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Pension De-Risking

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MARQUETTE UNIVERSITY

PENSION DE-RISKING

Paul M. Secunda[*] & Brendan S. Maher[**]

ABSTRACT

The United States is facing a retirement crisis, in significant part because defined benefit pension plans have been replaced by defined contribution retirement plans that, whatever their theoretical merit, have left significant numbers of workers unprepared for retirement. A troubling example of the continuing movement away from defined benefit plans is a new phenomenon euphemistically called "pension de-risking."

Recent years have been marked by high-profile companies engaging in various actions designed to reduce the company's exposure to pension funding risk (hence the term "pension de-risking"). Some de-risking strategies convert a federally-guaranteed pension into a more risky private annuity. Other approaches convert the pension into cash for the beneficiary, which may be insufficient to provide lasting retirement income. These strategies have raised many concerns that participants are getting the short end of the stick and that pension de-risking is undermining the statutory purpose of ERISA.

Regulators are only beginning to consider ways to appropriately police pension de-risking behavior. We propose that the government should take an aggressive stance in regulating such conduct. Participants as a class should not be made worse off by a pension de-risking transaction, and the relevant de-risking rules should so reflect. More specifically, regulators should (1) encourage desirable forms of de-risking by establishing regulatory safe harbors; (2) require a battery of procedural safeguards for annuitization transactions; (3) require improved disclosures for cash buyouts; and (4) limit cash buyouts when beneficiaries are not likely to meaningfully understand the potentially adverse consequences of trading a pension for cash.

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INTRODUCTION

Retirement planning is difficult and dangerous. It is dangerous for individuals because poor planning can mean post-employment penury. It is dangerous for companies because it is much easier to make retirement promises than to keep them. It is dangerous for elected officials because they will take the blame if elderly poverty is widespread. The bad news is that we are living in dangerous times: too many Americans are saving too little for retirement.[1]

One reason for that is recent history. In the last thirty years, employers have transitioned away from "defined benefit" (DB) plans that promised workers a monthly pension to "defined contribution" (DC) plans that offer workers retirement savings accounts.[2] Whatever the theoretical appeal of DC plans, the real world result has been disappointing. Workers have neither saved enough nor invested those savings wisely.[3]

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[1] *See* Hazel Bradford, *Study: Retirement Crisis Real and Getting Worse,* PENSIONS AND INVESTMENTS (Jan. 26, 2015), http://www.pionline.com/article/20150126/ONLINE/150129904/study-retirement-crisis-real-and-getting-worse ("The most convincing estimates project that more than 50% of households will fall short, and even the most optimistic studies predict that nearly one-quarter of retirees will, CAP [Center for American Progress) researchers found."). Low rates of personal savings are alarming and have a detrimental impact on retirement, serving only to "exacerbate[] the impact of looming shortfalls in Social Security and in employer-sponsored pension programs." Stephen F. Befort, *The Perfect Storm of Retirement Insecurity: Fixing the Three-Legged Stool of Social Security, Pensions, and Personal Savings*, 91 MINN. L. REV. 938, 961 (2007). *See also* Teresa Ghilarducci, *Retirement Security Worse on ERISA's 40th Anniversary*, 6 DREXEL L. REV. 453, 453 (2014) (discussing how about 48% of workers between the ages of fifty and sixty-four will be poor when they reach retirement).

[2] *See* Samuel Estreicher & Laurence Gold, *The Shift From Defined Benefit to Defined Contribution Plans*, 11 LEWIS & CLARK L. REV. 331, 331 (2007) (discussing the shift from defined benefit to defined contribution pension plans).

[3] *See* Bradford, *supra* note 1 ("The biggest problems are that far too many people don't have access to a private-sector retirement plan, and secondly, the plans they do have access to aren't very good.") (quoting David Madland). *See also* Shlomo Benartzi and Richard H. Thaler, *Behavioral Economics and the Retirement Savings Crisis*, SCIENCE MAG., 1152 (Mar. 8, 2013), http://faculty.chicagobooth.edu/richard.thaler/research/pdf/Behavioral%20Economics%20and%20the%20Retirement%20Savings%20Crisis.pdf (discussing increased percentage of workers at risk of not having adequate funds in retirement). Further, the Department of Labor has expressed concern over individuals' ability to

Many large companies, interestingly, still have "legacy" DB plans: retirement plans applicable to older employees that were in place before the company transitioned into a DC plan for newer employees.[4] The burden of funding and maintaining those plans is substantial.[5] A growing number of firms are seeking to creatively manage those obligations in ways designed to reduce the company's exposure to funding risk.[6] The industry term for those risk-reducing strategies is "pension de-risking."[7]

Some "de-risking" strategies are internal, meaning that the pension obligation is retained by the company but managed differently.[8] Other solutions are external, meaning that the pension obligation is offloaded from the company to another party.[9] Observers are particularly worried about external de-risking, and rightly so. For example, the

understand investment principles in order to make well-informed decisions in the context of their defined contribution plans. *See* Matthew Venhorst, *Helping Individual Investors Do What They Know is Right: The Save More for Retirement Act of 2005*, 13 CONN. INS. L.J. 113, 119 (2006).

[4] *See* Daniel Keating, *Why the Bankruptcy Reform Act Left Labor Legacy Costs Alone*, 71 MO. L. REV. 985, 986, 988–90 (2006) (explaining how underfunded defined benefit plans are category of labor "legacy" costs for employers, and defining "legacy" as a type of "deferred maintenance" that employer owes employee).

[5] *See, e.g.*, Janice Kay McClendon, *The Death Knell of Traditional Defined Benefit Plans: Avoiding a Race to the 401(k) Bottom*, 80 TEMP. L. REV. 809, 822–25 (2007) (discussing funding considerations as one of the factors contributing to the shift from defined benefit to defined contribution pension plans). *Cf.* Press Release, Pension Benefit Guaranty Corp., PBGC Annual Report Shows Improvement in Single-Employer Program and Deterioration in Multiemployer Program (Nov. 17, 2014), *available at* http://www.pbgc.gov/news/press/releases/pr14-15.html (concluding that the "program's potential exposure to future pension losses from financially weak companies" to be about $167 billion).

[6] *See* Letter from Senators Harkin and Wyden to Jacob Lew, U.S. Secretary of Treasury; Thomas E. Perez, U.S. Secretary of Labor; Richard Cordray, Director, Consumer Financial Protection Bureau; and Alice Maroni, Acting Director, Pension Benefit Guaranty Corporation (Oct. 22, 2014), http://op.bna.com/pen.nsf/id/krkl-9q5t87/$File/102214%20Derisking%20Letter.pdf ("Employers undertake de-risking transactions to mitigate future pension funding risks").

[7] *See id.*

[8] *See infra* Part I.B.

[9] *See* Mary B. Andersen, *Understanding the Basics About Derisking Becomes First Step to Decisionmaking*, PENSION PLAN FIX-IT HANDBOOK NEWSLETTER (Thompson Info. Serv., Bethesda, MD), Jan. 2014, at 2.

"annuitization" approach converts a federally-protected pension into a more risky private annuity;[10] the "lump sum" approach converts the pension into cash for the beneficiary, which may be insufficient to provide lasting retirement income.[11] Neither approach prioritizes beneficiary welfare in a fashion consistent with the protective purpose of the Employee Retirement Income Security Act of 1974 ("ERISA").[12]

Like many pension matters, de-risking sounds arcane but involves obscene amounts of money. In the last few years, for example, Verizon, General Motors, Ford, Motorola, and Bristol Myers Squibb have all undertaken pension de-risking transactions worth together over $100 billion dollars and affecting hundreds of thousands of workers, retirees, and their beneficiaries.[13] More will come.

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[10] *See Private Sector Pension De-Risking and Participant Protections: Hearing Before the ERISA Advisory Council* 4–5 (June 5, 2013) (statement of Robert S. Newman, Covington & Burling LLP), *available at* http://www.dol.gov/ebsa/pdf/covingtonburling060513.pdf [hereinafter Newman Testimony] (discussing purchase of annuity certificates as external de-risking strategy companies use, resulting in a loss of ERISA protection of plan benefits).

[11] *See Private Sector Pension De-risking and Participant Protections: Hearing Before the ERISA Advisory Council* 8–9 (August 29, 2013) (statement of David Certner, Legislative Council and Legislative Policy Director, AARP), *available at* http://www.dol.gov/ebsa/pdf/AARP082913.pdf [hereinafter Certner Testimony] (observing that lump sum offers are less secure and have a reduced value compared to an individual's pension annuity). Individuals who retain their defined benefit annuity "are far less likely to outlive their assets or fall into poverty." *Id.* at 8.

[12] 29 U.S.C. § 1001 et seq. (2012).

