joint-and-survivor annuity. That rule, however, also provides that if the spouse remains married for a year, the plan must treat the spouse as married as of the annuity starting date, thus triggering consent requirements as of that time. The rule uses this retroactive look-back approach rather than providing for a new annuity starting date, again suggesting that the drafters of the rule contemplated a single annuity starting date.

There is also a strong policy basis for favoring this interpretation over an interpretation in which there can be multiple annuity starting dates for a particular plan benefit. The normal form for a benefit under a pension plan is a single life annuity in the case of an unmarried participant and a qualified joint and survivor annuity in the case of a married participant. Section 417 permits an employee to elect an alternative to the normal form of benefit, and if married only with spousal consent. Section 417 and the regulations thereunder specify the information that the plan must provide to the participant and spouse and the timing for both the provision of the information and the date of election. The structure of Section 417, then, is premised on the importance of the election of the benefit form and mandates a procedure intended to maximize a participant’s ability to make an informed choice as to the form in which to take the benefit. A participant will generally make this election by age 65, but in any event no later than the date on which the employee either retires or attains age 70.5.

Allowing a plan to offer people already in pay status a lump sum option, will result in some participants having to make an election at a later age than 70.5, a time when reduced mental functioning becomes increasingly common. Indeed, it is estimated that almost 10% of adults suffer from Alzheimer’s disease or similar dementias by age 75, 13% at age 77, and between 30% and 50% at age 85.\[^{36}\] Moreover, many older individuals who suffer cognitive impairment are unaware of it. There is also research suggesting that older individuals, even if not suffering from detectable dementia, may be more susceptible to the influence of others than younger individuals, making them potentially vulnerable to pressure from financial advisers who seek to manage their money, to creditors, and to relatives. Section 417 contemplates people making informed choices about benefits; permitting second annuity starting dates when people are older and more likely to suffer cognitive impairment than would be the normal case under section 417 is thus fundamentally inconsistent with the structure and purpose of section 417’s notice and election requirements.

Moreover, in some plans married participants were initially offered a lump sum alternative form of lump sum but rejected it, sometimes because the spouse refused to consent. A second annuity starting date provides the participant in such cases an additional opportunity to

\[^{35}\] This position is consistent with the statutes reference to “the annuity starting date” of a benefit rather than “an annuity starting date” for a benefit, which suggests that there is a single annuity starting date with respect to a particular benefit.

\[^{36}\] See 2014 Alzheimer’s Disease, Facts and Figures, note 24, supra.
pressure the spouse to consent, and at a time when the spouse is more likely to be suffering some cognitive impairment. This too seems inconsistent with Section 417’s protection of the spouse’s independent right to consent to a benefit without a survivor annuity.

There are other troubling aspects of permitting multiple annuity starting dates. First, there is no clear limiting principle, which means that an employer could offer numerous lump sum windows. An employer could also build a permanent lump sum option into a plan, essentially providing participants the option to elect a death benefit if they become terminally ill. As discussed later in this paper, the value of this benefit may be inconsistent with the incidental benefit rule (which limits death benefits) and inconsistent with a pension plan’s purpose to provide income for life. Finally, an employer could introduce a lump sum window at a time when a particular highly compensated individual wants to convert an annuity benefit into a lump sum.

Some have argued, however, that the IRS would be altering a long-standing although non-published position if it prohibited or placed limits on a plan’s ability to provide multiple annuity starting dates for a single benefit, allowing participants in pay status to have a fresh-start election. The basis for this view apparently is that the terminating plans sometimes have been amended to provide a lump sum benefit election for individuals in pay status. This appears to be the case, although with certain caveats. First, the question of whether this position violated the consent requirements of the Internal Revenue Code and the parallel provisions of ERISA was never explicitly evaluated by the agencies and was never the subject of regulatory or sub-regulatory guidance, except under section 401(a)(9), as discussed above. Second, early PBGC regulations implicitly prohibited offering benefits to individuals in pay status, although in 2013 the PBGC indicated that in response to a question at a meeting of actuaries that it would permit terminating plans to offer lump sums to individuals already in pay status. The fact that this issue was raised as late as 2013, however, suggests that many in the benefits community believed that PBGC regulations did not permit offering a lump sum payment to participants in pay status as part of a plan termination.