[13] *See, e.g.*, Lee v. Verizon Commc'ns Inc., 2012 WL 6089041 (N.D. Tex. Dec. 7, 2012) (holding Verizon pension de-risking transaction not unlawful under ERISA); Fred Meier, *Ford Offers Retirees Lump Sum to Buy Out Pensions*, USA TODAY (Apr. 27, 2012), http://content.usatoday.com/communities/driveon/post/2012/04/ford-will-offer-to-buy-out-its-retirees-pensions/1#.U0Sn9fldWdw (Ford); *GM Announces U.S. Salaried Pension Plan Actions: Offers Lump-Sums to Many Retirees; Prudential to Assume Monthly Benefits,* GM (June 1, 2012) http://media.gm.com/media/us/en/gm/news.detail.html/content/Pages/news/us/en/2012/Jun/0601_pension.html [hereinafter *GM Announces US Salaried Pension Plan Actions*] (GM); *Motorola Solutions Announces Third-Largest Pension De-Risking Transaction*, THE NAT'L LAW REVIEW (Sept. 26, 2014), http://www.natlawreview.com/article/motorola-solutions-announces-third-largest-pension-de-risking-transaction [hereinafter *Motorola Solutions*] (Motorola); Robert Stever, *Bristol-Myers Squibb Announces $1.4 Billion Pension Buyout*, PENSION AND INVESTMENTS (Sept. 30, 2014) (Bristol-Myers Squibb), http://www.pionline.com/article/20140930/ONLINE/140939971/bristol-myers-squibb-announces-14-billion-pension-buyout (Bristol-Myers Squibb).

This Article is the first treatment of pension de-risking in the legal literature. In Part I, we offer a succinct explanation of what pension de-risking is and why it will accelerate. In so doing, we provide an accessible foundation for future de-risking discussions by clearing away the complex regulatory brushwood that so often frustrates mainstream consideration of pension issues.

In Part II, we offer a policy frame that clarifies the problem pension de-risking poses. Pension regulation should promote retirement security. By converting federally-protected pensions into private annuities or cash, pension de-risking does the opposite. Regulators should keep that in mind.

In Part III, we offer a roadmap for reform. In many pension contexts, robust regulation may deter employers from offering voluntary retirement plans in the first place, so regulators need balance protecting beneficiaries against employer flight.[14] No similar pressure exists here. No employer will be deterred from offering a DB plan on account of strict de-risking rules, because virtually no employers are offering new DB plans in the first place.[15] Accordingly, regulators can realistically prioritize protecting beneficiaries.

After describing the legal framework for de-risking, we make four suggestions. The government should (1) encourage internal de-risking by establishing regulatory safe harbors; (2) require a battery of procedural safeguards for annuitization transactions; (3) require improved disclosures for cash buyouts; and (4) limit cash buyouts when beneficiaries are not likely to meaningfully understand the potentially adverse consequences of trading a pension for cash.

I. CONCEPTUALIZING PENSION DE-RISKING

On its own, the term "pension de-risking" is too vague to do much useful work. Below we develop a vocabulary that will make discussion of the phenomenon, and potential reforms, intelligible. We also explain

[14] *See* Pilot Life Ins. Co. v. Dedeaux, 481 U.S. 41, 54 (1987) (ERISA's "civil enforcement scheme . . . represents a careful balancing of the need for prompt and fair claims settlement procedures against the public interest in encouraging the formation of employee benefit plans").

[15] *See* Edward A. Zelinsky, *The Defined Contribution Paradigm*, 114 YALE L. J. 451, 488 (2004) ("By the 1980s, the defined benefit system was stagnating. Virtually no new defined benefit plans were being created.").

why pension de-risking demands immediate attention: because it is likely to accelerate.

A. ERISA & Pension Basics

ERISA, with narrow exceptions, governs retirement promises made incident to employment.[16] ERISA requires such pension promises to be effectuated under a "plan" that is created by the sponsoring employer.[17] Those plans, for our purposes, come in two varieties: the "defined benefit" (DB) plan and the "defined contribution" (DC) plan.

A DB plan is where the retirement promise is defined in terms of what the employee can expect to receive upon retirement, e.g., a fixed, periodic payment based on the employee's years of service and average salary.[18] A DB entitlement is functionally an annuity earned through service and paid for by foregone wages. A DB benefit is what most people think of when they hear the word "pension." ERISA heavily regulates DB arrangements.[19]

A DC plan, in contrast, is where the retirement entitlement is defined in terms of what the employee (and sometimes the employer) "contributes" to a retirement savings account, plus any investment appreciation on those contributions.[20] A DC arrangement is functionally a constrained savings account. A classic example of a DC arrangement is a 401(k) plan. ERISA regulates DC arrangements, but far less strictly than it does DB plans.[21]

Pension de-risking involves DB plans, and for all forms of de-risking, the underlying motivation is the same. An employer made a DB promise long ago. Afterward, it determines that its current strategy

[16] *See* Brendan S. Maher & Peter K. Stris, *ERISA & Uncertainty*, 88 WASH. U. L. REV. 433, 445–46 (2010).

[17] 29 U.S.C. §§ 1002(1)–(3) (2012).

[18] Maher & Stris, *supra* note 16, at 446.

[19] *See id.* at 451–56 (discussing ERISA regulation of defined benefit plans).

[20] *Id.* at 448.

[21] *See id.* at 456 (maintaining that ERISA does regulate defined contribution plans and subjects plans to some of rules that govern defined benefit plans, however, "these plans were a relatively minor part of the pension landscape" when ERISA was enacted).

for keeping the pension promise is too expensive or uncertain.[22] So the company considers a number of alternate strategies to handle its pension obligation. Thus, at the broadest level, pension de-risking refers to *any* strategy a company undertakes to mitigate the risk associated with carrying a DB pension obligation.[23]

As we discuss below, some de-risking strategies are "internal," meaning that the pension obligation is retained within the company and its plan, but the plan is managed differently.[24] Other solutions are "external," meaning that the pension obligation is offloaded to another party.[25] The focus of this Article is largely on external de-risking; external strategies particularly worry observers because they transfer risk to beneficiaries and are only partially subject to ERISA.[26] Internal strategies, in contrast, are less worrisome because they do not transfer any risk to beneficiaries and are entirely governed by ERISA.[27] To the extent, however, that regulatory uncertainty regarding the permissibility of internal de-risking strategies will motivate some employers to pursue external de-risking strategies instead, we pause to discuss internal de-risking.

B. Internal De-risking

An internal de-risking strategy is any strategy in which the plan retains the underlying DB obligation but adjusts its mix of assets to

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[22] *See Private Sector Pension De-risking and Participant Protections: Hearing before ERISA Advisory Council* 1 (August 29, 2013) (statement of Brendan S. Maher, Law Professor, University of Connecticut School of Law) *available at* http://www.dol.gov/ebsa/pdf/UCLaw082913.pdf [hereinafter Maher Testimony]. *Cf.* Kenneth Glenn Dau-Schmidt, *Promises to Keep: Ensuring the Payment of Americans' Pension Benefits in the Wake of the Great Recession*, 52 WASHBURN L.J. 393, 292, 407 (2013) (observing that recessionary times make it difficult for defined benefit plan sponsors to pay promised pension benefits).

[23] *See* Maher Testimony, *supra* note 22, at 2.

[24] *See infra* Part I.B.

[25] *See infra* Part I.C.

[26] *See* Newman Testimony, *supra* note 10, at 2 ("After an individual's pension benefits are settled, the individual ceases to be a participant in the plan, ERISA ceases to govern the benefit, and the PBGC no longer insures the benefit.").

[27] *See id.* (discussing in-plan de-risking strategies and how they are subject to ERISA's fiduciary duties of prudence, loyalty, and prudent diversification of plan assets).

reduce funding volatility.[28] DB plans in effect promise annuities, which are due at specific times, in specific amounts, and are subject to ERISA-imposed funding requirements along the way.[29] The upshot is that an investment strategy for the plan assets underlying the collective pension promise—even if over the long run it meets or exceeds its obligations—can be a bad "match" for the pension obligations that are or will soon come due.

Some internal de-risking strategies attempt to more closely match plan investments to plan benefit payouts.[30] A very simple internal de-risking strategy of this type would be for a plan to simply purchase and hold annuities that paid out to the plan as the plan's liabilities to pensioners came due. Other strategies attempt to reduce the volatility of the plan's investments, such as by purchasing high-grade bonds or hedging against undesirable market fluctuations.[31]

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[28] *See* Brendan McFarland & Erika Stoner, *2012 Asset Allocations in Fortune 1000 Pension Plans*, TOWERS WATSON (November 12, 2013), http://www.towerswatson.com/en-US/Insights/Newsletters/Americas/insider/2013/2012-asset-allocations-in-fortune-1000-pension-plans ("Such a [glide path strategy] reduces funding volatility by shifting assets from equities to debt as funding levels improve, thereby safeguarding gains by reducing risk.").

[29] *See infra* text accompanying notes 18–19. *See also* Anne Tucker, *Retirement Revolution: Unmitigated Risks in the Defined Contribution Society*, 51 HOUS. L. REV. 153, 168 (2013).

[30] This is sometimes referred to as "liability driven investing" or "LDI." *See, e.g.*, EMP'T RET. INCOME SEC. ACT ADVISORY COUNCIL, U.S. DEP'T OF LABOR, PRIVATE SECTOR PENSION DE-RISKING AND PARTICIPANT PROTECTIONS 13 (November 2013), *available at* http://www.dol.gov/ebsa/pdf/2013ACreport2.pdf [hereinafter Council De-Risking Report] ("[I]n-plan strategies include restricting participation or accruals, hedging and immunization (both considered liability-driven investing (LDI)), and buy-ins."). *See also* Paul M. Secunda, *The Forgotten Employee Benefit Crisis: Multiemployer Benefit Plans on the Brink*, 21 CORNELL J.L. & PUB. POL'Y 77, 94 (2011) (referring to same internal de-risking strategy as "liability aware" investing).