Other sections of the Internal Revenue Code and its regulations also relate to the question of whether a participant may have multiple annuity starting dates for a benefit under a plan. These sections include:

(a) Treas. Reg. § 1.401(a)-20(d)(2). This regulation provides that a participant’s form of benefit for accruals that occur after an annuity starting date will be bound by the participant’s initial election, unless the plan provides otherwise. Thus, the regulations permit but does not require a plan to allow a participant to elect a different form of benefit for the post-retirement

37 See 29 U.S.C. § 4041.24. The regulations provide that the participant notice for persons not in pay status shall describe “any alternative benefit forms” and also provides that the plan must provide specific information to such participants if the “plan benefits may be paid in a lump sum.” In contrast, the notice to participants in pay status provides that the notice will provide a description of “the amount and form of the participant’s or beneficiary’s plan benefit payable as of the proposed termination date” and does not contemplate lump sums.

38 See 2013 Enrolled Actuaries Meeting, Questions to PBGC and Summary of their Responses. But the PBGC regulations, as written, seem inconsistent with the PBGC’s 2013 response to the question. In addition, my conversations with representatives of the PBGC said that plans historically were not amended to provide such amendments, with the exception of small plans that had difficulty negotiating affordable group annuity premiums.
benefit accrual. The regulation does not expressly address whether the pre-retirement accrual itself, however, can have a separate annuity starting date.

(b) IRC §§ 417(e) and 411(a)(11). These sections permit a plan to pay a lump sum benefit without participant consent if the present value of the annuity benefit is less than $5,000. If read literally, these provisions would permit a plan to pay a lump sum to a person receiving an annuity under the plan once the benefit’s present value drops below $5,000.

Section 417(e)(1), however, provides that a plan can pay a lump sum “after the annuity starting date” only with participant and spousal consent is required when the plan provides such a distribution “after the annuity starting date.” This section can be read as contemplating an additional annuity starting date, but it can also plausibly be read as simply creating its own consent requirements. On the one hand, this suggests a new annuity starting date. But an equally plausible reading of the statute is that this statutory section creates its own notice and consent requirement, particularly given that it is referring to a commutation “after the annuity starting date.”

Section 417(e)(2) provides that a plan may distribute a lump sum in excess of $5,000 only with participant and spousal consent. This section, however, does not by its terms indicate whether a lump sum in excess of $5,000 can be offered to a participant after the starting date of the annuity and the purpose of section 417(e) and its parallel provision in section 411(a)(12) was to authorize plans to mandatorily cash out participants with small benefits, not to authorize a plan amendment providing a lump sum option to a participant in pay status.

Here, however, Treas. Reg. § 1.417(e)-1(b)(2)(9), provides that ”after the annuity starting date, consent is required for the immediate distribution of the present value of the accrued benefit . . . regardless of the amount of such present value.” But nothing in the preamble to the regulations suggest that the authors examined the legal permissibility of offering a lump sum to participants after the annuity starting date except in the limited circumstances of a benefit whose present value has declined below the $5,000 threshold.

(c) Prop. Treas. Reg. § 1.415(b)-1(iii). These regulations implemented under IRC § 415 included a provision entitled “Determination of annual benefit in case of multiple annuity starting dates.” This portion of the regulation required aggregation of benefits with different annuity starting dates, for example, when a participant commenced benefits under the plan and later commenced a separate benefit under a plan that, for section 415 purposes, was aggregated with the first plan. But the regulations also provided that the same rules apply “for purposes of determining the annual benefit of a participant where a new distribution election is effective during the current election year.” Thus, the regulation contemplates that the form of a benefit in pay status can be changed. But the regulation was providing rules applicable to section 415; there is no indication that the drafters analyzed whether section 417 permitted multiple annuity starting dates. More pertinent, the IRS did not finalize the regulation in light of several issues raised by commentators. A Treasury Decision on the final regulations explained that “the IRS

39 Research for this paper has not been able to identify any plan that cashes out benefits in these circumstances other than on plan termination.
40 Treas. Reg. § 1.415(b)-1(iii). The regulation was not, as the text notes, finalized, although it currently is a temporary regulation.
41 Treas. Reg. § 415(b)-1(iii)(B).
and the Treasury Department have determined that revisions to these rules are needed before these rules are adopted in final form. Accordingly, these regulations reserve a place for regulations regarding multiple annuity starting dates. The IRS and the Treasury Department are developing new proposed regulations regarding multiple annuity starting dates, and corresponding revisions to regulations under §1.401(a)(9)-6.”

The new regulations under section 401(a)(9) have been promulgated and do place limits on changes in benefit forms, but the IRS and the Treasury Department have not proposed new section 415 regulations on multiple annuity starting dates. Just as the proposed regulations were not sufficiently coordinated with section 401(a)(9)’s requirements concerning changes in benefit forms, they failed to coordinate with any inherent limitations—such as the ones proposed in this section of the paper—under section 417.

Although section 417 is ultimately ambiguous on the question of whether there can be multiple annuity starting dates for a single benefit, the section can be plausibly interpreted as prohibiting new starting dates after an annuity benefit has commenced. Treasury and the IRS could issue guidance on this question or expressly signal that they are not taking a current position on the issue.

iii. Violation of the Anti-alienation Rule.

Section 413(a)(13) of the Internal Revenue Code prohibits an employee assigning or alienating a qualified plan benefit. Thus, it would not be permissible for a participant to transfer future benefits to a third party in exchange for a lump sum, even a lump sum calculated with more conservative actuarial assumptions than are required by Section 417 of the Internal Revenue Code. While section 401(a)(13) does not prevent a plan from offering optional forms of benefits, once a benefit has commenced the offer to commute the remainder to a lump sum is arguably an alienation of future benefits, just as if the payment were to come from another individual or entity (including the employer).


Defined benefit plans are pension plans and are eligible for favorable tax treatment only if they conform to a long-standing Treasury Regulation definition of a pension plan. The definition provides that “a pension plan within the meaning of section 401(a) is a plan established and maintained by an employer primarily to provide systematically for the payment of definitely determinable benefits to his employees over a period of years, usually for life, after retirement.” A pension benefit paid in a lump sum, a feature that a few pension plans included prior to ERISA, was consistent with the idea of a pension plan, for the lump sum was definitely determinable in accordance with specified factors in the plan and the employee could ration the lump sum over his or her life. However, a plan amendment permitting a participant to transform an annuity in pay status into a lump sum is arguably inconsistent with the idea that a pension plan must be established and maintained to pay a benefit payable over a period of years, usually for life, after retirement. Moreover, as already discussed in this paper, the lump sum benefit for a person already in pay status, moves from a guaranteed source of lifetime income to a sum of money that is too small to generate a comparable stream of income during the participant’s remaining life without taking on high levels of risk. It can thus be argued that offering a
participant the opportunity to convert an annuity in pay status to a lump sum is inconsistent with the definition of a pension plan and is thus impermissible.


Treas. Reg. § 1.401-1(b)(1)(i) also provides that a pension plan may pay incidental death benefits, which are elsewhere defined as a benefit equal to 100 times the monthly accrued benefit payable at normal retirement age.\(^{42}\) A version of this limitation would also presumably apply to death benefits (other than the statutorily required joint and survivor benefit) after retirement, and given that the benefit has already commenced, the death benefit would presumably be limited to a fraction of the one-hundred multiplier that applies to lifetime benefits.

As already discussed, the only individuals who rationally would select to convert an annuity in pay status to a lump sum benefit would be someone who has reason to know that they will die soon after the election. In effect, then, the election of a lump sum by a participant in pay status will often be the functional equivalent of the election of a death benefit. The present value of the that lump sum, in present value terms (assuming normal life expectancy) would often exceed the 100 to 1 ratio for a participant prior to attainment of retirement age and thus arguably is inconsistent with the incidental benefit rule.\(^ {43}\)

vi. Concluding Thoughts on Legal Impediments to Lump Sum Offers to Participants in Pay Status.

There are plausible interpretation of sections of the Internal Revenue Code that could justify an IRS decision to prohibit lump sum offers to individuals in pay status or, in the alternative, to suspend private letter rulings related to section 401(a)(9) while these issues are studied. The paper does not claim that any of these arguments compel restrictions on lump sum payments after annuity commencement, but the arguments are potential sources of authority for Treasury and the IRS to interpret Code requirements to prohibit or restrict lump sum payments after benefits have commenced.