[31] *See* Newman Testimony, *supra* note 10, at 1 ("Hedging involves investing to offset some of the factors that drive funding volatility, such as changes in interest rates."); *Mercer Proposes 5 Ways for Pension Sponsors to Manage Funded Position, Risk in 2015*, PENSION PLAN FIX-IT HANDBOOK NEWSLETTER (Thompson Info. Serv., Bethesda, MD), Feb. 2015, at 4 (explaining that building portfolio of high-grade bonds can be a way to manage plan liabilities).

C. External De-risking

An external de-risk occurs when an entity other than the plan becomes the bearer of the risk associated with providing retirement income to the beneficiary. In other words, the risk associated with the pension promise is "externalized" relative to the plan. As many observers have correctly noted, the term "de-risking" in this context is fairly misleading; meaningful risk still exists, it is just no longer borne by the plan.[32] A more precise articulation of how the risk is externalized, however, is necessary.

Consider the beginning point of any external de-risk: the plan owes beneficiaries a DB pension it wishes to offload. Recall that a DB pension is essentially an (1) annuity that is (2) heavily regulated by ERISA. Thus, without spelling out any more details, we can say that any company considering de-risking starts out owing beneficiaries an "ERISA Annuity." From that perspective, external de-risking is the process by which a company converts a pension entitlement in the form of an ERISA Annuity into something else. The question: what is that something else?

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[32] *See Private Sector Pension De-risking and Participant Protections: Hearing before ERISA Advisory Council* 3 (August 29, 2013) (statement of Norman Stein, Professor, Drexel University Earle Mack School of Law*) available at* http://www.dol.gov/ebsa/pdf/DrexelU082913.pdf [hereinafter Stein Testimony] ("The term de-risking is not a statutory or technical term; rather, it is a generic term that refers to a variety of approaches that employers use to control the risks inherent in the promise to pay employees a set monthly payment for life after they retire."). *See also* Edited Transcript, VZ-Q4 2012 Verizon Earnings Conference Call 8 (Jan. 22, 2013, 1:30 PM), http://www.verizon.com/about/file/947/download/?token=0WOyrHdm. As Verizon CFO Francis J. Shammo observed, Verizon's annuity de-risking transaction reduced the company's exposure "to funding and income statement volatility caused by changes in investment returns, discount rates, and longevity risks." *Id.* The company's investment and longevity risk does not just vanish, of course. It simply gets transferred to the retiree. *See also Motorola Launches Third-Largest U.S. Pension Buyout, Hopes to Shed $4.2 Billion In Obligations: Deal Also Offers Lump Sums to 32,000 Terminated Vested Participants Not Yet Retired*, PENSION PLAN FIX-IT HANDBOOK NEWSLETTER (Thompson Info. Serv., Bethesda, MD), Nov. 2014, at 4. Annuitization, for example, transfers the risk of pension promises to insurance companies and also to plan participants, who have no PBGC protection in the event the insurance company is unable to pay pension benefits. *Id.*

There are two things a company may convert an ERISA Annuity into: (1) a Non-ERISA Annuity or (2) a Non-ERISA Lump Sum.[33] A Non-ERISA Annuity is exactly what it sounds like: an annuity promise regulated by some law other than ERISA. A Non-ERISA Lump Sum requires a little more explanation. As a matter of actuarial math, all annuities can be converted to lump sums based on certain assumptions about the lifetime of the beneficiary and the applicable discount rates.[34] A Non-ERISA Lump Sum is what results when an ERISA Annuity is converted into an actuarially equivalent lump sum (and then given to the beneficiary to use outside the confines of an ERISA-governed plan).

Thereby, without having yet considered any specifics, we can conceive of "external de-risking" as referring to the set of processes by which a plan sponsor can permissibly convert an ERISA Annuity into either (1) a Non-ERISA Annuity or (2) a Non-ERISA Lump Sum. Of considerable interest to regulators and reformers is what the legal rules governing those processes should be. Some of those rules are fairly clear, but others are not. Yet discussion of possible reforms—whether to revise existing rules or promulgate new ones—can only sensibly proceed after a realistic appraisal of *why* the employment-based retirement arrangements are regulated in the first place. We offer such an appraisal in Part II below. Before doing so, however, we explain why pension de-risking is a phenomenon likely to grow.

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[33] *See* Newman Testimony, *supra* note 10, at 2 (describing lump sum offers and annuity purchases from insurance companies as two "settlement strategies" designed to "discharge the plan's obligations to participants"). The IRS generally prohibits the offering of lump sums to retirees, except in plan termination cases. *Id.* at 3. However, the IRS has issued a few private letter rulings allowing lump sum offers to be made to retirees who were receiving annuity payments from the pension plan, subject to certain criteria. *Id.* As for annuities, plans are not allowed to make annuity purchases unless it is at least 80% funded. *Id.* at 4.

[34] *See* COLLEEN E. MEDILL, INTRODUCTION TO EMPLOYEE BENEFITS LAW: POLICY AND PRACTICE 115 (4th ed. 2015) A promise to pay money twenty years from now is worth less than the face value of the promise, both because there's a risk the promisor will not pay, and because money later is worth less than money today. *Id.* at 115-16. A promise to make periodic payments beginning at retirement and ending at death (which is what a simple pension is) is also worth some net-present-value-adjusted amount of money today ("lump sum"); that adjustment depends on interest rates and the expected lifetime of the recipient. *Id.* at 117.

D. Why Pension De-risking Will Accelerate

For three reasons, the current environment favors pension de-risking transactions. First, employers today face less general hostility when moving away from DB approaches than they would have in the past. Younger American employees are more likely to receive—and expect to receive—a DC plan than in the past.[35] Whereas older generations were used to a DB plan environment where the company was responsible for their pensions (backed by a federal guarantee),[36] younger workers have grown up in a different world. They have long known that they, rather than their employer or the government, are primarily responsible for their own retirement security.[37] Generally, only older workers and retirees are threatened when employers undertake pension de-risking strategies.[38] The only other employees impacted by these transactions are the so-called "vested terminated employees," who even though they have vested pension rights, no

[35] *See* McClendon, *supra* note 5, at 820–21 (discussing the changing demographics in the American workplace, and the effects this has had on the shift from defined benefit to defined contribution plans). Today's workers tend to favor the 401(k) plan, and its defined contribution counterparts, because they "place[] less emphasis on retirement plans that reward long-term service and, instead, favor plans that provide more immediate, tangible retirement benefits, those that offer benefit front-loading, accessibility, and portability"). *Id.* at 821.

[36] *Id.* at 814. "The 1980s and 1990s evidenced a mass exodus from defined benefit plan sponsorship." *Id.* Prior to then, the defined benefit plan was the primary means by which employers provided pension benefits to employees. Susan J. Stabile, *The Behavior of Defined Contribution Plan Participants*, 77 N.Y.U. L. REV. 71, 74 (2002).

[37] Because of the shift from defined benefit to defined contribution plans, many American workers now rely on defined contribution plans, such as the 401(k) plan, as their primary source of "employer-provided retirement income." Stabile, *supra* note 36, at 74–75. 401(k) plans place many important plan decisions in the hands of the individual, such as whether to participate in the plan, how much to contribute, and how to invest those contributions, and so individuals really are responsible for their own retirement security. *Id.* at 78.

[38] *See* Certner Testimony, *supra* note 11, at 2 (stating that companies who are making the decision to de-risk are often "targeting retirees in pay status"). Offers of lump sums to retirees in pay status can be "greatly disruptive and distressing," and many retirees faced with lump sum offers have reported increased levels of stress, anxiety, and sleeplessness. *Id.* at 9–10.

longer work for the employer.[39] These vested terminated employees have even less of a voice in seeking to dissuade employers from undertaking these transactions because of their absence from the workplace and, in some cases, their unfamiliarity that they even have such benefits from a past job.[40] Indeed, some studies suggest that terminated vested employees prefer receiving a lump sum payment than having to wait until retirement age to receive what might be a relatively small pension annuity.[41] So, far from fighting such pension de-risking moves, such workers might actually support them.

Second, financial forces support more pension de-risking behavior.[42] New funding rules under the Pension Protection Act of 2006,[43] as well as higher PBGC premiums, have forced companies to

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[39] *See* PENSION BENEFIT GUARANTY CORPORATION, http://www.pbgc.gov/about/pg/header/glossary.html#27 (last visited June 16, 2014) ("[A terminated vested employee is "[g]enerally, a former employee who worked long enough to earn 'Vested Benefits' in a pension plan, but who left the company sponsoring the plan without receiving a retirement benefit immediately. Such a participant can receive benefit payments from the plan once he or she reaches the plan's 'Normal Retirement Age' or, if the plan allows, the plan's 'Early Retirement Age.'").

[40] *See* EMP'T RET. INCOME SEC. ACT ADVISORY COUNCIL, U.S. DEP'T OF LABOR, LOCATING LOST AND MISSING PARTICIPANTS 11, 22 (November 2013), *available at* http://www.dol.gov/ebsa/pdf/2013ACreport3.pdf

[41] *See* Council De-Risking Report, *supra* note 30, at 16. *See Private Sector Pension De-risking and Participant Protections Hearing before ERISA Advisory Council* 6 (June 5, 2013) (statement of Craig Rosenthal, Partner, Mercer, American Benefits Council) *available at* http://www.dol.gov/ebsa/pdf/ABC060513.pdf [hereinafter Rosenthal Testimony] ("[I]n the case of one-time lump sum offers (including offers in connection with a plan termination), the election percentage for participants who have not yet commenced benefits tends to be lower, typically in the 40% to 60% range. It is important to note that in situations where there is a one-time offer of a lump sum, the lump sum election percentages are often correlated with the age of the participant.").

[42] *See* Rosenthal Testimony, *supra* note 41, at 1–2 (describing all of the changes and developments in the law regarding pension plan funding, which have increased the cost of providing and maintaining defined benefit pension plans). Some of the financial forces motivating companies to de-risk include the "size of the pension plan liabilities relative to the overall size of the plan sponsor," administrative costs, higher PBGC premiums, and balance sheet volatility. *Id.* at 3.

[43] See Pension Protection Act of 2006, Pub. L. 109–280, 120 Stat. 780 (2006), *available at* http://www.gpo.gov/fdsys/pkg/PLAW-109publ280/html/PLAW-109publ280.htm.

put aside larger and larger amounts of money to keep their pension plans fully-funded and in compliance with ERISA obligations.[44] And financial accounting rules (including FAS 158)[45] have required companies to place their pension liabilities in their public financial statements,[46] making more readily apparent the sheer size of the pension funding obligations that many companies bear.[47] Thus, in recent times, pension obligations have become larger (as compared to company size) as well as more transparent to investors inclined to demand cost-cutting from management.[48] In addition, expected rising interest rates and improved funding ratios for many plans in light of the recent stock market surge mean that it will be less expensive to transfer their pension liabilities to insurance companies.[49]

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[44] *See* Joe Lustig, *Plan Sponsor De-risking Likely to Continue Even With Higher Funding, Practitioners Say*, BLOOMBERG BNA (Jan. 30, 2014), http://www.bna.com/plan-sponsor-derisking-b17179881745/ ("Pension regulations on plan terminations could also mean that improved funding levels are a catalyst for such steps, while increases in pension insurance premiums might help push the de-risking tide as well.").

[45] FAS 158 refers to the Financial Accounting Standards Board's Statement 158: Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans—an amendment of FASB Statements No. 87, 88, 106, and 132(R), *available at* http://www.fasb.org/summary/stsum158.shtml.

[46] *See* Rosenthal Testimony, *supra* note 41, at 2 ("[I]mplementation of FAS 158 required most sponsors to reflect the market-to-market values of pension plan assets and liabilities directly on their balance sheets starting at year-end 2006").

[47] *See* Lustig, *supra* note 44 (quoting Professor Norman Stein for the proposition that, "plan sponsors should lobby Congress to change the funding rules so that funding is evaluated over a broader period of time rather than as a snapshot."). *See also* Stein Testimony, *supra* note 32, at 2.

[48] *See* Stein Testimony, *supra* note 32, at 3.

[49] *See* Rick Baert, *Pension Buyouts Expected to Surge – but not yet*, PENSIONS & INVESTMENTS (Oct. 14, 2013), http://www.pionline.com/article/20131014/PRINT/310149973/pension-buyouts-expected-to-surge-8212-but-not-yet (last visited Mar. 6, 2013). For example, in October 2013, the cost of purchasing annuities from an insurer decreased to 108.3% of the value of transferred liabilities. See Kevin Olsen, *Mercer: Buyout vs. economic cost of pension funds at smallest margin in 2013*, PENSION & INVESTMENTS (Nov. 27, 2013), http://www.pionline.com/article/20131127/ONLINE/131129884/mercer-buyout-vs-economic-cost-of-pension-funds-at-smallest-margin-in-2013. As of December 2014, the cost of purchasing annuities from an insured further decreased to 105.3%. See James Comtois, *Mercer: Pension annuity buyout premium decreases relative to liability*, PENSION & INVESTMENTS (Jan. 30, 2015)

Third, employers no longer need DB plans to recruit and retain the best workers.[50] Because most private-sector employers are only offering DC plans to their newly-hired workers, there is no pressure to offer or retain DB plans.[51] Of course, the decline of organized labor in the private-sector also leads to a dynamic where workers as a whole have less of a voice in the American workplace to protest these types of de-risking transactions by their employers.[52] Labor realities thus also favor a surge in pension de-risking activity.

Because of these demographic, financial, and labor factors, DB plans pose little upside and lots of risk to employers who still maintain them.[53] As a result, where feasible and cost-effective, companies will seek to off-load these pension obligations through external pension de-risking transactions. The last several years bear this out.

In 2012, Ford Motor Company, General Motors, and Verizon all engaged in external pension de-risking transactions. Ford offered lump

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http://www.pionline.com/article/20150130/ONLINE/150139987/mercer-pension-annuity-buyout-premium-decreases-relative-to-liability (based on Mercer pension buyout index).

[50] While benefits are still crucial when recruiting millennials, the focus has shifted from offering the "relic of the old regime" benefits to offering long term financial planning and health benefits. *See* Neil Howe, *How the Millennial Generation is Transforming Employee Benefits*, INTERNATIONAL SOCIETY OF CERTIFIED EMPLOYEE BENEFIT SPECIALISTS 12 (2014), http://www.iscebs.org/Resources/BQ/Documents/bq214a.pdf.

[51] Brendan MacFarland, *Retirement Plan Types of Fortune 500 Companies in 2012*, TOWERS WATSON 1 (Oct. 2012), http://www.aztreasury.gov/wp-content/uploads/2013/1609_final_report/Towers_Waston_annual_survey_of_Fortune_100_companies.pdf. The number of Fortune 500 companies that have been offering solely defined contribution plans has risen, and in 2012, only 30 Fortune 500 companies offered new hires some form of defined benefit plan. *Id.* "Only 11 still offer[ed] a *traditional* [defined benefit] plan to new hires." *Id.* (emphasis added).

[52] *See* Thomas I.M. Gottheil, *Not Part of the Bargain: Worker Centers and Labor Law in Sociohistorical Context*, 89 N.Y.U. L. REV. 2228, 2229 (2014) ("From 1973 to 2013, union density declined from 24.0% to 11.2% of all employed workers and from 24.2% to 6.7% of private sector workers").

[53] *See* Meghan Elwell & Alex Pekker, *Pension funds should derisk now*, PENSION AND INVESTMENTS (March 11, 2014), http://www.pionline.com/article/20140311/ONLINE/140319974/pension-funds-should-derisk-now ("[E]ven plan sponsors that appear to be fully de-risked with completely frozen, fully funded and fully hedged plans with respect to interest rate risk should be prepared to fund mortality improvements and actuarial experience risk.").

sums to approximately 90,000 retirees and former employees as a way to reduce its significant pension liabilities.[54] GM pursued a two-prong de-risking strategy, offering lump sum buyouts to approximately 44,000 beneficiaries and purchasing an annuity contract through Prudential for another 110,000 beneficiaries.[55] Verizon struck a $7.4 billion group annuity deal with Prudential by which Prudential assumed responsibility for approximately 41,000 Verizon pensioners.[56]

In 2013, SPX Corporation announced a lump sum and annuity buy-out transaction worth some $800 million, with Massachusetts Mutual Life Insurance Company as the counterparty.[57] The SPX plan impacts both terminated vested employees and retirees, with the former being offered lump sums and the latter being forced to take the annuity buy-out.[58]

In 2014, Motorola and Bristol-Myers Squibb joined the external de-risking club. Motorola transferred $3 billion of its pension liabilities to Prudential.[59] Motorola also offered lump sum buyouts to about 32,000 terminated vested plan participants.[60] Bristol-Myers Squibb engaged in

[54] Meier, *supra* note 13. At the end of 2011, Ford Motor Co. had significant pension liabilities (approximately $50 billion to U.S. pensioners) and an underfunded plan (an approximately $15.4 billion deficit). *Id.* Ford has not indicated how many beneficiaries accepted the buy-outs, although it has attributed a $1.2 billion reduction in pension liabilities to its lump-sum initiative. *Id.*

[55] *See GM Announces U.S. Salaried Pension Plan Actions*, *supra* note 13. The annuity contract was purchased for $25 billion. *Id.* At the end of 2011, GM had some $134 billion in pension liabilities and a funding deficit of $25 billion. *See* Andreas Knoch, *CFOs Have to Address Pension Risks*, CFO INSIGHT (June 13, 2012), http://www.cfo-insight.com/risk-management-it/risk-management/cfos-have-to-address-pension-risks/.

[56] Lee v. Verizon Commc'ns Inc., 2012 WL 6089041 (N.D. Tex. Dec. 7, 2012).

[57] *See* Kevin Olsen, *SPX offloads $800 million in pension risk; MassMutual to take portion in buyout*, PENSIONS & INVESTMENTS (Nov. 14, 2013), http://www.pionline.com/article/20131114/ONLINE/131119925.