2. Other Legal Requirements

If Treasury disagrees that the provisions of the Internal Revenue Code and regulations do not provide it with sufficient authority to prohibit a plan from offering participants already in pay status a lump sum option, there are provisions in the Code and in ERISA that bear on such amendments and how they should be implemented. The IRS and Treasury, and in some cases the Department of Labor and the EEOC, could issue regulatory guidance and initiate audit and/or enforcement actions related to these issues, which would ensure compliance with legal requirements and, in doing so, increase protections for participants. Such regulatory actions


\(^{43}\) One means of converting the limitation on pre-retirement death benefit to a comparable limitation on a post-commencement death benefit would be to multiply the 100 factor by a fraction, with the numerator the number of years that the participant has received the benefit and the denominator the participant’s life expectancy at retirement age.
might also, at least at the margins, discourage plan sponsors from amending plans to create window lump sum benefits.

i. Consent under Internal Revenue Code § 401(a)(11) and 417.

As this paper earlier discussed, a plan can only pay a participant a form of benefit other than a joint-and-survivor annuity (a single annuity in the case of an unmarried participant) if the participant affirmatively elects such benefit, with the consent of the spouse if the participant is married. Section 417 requires that the plan provide them with notice of information relevant to the election, including the effects of an election to take an optional form of benefit. Treasury Regulations require that the participant be informed of the relative value of each optional form of benefit compared to the normal form of benefit.\footnote{See Treas. Reg. § 1.417(a)(3)-(1)(C).}

Because many older individuals begin experiencing cognitive decline as they age, the meaning of elect and consent on the part of such individuals should require more than simply signing a document. A plan that offers older participants a lump sum option to older individuals in pay status have an obligation to ensure that the statute’s elect and consent requirements are satisfied, which means ensuring that neither the participant nor spouse are experiencing cognitive deterioration. Guidance in this regard could be issued by the IRS and Treasury, which have regulatory authority over the election and notice provisions, and/or by the Department of Labor, which could interpret ERISA’s fiduciary provisions to require that the fiduciary ensure that older participants, have capacity to consent to a lump sum distribution. A related issue is the extent to which section 417 elections and spousal consent can be made by an appointed guardian or through a power of attorney, particularly in situations in which the guardian may have a conflict interest with the participant.

ii. Age Discrimination

Many plans that have offered a lump sum option to participants in pay status have limited the option to people below a designated age, apparently because more people above the age are likely to have accurate information about their life expectancy, increasing plan costs through adverse selection. The exclusion of certain people from the lump sum option arguably results in age discrimination under the Internal Revenue Code, which prohibits a reduction in the rate of accrual based on age. The IRS and the Department of Treasury have not addressed whether an addition of a form of benefit comes within the meaning of “rate of accrual,” but if it determines that the addition of a benefit option increases the rate of accrual, providing a new benefit option for participants only if they have not attained a specified age, would seem to be prohibited.

If it is not prohibited, a participant might be violating other sections of the ADEA, which prohibits discrimination against members of the prohibited age group, those over 40. Courts and the agencies have held that unless extra cost would result, an employer cannot favor some members of the protected class over older members of the class. Because Section 417 uses common conversion factors and method for all employees, the cost of providing a lump sum for a participant over a certain age is theoretically identical to the cost of providing a lump sum for a participant younger than that age. Thus, the EEOC could be asked to provide guidance in this
area if Treasury concludes that this variety of age discrimination does not have the effect of reducing an accrual rate based on a participant’s age.

iii. Participant Notice

A fiduciary may have an obligation to provide effective notice to assist participants in making an election of a lump sum payment. The current "relative value" regulations, which require that the relative value of different benefit options be disclosed, use the section 417(e) interest and mortality assumptions, which as discussed earlier do not fairly represent the lower value of lump sums to retirees with expected average life expectancies. Perhaps the fiduciary must provide better information, using the more conservative actuarial assumptions that insurance companies use to set premiums. In any event, the Department of Labor and the Department of Treasury could issue guidance that requires additional notice to individuals in pay status, including the real-world economic losses described earlier in this paper.

iv. Identification of Spouse

The IRS might audit plans to ensure that the proper spouse(s) gives consent. This would involve the plan determining whether a participant has married since initially selecting a benefit and also whether a participant has been divorced, has a QDRO, or has been widowed. In addition, if a lump sum option is offered to a participant whose spouse initially consented to a single-life annuity, Section 417 seems to require that a joint-and-survivor annuity again be offered and the IRS might issue guidance on this issue.

v. Investment Advisors

In several de-risking transactions the plan or plan sponsor made available so-called independent advisors to assist retirees in deciding whether to elect the lump sum. The selection of such advisors, and the characterization of them as independent, are both fiduciary actions which should be monitored by the Department of Labor.

vi. Subsidized Joint and Survivor Annuities.