[58] *Id.* Industry press has described insurance companies jockeying for position in the growing de-risking space. *Id.*

[59] *Motorola Solutions*, *supra* note 13. The transfer is third to General Motors and Verizon, whose pension liability transfers equaled $25 billion and $7.5 billion, respectively. *Id.* The annuity contract affects some 30,000 plan participants who are currently in pay status. *Id.*

[60] Rob Kozlowski, *Motorola wraps up pension buyout at light speed*, PENSIONS & INVESTMENTS (Sept. 29, 2014), http://www.pionline.com/article/20140929/PRINT/309299976/motorola-wraps-up-

a $1.4 billion annuitization transaction with Prudential, which affected about 8,000 plan participants in pay status.[61]

Indeed, external pension de-risking activity in the past few years has been so substantial that the Department of Labor's ERISA Advisory Council moved to investigate the phenomenon.[62]

II. DE-RISKING & RETIREMENT SECURITY

A. Performance & Delivery

Central to pension regulation are two objectives: first, that pension promises made are actually *performed*, and second, that the pension promises that are performed actually *deliver* the socially desirable outcome they are supposed to, namely, retirement security. Neither of those rationales favors permissive pension de-risking.

On the question of performance: employment-based retirement promises can come in a variety of different forms. Whatever their form, however, society desires that retirement promises be *kept*, because workers are acutely vulnerable when they are not.[63] All else equal, legal rules should promote pension promise performance.

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pension-buyout-at-light-speed. At the end of the de-risking transactions, Motorola is hoping to have cut their pension liabilities in half. *Id.* Motorola's current pension plan liabilities total approximately $8.4 billion. *Id.*

[61] Stever, *supra* note 13. At the end of 2013, the Bristol-Myers Squibb plan was actually about 102.4% funded. *Id.* However, the company entered into the transaction with the hopes of being able to better manage the cost of maintaining the defined benefit plan. *Id.*

[62] "Section 512 of ERISA provides for the establishment of an Advisory Council on Employee Welfare and Pension Benefit Plans, known as the ERISA Advisory Council" to advise the Secretary of Labor. ERISA Advisory Council. U.S. DEP'T OF LABOR, http://www.dol.gov/ebsa/aboutebsa/erisa_advisory_council.html (last visited Feb. 8, 2015). The Council reported its findings and recommendations to the Secretary of Labor in November 2013. Council De-Risking Report, *supra* note 30. Professor Maher provided testimony to the Council in August 2013, *see* Maher Testimony, *supra* note 22, and Professor Secunda served as part of the Council's Issue Drafting Group on Pension De-Risking. *See* Council De-Risking Report, *supra* note 30.

[63] *See* Paul M. Secunda, *An Analysis of the Treatment of Employee Pension and Wage Claims in Insolvency and Under Guarantee Schemes in OECD Countries: Comparative Law Lessons for Detroit and the United States*, 41 FORDHAM URB. L.J. 867, 872 (2014) (discussing the

On the question of delivery: assuming a retirement promise is performed, society wants such retirement promises to be effective in yielding retirement security. Assuming both Retirement Promise A and Retirement Promise B will be performed, the more desirable promise is the one that leads to greater retirement security. All else equal, legal rules should disfavor pension promises that are comparatively less likely to promote retirement security.

None of the above is particularly controversial, although it is routinely forgotten as interest groups and litigants furiously battle over the meaning of obscure provisions of both ERISA and the Internal Revenue Code. Such appears to be happening with respect to pension de-risking. If we take a step back, however, much of the pension de-risking debates can be concisely crystallized.

If pension de-risking is permissively regulated, ERISA Annuities are likely to be converted into Non-ERISA Annuities or Non-ERISA Lump Sums; if pension de-risking is strictly regulated, they are unlikely to be converted. Most observers who favor strict regulation do so (1) because they believe converting ERISA Annuities into Non-ERISA Annuities is undesirable because the latter promise is less likely to be *performed* than an ERISA Annuity promise, or (2) because they believe that converting ERISA Annuities into Non-ERISA Lump Sums will *deliver* less retirement security than an ERISA Annuity promise.[64] In Parts II.B and II.C below, we explain why those beliefs are likely justified and should form the basis for regulatory action.

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vulnerability of employees and pensioners among creditors during the Detroit municipal bankruptcy proceedings).

[64] Proponents of permissive de-risking either (1) deny that de-risking leads to a degradation of promise performance or retirement security, *see*, e.g., *Private Sector Pension De-risking and Participant Protections: Hearing Before ERISA Advisory Council* 1–2 (June 5, 2013) (statement of John G. Ferreira, Partner, Morgan, Lewis & Bockius, LLP) *available at* http://www.dol.gov/ebsa/pdf/morganlewis060513.pdf (explaining that there is no need for further regulations and guidance of de-risking transactions, and that such transactions actually benefit plan participants in numerous ways), or (2) argue that such a degradation is acceptable because it is outweighed by some other value, *see*, e.g., Newman Testimony, *supra* note 10, at 6 (explaining that de-risking transactions should be permitted because it enables the employer to reduce the financial volatility stemming from legacy plans in order to more effectively manage on-going plan costs, especially in light of the fact that these plans are voluntary to begin with).

B. Non-ERISA Annuities: An Under-performance Problem

A Non-ERISA Annuity promise is less likely to be performed than an ERISA Annuity promise because the former lacks regulatory features that make performance likely.

Three features are particularly crucial. First, ERISA requires that DB plans meet minimum funding requirements.[65] A pension promise does not by its nature require that any money be set aside today, but ERISA requires that future pensions be funded in advance (at levels determined by statute and dependent upon certain actuarial assumptions).[66] Second, as a matter of federal law, ERISA imposes strict fiduciary duties upon plan fiduciaries, requiring that those who manage the plan act prudently and in the best interest of beneficiaries.[67] Third, through the Pension Benefit Guaranty Corporation, ERISA insures (to a certain level) DB pensions.[68] All of these requirements obviously increase the likelihood that the ERISA Annuity promise will be performed.

When an ERISA Annuity is converted into a Non-ERISA Annuity, however, these safeguards vanish. They vanish because converting ERISA Annuities into Non-ERISA Annuities is achieved by effectively transacting beneficiaries out of ERISA (and the guarantees of the PBGC). If "[t]he entire benefit rights of the individual (1) [a]re fully guaranteed by an [insurer] licensed to do business in a State, and are legally enforceable by the sole choice of the individual against the [insurer]; and (2) [a contract] describing the benefits to which the individual is entitled under the plan has been issued to the individual,"[69] the beneficiary is thereafter "not a participant covered under an

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[65] 29 U.S.C. § 1083 (2012); Tucker, *supra* note 29, at 167.

[66] *See* Tucker, *supra* note 29, at 168–69 (explaining that employers fund defined benefit plans through annual contributions that are recommended by actuaries based on the number of employees, the age of the plan participants, and the benefits that are to be paid to plan participants).

[67] 29 U.S.C. § 1104(a) (2012); Tucker, *supra* note 29, at 195.

[68] *Guaranteed Benefits*, PENSION BENEFIT GUARANTY CORPORATION (2015), http://www.pbgc.gov/wr/benefits/guaranteed-benefits.html. "The 2015 maximum monthly guarantee for a 65-year-old retiree is $5,011.36, which amounts to about $60,136 per year." *Id*. The PBGC is funded by premiums paid by DB plans.

[69] 29 CFR § 2510.3-3 (2014).

employee welfare plan."[70] Beneficiaries are thereafter protected by state, rather than federal, law.[71]

Although state law varies, in the main, state rules designed to ensure the full payment of annuity contracts are less protective than ERISA.[72] The funding requirements for annuities are less demanding than ERISA;[73] the legal obligations governing those who manage the assets funding the annuity contracts are more permissive than ERISA;[74] and the backstop guarantees offered by state guaranty associations are less robust than those offered by the PBGC.[75] This is not to say that in every case converting an ERISA Annuity into a Non-ERISA Annuity will have an appreciably negative effect on the likelihood of performance. In general, however, it will reduce the likelihood of full performance.

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[70] *Id.*

[71] As Justice Scalia observed, when terminating a plan through the purchase of annuities, "[t]he assets of the plan are wholly removed from the ERISA system, and plan participants and beneficiaries must rely primarily if not exclusively on state contract remedies if they do not receive proper payments or are otherwise denied access to their funds." Beck v. PACE Intern. Union, 551 U.S. 96, 106 (2007).

[72] *See Private Sector Pension De-Risking and Participant Protections: Hearing Before the ERISA Advisory Council* 17 (Aug. 29, 2013) (statement of Peter Gallanis, President, NOLHGA), *available at* http://www.dol.gov/ebsa/pdf/NOLHGA082913.pdf [hereinafter Gallanis Testimony] (demonstrating the difference in PBGC and state guaranty Model Act pension benefit protections).

[73] *See Private Sector Pension De-Risking and Participant Protections: Hearing Before the ERISA Advisory Council* 2 (Aug. 29, 2013) (statement of William Kadereit, President, National Retiree Legislative Network), *available at* http://www.dol.gov/ebsa/pdf/NRLN082913.pdf (discussing how the annuity contracts cause participants to lose the minimum funding protections under ERISA for qualified plans).

[74] *See id*. (discussing how the fiduciary and disclosure requirements under ERISA do not apply to annuity contracts that are purchased in plan de-risking transactions).

[75] *See id.* at 3. *See also* Gallanis Testimony, *supra* note 72, at 17 (demonstrating the difference in PBGC and Model Act pension benefit protections).

C. Non-ERISA Lump Sums: An Under-delivery Problem

In pure mathematical terms, any annuity can be converted to an actuarially equivalent lump sum.[76] Of course, if one uses unrealistic actuarial assumptions to convert an annuity into a lump sum, then one can rob the beneficiary of value. Obviously these conversions need to be properly regulated.

But let us assume for the sake of argument that the conversions will be actuarially fair. Should regulators be indifferent between a beneficiary holding an ERISA Annuity or an actuarially equivalent Non-ERISA Lump Sum? The weight of the evidence—as well as behavioral economic theory—suggests not. In terms of delivering retirement security, annuities are vastly preferable to lump sums.

Consider first the traditional definition of retirement security: that an individual will receive, for the balance of her retirement, income equal to approximately 70% of her income while employed.[77] An ERISA Annuity naturally throws off income, is calculated based on the beneficiary's working salary, and lasts for the duration of the beneficiary's life.[78] The beneficiary need do no more than, upon retirement, cash their monthly check until death.

In contrast, for a lump sum to provide retirement security, matters are more complicated for the beneficiary. A lump sum received mid-career can be thought of as a conversion to a DC plan, where the initial contribution is the lump sum actuarial equivalent of the ERISA Annuity earned to date. To understand the problem of de-risking an ERISA Annuity into a Non-ERISA Lump Sum, let us briefly rehearse the problems associated with DC arrangements in general.

For DC plans to "work" from a societal perspective, participants must habitually *save* at the appropriate rate, they must earn an appropriate *investment return* on those savings, and they must *consume* that balance, post-employment, at an appropriate rate. Put more

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[76] *See supra* text accompanying notes 34–35 (explaining actuarial equivalence between lump sums and annuities).

[77] *Top 10 Ways to Prepare for Retirement*, U.S. DEP'T OF LABOR, http://www.dol.gov/ebsa/publications/10_ways_to_prepare.html (last visited Feb. 12, 2015).

[78] *See supra* text accompanying notes 18–19. *See also* Befort, *supra* note 1, at 946 ("Traditional defined benefit plans provide a predetermined, specified retirement benefit, usually in the form of a life annuity, linked to pre-retirement earnings").

concretely, for a DC participant to have assets sufficient to fund retirement income equal to some W% of this career wage, that worker must (1) annually save X% of this compensation, (2) earn Y% in investment appreciation on those savings, and (3) draw down those savings at Z% a year in retirement. Many workers have proved unable to do those things.[79] Put differently: (1) DC participants do not save enough of their current income (2) they do not optimally invest their savings, or (3) they do not properly manage post-employment longevity risk, i.e., they spend their DC savings too quickly.[80] For many workers, then, the stark reality is that DC plans have under-delivered retirement security.[81]

Precisely why DC plans have under-delivered is subject to intense scholarly debate.[82] We do not resolve that debate here, although we side with the majority of scholars to have considered the issue. We believe, as do most observers, that DC plans have failed because they transferred to unsophisticated and unprepared individuals the

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[79] *See generally* Stabile, *supra* note 36. *See also* Colleen E. Medill, *Transforming the Role of the Social Security Administration*, 92 CORNELL L. REV. 323, 329–31 (2007) (describing how many Americans are financially illiterate and have psychological biases that may adversely affect the numerous and complex decisions they have to make in the context of defined contribution plans).

[80] For example, it is estimated that participants in defined contribution plans, such as 401(k)'s, who expect to maintain their standard of living will need to save approximately 17% of the income they earn from age 25 to 66. *See, e.g.*, Ghilarducci, *supra* note 1, at 454. Yet plan participants in 401(k) plans are only contributing approximately 7.5 to 8 percent of their income. Amy Monahan, *Employers As Risks*, 89 CHI.-KENT L. REV. 751, 757 (2014).

[81] *See* Bradford, *supra* note 1 ("Roughly 31% of Americans have no retirement savings and no access to defined benefit plans, according to Federal Reserve data, including 19% of people ages 55 to 64. Of the 65% of private-sector workers with access to workplace retirement plans, only 48% participated in one in 2014.").

[82] *Compare* Bradford, *supra* note 1 (discussing how many people do not have access to private-sector retirement plans, and those plans that people do have access to are not that beneficial), *with* McClendon, *supra* note 5, at 828 (discussing how defined contribution plans do not provide for a set benefit at retirement, and do not guarantee plan participants "significant benefit accruals"), *and* Stabile, *supra* note 36, at 88–89 (discussing how many plan participants lack the financial knowledge and literacy needed to make important investment decisions that are required by defined contribution plans).

responsibility for making saving, investment, and longevity decisions. And those individuals have made poor choices.[83]

There is no longer any serious doubt that human beings—even educated human beings—are naturally inclined to, and systematically do, behave sub-optimally.[84] (By sub-optimally, we mean that, given some plausible assumptions about what most people prefer, individuals make choices that fail to maximize those preferences.) The rich literature of behavioral economics has identified and categorized the many ways in which individuals' choices are afflicted with "cognitive biases" that result in poor decision-making.[85]

Many of those cognitive biases threaten wise retirement planning. For example, individuals generally value the present more than they should and are overly optimistic about the future.[86] These individuals are prone to spend too much today and save too little for retirement.[87] Second, there is a tendency to procrastinate, which means that individuals tend to put off saving for retirement or making difficult choices regarding retirement planning.[88] Many people, without a nudge, will fail to enroll in a retirement savings program at all. Even if

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[83] *See supra* note 79, 82.

[84] Admittedly, this question can become contentious on the specifics: what do most people prefer, and how do we know what that is? We do not here attempt to resolve that question; instead we merely assert a largely but not entirely uncontroversial point: most people wish to have retirement income equal to some reasonable percentage, say 70%, of their employment income, for the duration of their retired lives. *See* discussion *infra* note 77 and accompanying text.

[85] *See generally* DANIEL KAHNEMAN, THINKING, FAST AND SLOW (2009) (discussing and cataloguing cognitive biases).

[86] *See* Kelli A. Alces & Brian D. Galle, *The False Promise of Risk-Reducing Incentive Pay: Evidence from Executive Pensions and Deferred Compensation*, 38 CORP. L. J. 53, 75 (2012) ("There is extensive evidence . . . that humans tend to excessively weigh costs and benefits in the present and very near future at the expense of those that are more distant.").

[87] *Id.* at 75–76 ("[T]he time and mental effort of choosing a retirement plan looms much larger than the budget crunch one will face at retirement from choosing the wrong plan.").

[88] *See* Brian Galle, *Federal Fairness to State Taxpayers: Irrationality, Unfunded Mandates, and the "SALT" Deduction*, 106 MICH. L. REV. 805, 819–23 (2008).

they are automatically enrolled, they tend to stick with plan default options and contribution levels.[89]

Compounding such cognitive biases are more traditional obstacles to making rational retirement decisions, such as lack of financial literacy. An oft-cited survey of financial literacy revealed that only 14% of Americans could answer five extremely simple questions about interest rates and diversification.[90] Even when financially literate, DC participants face high information costs compared to their DB plan counterparts. A DC plan participant needs to gather and evaluate a significant amount of information in order to make informed decisions; a DB participant does not.[91] In order to combat the high information costs associated with DC plan decision-making, plan participants end up using "mental shortcuts" or "heuristics" which lead to poor investment decisions.[92]

In the past thirty years, occupational pensions have shifted from DB-dominated to DC-dominated. Private sector worker participation in DB plans dropped from 62% in 1975 to 7% in 2009.[93] Conversely, worker participation in DC plans rose from 16% in 1975 to 67% in

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[89] *See* RICHARD H. THALER & CASS R. SUNSTEIN, NUDGE: IMPROVING DECISIONS ABOUT HEALTH, WEALTH, AND HAPPINESS 74–102 (rev. ed. 2009); Lauren E. Willis, *When Nudges Fail: Slippery Defaults*, 80 U. CHI. L. REV. 1155 (2013).

[90] MEDILL, *supra* note 34, 570-571 (citing 2012 findings from United States Department of the Treasury National Financial Capability Study of 25,000 American adults, available at http://www.usfinancialcapability.org/about.php).

[91] *See* Medill, *supra* note 79, at 327 (explaining how defined contribution plans, such as 401(k) plans, "makes the individual worker primarily responsible for funding his or her own retirement benefits and investing his or her retirement assets.").

[92] *Id.* at 333–34. Some of the negative impacts of plan participants' mental shortcuts include overinvesting in company stock, relying on their own aversion to risk and investing too conservatively, and allocating their plan assets proportionately. *Id.* at 334–35.

[93] *EBRI Databook on Employee Benefits,* EMP. BENEFITS RESEARCH INST. (Mar. 2011), at 4, http://www.ebri.org/pdf/publications/books/databook/DB.Chapter%2001.pdf. Other statistics show that in 1975, defined benefit plans accounted for one-third of all pension plans in the nation. Estreicher & Gold, *supra* note 2, at 331. By 1998, defined benefit plans accounted for only one-twelfth of all pension plans. *Id.* at 331–32. In 2011, that number dropped further to about one-sixteenth. *See* MEDILL, *supra* note 34, at 131.