Some plans provide subsidized joint-and-survivor annuities but base the lump sum only on the life annuity. In such cases where a participant is receiving a joint-and-survivor annuity, the section 401(a)(9) regulatory requirement that an increase in an annuity payment results from a plan the amendment increasing benefits is almost certainly not satisfied, since the new benefit is worth less than the annuity benefit.

vii. Effect of Lump Sum Payments on Plan Funding.

Offering lump sum payments in a window period can have a deleterious effect on overall plan funding. Internal Revenue Code 436(d) prohibits a single employer defined benefit plan to pay a 100% lump sum benefit if the plan’s funding level attainment level is less than 80% for the year, but this is calculated as of the plan’s valuation date for the year.\footnote{If the plan’s funding level attainment is less than 80% but greater than 60%, the plan may pay 50% of the lump sum’s value. IRC § 436(d)(3)(A)(i) & (d)(5)(A)} The Pension Benefit Guaranty Corporation has an interest in monitoring plans when they make such payments and the Department of Labor may want to clarify that a plan fiduciary cannot significantly erode the
plan’s funding level in cases to which section 436(d) does not apply. Similarly, the IRS and the Department of Treasury might consider issuing guidance under which the employees who receive a lump sum are considered to have been constructively spun off into a separate plan and apply section 414(l) to the transaction.

B. Transfer of Liabilities to Insurance Company

1. Are Transfers of Liabilities to Insurance Companies Prohibited from an Ongoing Pension Plan?

Some have argued that the normal form of plan benefit is payment from the plan to participants and a transfer of a benefit liability to an insurance company and the subsequent distribution of the annuity obligation is an alternative form of benefit requiring consent. While this argument is not implausible, it is a long-standing practice and it is not likely that the courts or the agencies would accept it, particularly given that such liability transfers is the normal form of benefit distribution in a plan termination and that there is a long history predating ERISA and uninterrupted by ERISA’s passage, of defined benefit plans distributing annuity contracts. Moreover, if ongoing plans are forbidden from distributing annuity contracts, a plan sponsor could de-risk using a spinoff termination, which as just noted require the terminating plan to transfer liabilities to an insurance company.

The PBGC, however, has expressed concern that the purchase of a group annuity contract as a step toward an ultimate standard termination of the plan may be violating various Title IV requirements, including provisions in Title IV designed to protect participants. In a 2009 request for information published in the Federal Register, the PBGC expressed several concerns when plans purchased annuity contracts for distribution to participants prior to an expected plan termination:

The first concern is that the purchase circumvents the statutory and regulatory protections afforded under the standard termination process. A participant whose plan benefits are fully satisfied through purchase of an irrevocable commitment prior to the first day a NOIT is issued in a related termination would not receive disclosures required as part of the standard termination process, including advance notice of the termination, advance information about the insurer, and a statement that PBGC no longer guarantees those plan benefits. Such participants may not have the same opportunity to correct personal information used to calculate their benefits or provide personal data not available to the plan. In addition, PBGC would not receive information necessary to determine whether participants received the correct benefits, including information on the number of persons for whom irrevocable commitments were purchased and the benefits provided through the purchase of irrevocable commitments.

The second concern is that plan assets could be insufficient for plan benefits at the time of any distribution upon termination, since plan assets used to
purchase irrevocable commitments (and the investment returns on those assets) would no longer be available to pay other plan benefits. If the plan was sufficient for guaranteed benefits, it might still terminate as a distress termination, but some participants would lose nonguaranteed benefits. If the plan was not sufficient for guaranteed benefits, PBGC might have to terminate and trustee the plan, and some participants and PBGC could be harmed. This concern generally does not arise with irrevocable commitments purchased after the first day a NOIT is provided, because the exception in § 4041.22(b) applies only if the distribution is not reasonably expected to jeopardize the plan’s sufficiency.47

The PBGC, however, decided not to take any regulatory action, but indicated that it would continue monitoring industry practices. PBGC may want to review whether industry practice has evolved sufficiently to review whether regulatory action is appropriate. It may also want to consider whether similar principles should apply to plan amendments to permit participants in pay status to elect lump sums during a window period.

2. Other Legal Requirements

i. Choosing An Annuity.