2009.[94] In that same time frame, retirement security has eroded. For example, the percentage of workers who were "at risk of having inadequate funds to maintain their lifestyle through retirement" increased from 31% in 1983 to roughly 53% in 2010.[95] Indeed, a wealth of data shows how DC plans have failed to deliver retirement security.[96]

The same problems that afflict DC plans generally will afflict beneficiaries who receive Non-ERISA Lump Sums instead of ERISA Annuities: they will have problems in optimally saving, managing, and spending the lump sum over the course of their lifetimes.[97] Indeed, the de-risking problem is worse. Traditional DC plans, first, are governed by ERISA, which means that the plan sponsor may retain some residual responsibility for providing a sensible menu of investment options for monies contained within the plan.[98] Non-ERISA Lump Sums, in

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[94] *EBRI Databook on Employee Benefits*, *supra* note 93, at 4. In 2011, the number of defined contribution plans outnumbered defined benefit plans fourteen to one. *See* MEDILL, *supra* note 34, at 131.

[95] *See* Benartzi & Thaler, *supra* note 3.

[96] According to a 2014 Employee Benefit Research Institute ("EBRI") retirement confidence survey, about a quarter of Americans are not at all confident in their retirement savings, and an additional 37% are only somewhat confident. *EBRI's 2014 Retirement Confidence Survey: Confidence Rebounds—For Those with Retirement Plans*, EMP. BENEFIT RESEARCH INST. (Mar. 18, 2013), http://www.ebri.org/pdf/surveys/rcs/2014/PR1066.RCS.18Mar14.pdf. Worker retirement savings remains low, according to the survey, and not many Americans are taking even basic steps towards preparing for retirement. *Id.* While many American workers realize that they need to bolster their retirement savings, many have not even tried to estimate the savings that they will need in order to live comfortably during retirement, and only about one in five workers have obtained financial advice to assist in retirement planning. *Id.* However, of those workers who have sought out and obtained financial advice only 27% of those workers admitted to following the advice of the financial planner, while the rest have only followed some or most of the advice. *Id.*

[97] For already retired beneficiaries who receive lump sums, then there will be no "saving" problem, but investment and consumption problems will remain.

[98] *See* 29 U.S.C. 1104(c) (2012). The degree of residual fiduciary responsibility is unsettled. *Compare* DiFelice v. U.S. Airways, Inc., 497 F.3d 410 (4th Cir. 2007) (fiduciaries can be held liable for selecting imprudent menu of investment options) *with* Langbecker v. Elec. Data Sys. Corp., 476 F.3d 299, 310 (5th Cir. 2007) (finding no fiduciary liability for offering an imprudent "menu" of investment options). The Department of Labor has taken the position that fiduciaries remain liable for the selection of investment options in a participant-directed DC plan. *See* 29 C.F.R. §

contrast, can be used imprudently by beneficiaries much more easily. Second, to the extent a de-risked beneficiary is not simultaneously enrolled in the employer's DC plan, the beneficiary loses a key advantage of most workplace plans: default savings.[99]

III. THINKING ABOUT REFORM

A. The Comparative Strength of Regulators

ERISA does not require that employers offer retirement benefits; it merely regulates retirement benefit promises that are made.[100] Because of the voluntary nature of retirement promises, regulators are often faced with a difficult choice: if the legal rules are too protective of beneficiaries or too burdensome to employers, fewer retirement promises will be made in the first place. Thus regulators—even if they have great discretion to act—must generally be quite cognizant of ensuring that promulgating protective rules for beneficiaries will not significantly undermine plan creation.[101]

In the pension de-risking context, however, that pressure barely exists. De-risking applies only to DB promises already made; those promises cannot be abandoned because sponsors believe de-risking rules are too protective of beneficiaries. Nor will strong rules undermine the creation of new DB plans; as we have emphasized, other forces have contributed to the steady decline of such plans.[102] No employer will be deterred from offering a DB plan because of strict

2550.404c-1 (2012) and *Final Regulations Regarding Participant Directed Individual Account Plans*, 57 Fed. Reg. 46906, 46924 n. 27 (Oct. 13, 1992).

[99] *See, e.g.*, Jack VanDerhei, *What Do You Call a Glass That is 60-85% Full?*, Employee Benefit Research Institute (July 7, 2011), https:// ebriorg.wordpress.com/ 2011/07/07/what-do-you-call-a-glass-that-is-60-85-full/ (summarizing research regarding the effect of default saving under the Pension Protection Act).

[100] Regina T. Jefferson, *Increasing Coverage in Today's Retirement System*, 6 DREXEL L. REV. 463, 464 (2014) (noting voluntary nature of retirement promises).

[101] Tucker, *supra* note 29, at 225 ("ERISA's objective of protecting the rights and benefits of plan participants also includes avoiding undue administrative burdens on employers and preserving employers' right to customize plans.").

[102] *See* discussion Part I.D.

rules against de-risking because virtually no employers are offering new DB plans in the first place.[103]

Accordingly, there is little pressure on regulators to balance the objective of "DB plan creation" against the goal of "promulgating rules protecting DB beneficiaries from de-risking." The former will continue to deteriorate irrespective of the latter.

In considering reform, regulators should be guided by a single principle: de-risking should make pension plan beneficiaries no worse off than if the transaction never occurred. That principle, incidentally, is not foreign to pension regulation. For example, in the merger context, ERISA requires that a "pension plan may not merge . . . unless each participant in the plan would (if the plan is then terminated) receive a benefit immediately after the merger . . . which is equal to or greater than the benefit he would have been entitled to receive immediately before the merger."[104] So, at the outset, we propose that the DOL adopt a similar "no worse off" mindset in regulating de-risking transactions.

B. Legal Framework for De-risking

As we explained in Part II, external de-risking processes can be conceived of as either "annuitization" or "lump sum" transactions. In this section we consider the legal rules that govern both forms of external de-risking, and also briefly consider the law governing internal de-risking.

Annuitization. Annuitization refers to a plan transferring its liabilities to an annuity provider; former plan beneficiaries become claimants on the annuity provider.[105] In external annuitizations, the new risk-bearers are the annuity provider and the beneficiaries, to the extent any failure by the annuity provider is not covered by a state guarantee.[106]

[103] *See supra* note 51 and accompanying text.

[104] 29 U.S.C. § 1058 (2012).

[105] Such describes "external" annuitization. *See infra* Part I.C. "Internal" annuitization, in contrast, is when the plan simply uses annuities as a plan asset that will help match plan cash flows to plan benefit liabilities. *See infra* Part I.B.

[106] *See* Newman Testimony, *supra* note 10, at 2, 4.

ERISA itself has long contemplated that terminated DB plans will convert their outstanding liabilities to Non-ERISA Annuities.[107] More recently, annuitization has been used by plan sponsors in non-termination settings. Either way, external annuitization transacts beneficiaries out of ERISA (and the guarantees of the PBGC).[108] Beneficiaries are thereafter protected by state, rather than federal, law.[109]

The legal framework for annuitization is informed by ERISA itself and the judge-made "settlor" doctrine. Regrettably, neither the settlor doctrine's boundaries, nor how de-risking maps onto it, are perfectly clear.

It is well-known that ERISA was inspired by and draws heavily upon the law of trusts.[110] Indeed, ERISA's drafters conceived of ERISA plans as statutory cousins of common-law trusts.[111] A common-law trust is created by a settlor, and trust law contains specific rules respecting the prerogative and judicial treatment of settlors.

Whether ERISA plans—which, unlike most trusts, are not donative—may appropriately be thought of as having a true "settlor" has long been debated by scholars.[112] Nonetheless, the Supreme Court has been persuaded that certain acts by plan sponsors are best conceived

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[107] *See id.* at 2 (discussing how non-ERISA annuity purchases are made when plan terminates).

[108] 29 CFR § 2510.3-3 (2014).

[109] *See supra* note 71 and accompanying text.

[110] *See* Hughes Aircraft Co. v. Jacobson, 525 U.S. 432, 447 (1999) ("[T]rust law may offer a 'starting point' for analysis in some situations") (internal citation omitted); Varity Corp. v. Howe, 516 U.S. 489, 496–97 (1996); Harris Trust and Sav. Bank v. Salomon Smith Barney Inc., 530 U.S. 238, 250 (2000). *See also* Michael J. Collins, *It's Common, But is it Right? The Common Law of Trusts in ERISA Fiduciary Litigation*, 16 LAB. LAW. 391 (2001) ("The common law of trusts served as the basis for ERISA's fiduciary duty provisions, and courts have often applied the common law of trusts in interpreting ERISA's fiduciary rules").

[111] *See* Collins, *supra* note 110, at 395 ("ERISA's legislative history makes clear that Title I is intended to 'apply rules and remedies similar to those under traditional trust law to govern the conduct of fiduciaries'") (quoting H.R. Rep. No. 93-1280, at 295 (1974)).