As earlier discussed, in 1995, the Department of Labor issued an interpretative bulletin with guidance for fiduciaries charged with selecting an insurer to which benefit liabilities will be transferred on plan termination. The bulletin takes the position that the responsible fiduciaries must select the safest available annuity. The bulletin, however, does not address selecting an annuity as part of a de-risking transaction, where the statutory context and policy considerations are not identical to plan terminations. Thus, the meaning of safest possible annuity in de-risking transactions may not be identical to plan terminations. For example, one option a fiduciary has in a de-risking transaction but not in a plan termination is to purchase the annuity but not distribute it to participants unless the fiduciary concludes that distribution of the annuity contract will not subject the participant to additional risk. Moreover, standards for evaluating annuity safety have evolved since 1995, when the Department issued the bulletin. Moreover, best practices have evolved since 1995. In both the GM and Verizon case, the plan hired an independent fiduciary that negotiated for a segregated asset pool backing the benefit commitments transferred to the insurer. Perhaps fiduciary responsibility should require negotiation of such protections or the equivalent, for example, the purchase of reinsurance from a second insurer.

The 1995 memo also does not address other issues about the annuity contract, such as whether the fiduciary has an obligation to replicate ERISA protections—for example, protecting the annuity contract against claims in bankruptcy or garnishment. If no provisions are made in the contract, participants will be subject to the default debtor protections under state law, which vary from state to state. Moreover, without contractual restraints in the annuity agreement, there may be no meaningful limits on the insurer’s ability to offer to commute the annuity contract into a lump sum payment or a riskier insurance product at some point in the future. The insurer’s

offer might not be subject to ERISA standards, including the consent of a spouse. And on marital separation, the division of an annuity contract is more complex than dividing a pension.  

Earlier the paper observed that Treasury Regulations require that when a plan distributes an irrevocable contract to a participant the contract must provide for certain protections, namely the protections of joint-and-survivor rules and the rules for electing optional benefits (including the rules for valuation of lump sums). But the Treasury regulations are limited to particular statutory provisions and it is unclear that the regulations apply beyond a participant’s initial selection of benefit form. Moreover, the insurance companies are not subject to ERISA’s fiduciary standards and it is unclear how the Treasury regulations would be enforced, since the insurance company rather than the plan is administering the contract. It is also not clear to ensure that the annuity contract reflects the regulatory requirement. It is also unclear what protections the participant might have under state insurance law. At best, the situation is unclear.

There are also concerns about who has responsibility if a participant in the future has questions about whether benefits have been correctly calculated, or if recoupment for overpayments is being correctly administered. The plan’s fiduciary had a fiduciary responsibility to consider such claims before the de-risking; the insurer may not have such a duty after the de-risking. Moreover, in at least one plan termination case, the insurance company on its own determined that the plan had miscalculated benefits and unilaterally reduced future benefits, apparently pocketing the difference.  

The prospect that this could happen in a de-risking case is troubling.

ii. Financial Impairment of Plan

Still another set of concerns revolve around the reality that a de-risking transaction can impair the funding levels of the remaining plan. Can a fiduciary implement a de-risking transaction if the effect is to reduce the funding ratio of the plan? A related issue is whether the transfer of assets with a resulting diminution of a plan's funding status can be construed as constructive violation of Section 414(l) of the Internal Revenue Code.

IV. Possible Regulatory Responses to De-risking

A. Lump Sums

1. The IRS suspends issuing private letters to plans respecting plan amendments offering lump sum election to participants in pay status while studying the permissibility of such lump sum offers under IRC §§ 401(a)(9), 401(a)(13), 417, and Treas. Reg. § 1.401-1(b)(1).

2. IRS and/or the Department of Labor issue separate or coordinated guidance on heightened consent and notice requirements when plans offer lump sum offers to older seniors in

---


49 This is a case that the author of the article was consulted on.

50 Section 414(l) provides that when a plan transfers assets or liabilities to another plan, each participant in the plan would if the plan were terminated receive a benefit immediately after the transfer which is equal to or greater than the benefit he would have been entitled to receive immediately before the transfer.
pay status and note a fiduciary duty to ensure is capable of providing informed consent. In many ways, this may be the most promising strategy to stop lump sums. The need for such guidance is real; as already noted, seniors by age 75 begin to experience diminished mental capacity at rates much higher than younger participants.

3. IRS issues guidance to plans for compliance for spousal notification and consent.

4. EEOC and IRS determine whether excluding older employees from lump sum offers is prohibited age discrimination.

5. The IRS issues new annuity tables that reflect mortality gains over the last decade.

6. DOL provides guidance indicating that in certain circumstances fiduciaries in de-risking transactions have a responsibility to provide participants with an independent fiduciary to advise them on whether to elect a lump sum. Ensure that independent fiduciaries are competent and truly independent.

B. Transfers of Benefit Obligations to Insurance Companies:

1. DOL issues guidance that indicates that fiduciaries have a responsibility to negotiate annuity contract provisions that replicate ERISA protections.

2. DOL issues guidance that indicates that fiduciaries have a responsibility to negotiate annuity contract provisions that prohibit an insurer from offering to exchange contract for either lump sum or other insurance contracts.

3. DOL issues guidance to ensure adequate participant protections in cases of benefit miscalculations and recoupment of benefit overpayments.

The issue here is that if a plan miscalculates a benefit (or improperly reduces a benefit through recoupment) and the liability for the benefit is transferred to an insurer, from whom does the participant seek redress? And redress here can mean at least two things: first, correction of the erroneous benefit calculation; and second, in the case of recoupment, fiduciary consideration of whether the benefit reduction should be modified because of hardship. Under current law, there might not be recourse against the plan because the retiree may no longer be a plan participant.

A possible solution is for DOL to issue guidance on the definition of participant so that a person continues to be a participant if they have a colorable claim that their entire benefit has not been transferred to the insurer or if they have a colorable claim that recoupment should be waived or mitigated because of hardship to the participant.


Even though the decision to amend a plan to provide for de-risking may be a settlor function, the selection of an annuity contract is a fiduciary activity. As already mentioned, the Department of Labor published an interpretive bulletin in 1975 on the selection of an annuity contract by a defined benefit plan for benefit distribution. The bulletin provides generally that a fiduciary in a
defined benefit plan must select the safest available annuity. The bulletin then describes the factors that the fiduciary must consider in a thorough, objective and analytic search to identify the safest available annuity. The bulletin also notes that a fiduciary may not purchase an inferior, i.e., annuity that is less safe than the safest annuity available, simply because there are not available funds to purchase the safest annuity. In that case, the fiduciary may act only if the plan sponsor provides the additional funds necessary to purchase the annuity. On the other hand, the bulletin also indicates that the fiduciary might in some circumstances choose a less safe annuity if the fiduciary determines that is in the best interests of the plan participants—for example, because it increases plan surplus, which will be used to benefit the participants.

The interpretative bulletin was issued in 1995, before the wave of current de-risking transactions. There are a number of issues concerning annuity purchases in de-risking transactions that cannot be fully or satisfactorily answered from the 1995 interpretive bulletin, and which the Department of Labor could clarify, including:

i. Whether in a de-risking transaction, the fiduciary must ensure that the annuity is at least as safe as a PBGC-guaranteed annuity, which might in certain circumstances mean not purchasing an annuity for some or all participants, or purchasing reinsurance from a second insurer, or retaining the annuity contract in the plan.

ii. Whether the fiduciary must insure that the transfer of benefit liabilities to an insurer does not impair the funded status of the plan after the de-risking transaction.

iii. Whether any independent fiduciaries who are engaged to identify an acceptable annuity provider should be asked to waive the statute of limitations so that participants can consider bringing actions against them if the insurer fails.

VI. Conclusion

This paper had two purposes: first to describe de-risking and the threats it poses to our nation’s aggregate retirement security, and second, to suggest statutory bases for the federal agencies to (i) prohibit the most problematic of de-risking strategies, the offer of lump sum benefits to retirees in pay status; (ii) provide additional protections for such participants if the agencies conclude that they are not in a position to prohibit the plan from offering lump sums to them and to generally make the practice of lump sum offers less appealing to employers (generally a corollary of increasing protections) for participants; and (iii) provide additional protections, both substantive and disclosure, for participants whose benefit obligations have been transferred to an insurer. The agencies are, of course, aware of many of the troublesome policy issues posed by de-risking, but there has been a disconnect between those concerns and at least the agency’s public regulatory responses to those issues. It is hoped that the analysis in this paper will assist the agencies in identifying possible sources of authority for regulatory action and in identifying several specific types of regulatory responses that would curb the worst aspects of de-risking.