[112] *See generally* Dana Muir & Norman Stein, *Two Hats, One Head, No Heart: The Anatomy of the ERISA Settlor/Fiduciary Distinction*, 93 N.C. L. REV. 459 (2015) (providing overview of long-running debate over meaning of settlor/fiduciary distinction under ERISA).

of as "settlor" actions akin to those that would have been taken by the "settlor" of a trust. Settlor actions, by command of the Supreme Court, are *not* subject to ERISA's fiduciary duties, although they are subject to explicitly enumerated ERISA requirements.[113] Importantly, a plan amendment is an act that falls within the settlor exception,[114] and annuitizations are done via plan amendment.[115]

While the choice to annuitize is a protected settlor function, *implementing* that choice is not. All ERISA fiduciaries are obligated to follow a plan's terms (unless such terms conflict with ERISA), and are likewise obligated to act with the care a prudent person would display in carrying out those terms.[116] Further, all fiduciaries must act loyally—they must act "solely" for the interests of beneficiaries and for the "exclusive purpose" of providing benefits to participants.[117] Although these duties are explicitly set forth in ERISA, the content of those duties has been defined by both regulation and judicial opinion; agency officials and judges, however, do not always concur.

In 1995, the Department of Labor issued an Interpretative Bulletin explaining that "[t]he selection of an annuity provider for purposes of a pension benefit distribution…is a fiduciary decision governed by the provisions of part 4 of title I of ERISA."[118] Fiduciaries must select the "safest annuity available, unless under the circumstances it would be in the interests of participants and beneficiaries to do otherwise."[119] A

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[113] *See Varity Corp.*, 516 U.S. at 531–32; *Hughes Aircraft Co.*, 525 U.S. at 444; Lockheed Corp. v. Spink, 517 U.S. 882, 890–91 (1996).

[114] *See Hughes Aircraft Co.*, 525 U.S. at 444 (describing how the fiduciary duty requirements under ERISA are not implicated where the plan sponsor made an amendment to the plan); Lockheed Corp., 517 U.S. at 891 (describing how the plan sponsor was acting "not as a fiduciary but as a settlor when it amended the terms of the Plan" to include a specific provision).

[115] *See Private Sector Pension De-Risking and Participant Protections: Hearing Before the ERISA Advisory Council* 2 (June 5, 2013) (statement of Stephen A. Keating, Co-Founder and Principal, Penbridge Advisors, LLC), *available at* http://www.dol.gov/ebsa/pdf/penbridgeadvisors060513.pdf ("[T]he decision to amend a plan to distribute benefits as annuity contracts is a settlor decision, not governed by ERISA's fiduciary obligations and not subject to fiduciary review").

[116] 29 U.S.C. § 1104(a) (2012).

[117] *Id.*

[118] 29 C.F.R. § 2509.95-1(c) (1995).

[119] *Id.*

fiduciary must not solely rely "on ratings provided by insurance rating services;" the entire mix of relevant circumstances need be objectively and thoroughly considered, including such factors as "the quality and diversification of the annuity provider's investment portfolio," "the size of the insurer relative to the proposed contract," and "the availability of additional protection through state guaranty associations and the extent of their guarantees."[120]

At least one federal court of appeals has rejected the Department's view that fiduciaries are presumptively obligated to select the safest annuity available. The Fifth Circuit has held that fiduciaries, in selecting annuities, are simply obligated to follow the exclusive benefit rule, i.e., to select annuity providers "with an eye single to the interests of the participants and beneficiaries."[121] The implication of the Fifth Circuit's view is that fiduciaries need afford less weight to choosing "safe" annuities than the Department of Labor believes is presumptively appropriate.

For its part, Congress was specifically concerned about annuitizations leaving beneficiaries worse off than they were under the plan. In 1994, Congress amended ERISA to provide a special cause of action to police improper behavior in annuitization transactions.[122] Should a fiduciary violate his duties in connection with an annuitization, section 1132(a)(9) specifically provides a federal cause of action to beneficiaries to "assure receipt by the participant or beneficiary of the amounts" promised by the annuity issuer.[123] While the scope of this provision is far from certain, it reveals Congressional intent that beneficiaries "may sue and recover money damages from their employers or other fiduciaries so that they can *at least* receive the amounts that were promised by the insurance contract or annuity, plus reasonable interest."[124]

Lump Sums. As we explained above, lump sum de-risking refers to when the plan offers beneficiaries the right to receive, in lieu of their promised pension annuity, a lump sum that is equivalent to the net

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[120] *Id.*

[121] Bussian v. RJR Nabisco, Inc., 223 F.3d 286, 298 (5th Cir. 2000).

[122] *See* 29 U.S.C. § 1132(a)(9) (2012).

[123] *Id.*

[124] H.R. Rep. 103-872, 41-43 (1994) (emphasis supplied).

present value of their defined benefit.[125] Lump sum de-risking is thus commonly described as a "lump sum buyout."

Lump sum buyouts are limited by both ERISA and the tax rules governing qualified plans.[126] First, the permissible assumptions for converting the pension into a lump sum are regulated to promote actuarially fair conversions.[127] Second, except for small entitlements, a beneficiary cannot be forced to take a lump sum; the beneficiary (and his or her spouse) must consent to receiving his pension in the form of a lump sum.[128] Third, Treasury regulations constrain lump-sum payouts depending on whether the beneficiary is currently receiving benefits.[129] Fourth, lump sum buyouts are only permissible if the plan is funded above a certain level.[130] Fifth, a plan must provide a participant with certain information before a lump sum election can be made.[131] None

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[125] *See supra* Part II.C.

[126] A plan is qualified, and thus entitled to favorable tax treatment, if it complies with the Internal Revenue Code and Treasury regulations. Edward W. Brankley & Frank P. Darr, *Debtor Interests in Pension Plans as Property of the Debtor's Estate*, 28 AM. BUS. L.J. 275, 279 (1990) ("Section 401(a) of the Internal Revenue Code sets forth the rules for qualification of a plan"). Only some plan qualification requirements are also required by ERISA. *Id.*

[127] Internal Revenue Code (I.R.C.) Section 417(e), 26 U.S.C. § 417(e) (2012), regulates the valuation of lump-sum payments. *See, e.g.,* Pension Benefit Guar. Corp. v. Wilson N. Jones Mem'l Hosp., 374 F.3d 362, 367 (5th Cir. 2004) ("§ 417(e) [is] the statute which controls the valuation of lump sum plan benefit payments"); Esden v. Bank of Boston, 229 F.3d 154, 164 n.13 (2d Cir. 2000) (1994 amendments to § 417(e) "added a statutory requirement that the Secretary prescribe an 'applicable mortality table' for converting annuities into lump-sums."); Kiefer v. Ceridian Corp., 976 F. Supp. 829, 833 (D. Minn. 1997) ("Section 417(e) of the Internal Revenue Code governs the interest rates plans can use to calculate lump sum benefits.").

[128] 29 U.S.C. § 1053(c) (2012) (beneficiary consent necessary for present value distribution); 29 U.S.C. § 1053(g)(2) (2012) (spousal consent necessary for 1053(c) distribution).

[129] Treas. Reg. §1.401(a)(9)-6 (2014) (lump-sum buyout prohibited for beneficiaries in pay status unless an exception applies).

[130] *See* 26 U.S.C. § 436(c)(1) (2012).

[131] Treas. Reg. § 1.417(a)(3)–1 (2014). The disclosure requirements are tax regulations promulgated by Treasury that relate to qualified plans, and have no direct counterpart under ERISA. ERISA's fiduciary duties, however, require that administrators make any disclosures that a prudent person in like circumstances would make to beneficiaries. *See* 29 U.S.C. § 1104(a)(1)(B) (2014) (ERISA's fiduciary duty of prudence).

of these regulations squarely address the concerns observers have about beneficiaries making poor choices with regard to choosing a lump sum over the lifetime income stream a pension promises.

Internal de-risking. The legal framework for internal de-risking strategies is largely the same as that governing the investment of plan assets generally: fiduciaries need to observe duties of loyalty, prudence, diversification, and otherwise comply with the plan and ERISA.[132] Unclear, however—and therefore likely to give pause to fiduciaries considering engaging in internal de-risking—is the likelihood of successful suits by plaintiffs unhappy about investment choices fiduciaries make (or do not make) in connection with pursuing internal de-risking strategies. Consider by way of example a fiduciary who chooses to pursue an internal de-risking strategy by purchasing annuities that are held by the plan, e.g., an internal annuitization. The premium associated with purchasing such annuities will be significant. Such a fiduciary might face claims from plaintiffs alleging that such a purchase violated, among other things, the fiduciary's duty of prudence (by paying too high a price for the annuities, which are plan investments).[133]

C. Proposals

Regulators are not unconstrained. Both statutory language and existing regulations cabin, formally or practically, what reform-minded regulators may plausibly accomplish. There is, nonetheless, room for regulators to act. We offer four suggestions below.

1. Promote Internal De-risking

As we have emphasized, there are significant differences between "internal" and "external" de-risking. Internal de-risking is far less worrisome, because it can accomplish the goal of reducing a sponsor's pension risk without undermining promise performance or the delivery of retirement security to beneficiaries. Where possible, then, regulators should promote internal de-risking strategies.

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[132] 29 U.S.C. § 1104(a)(1)(A)-(D) (2012).

[133] *See, e.g.,* Bussian v. RJR Nabisco, Inc., 223 F.3d 286, 299 (5th Cir. 2000) (finding that under these circumstances, "the only open course of action may be to appoint an independent fiduciary.").

When thinking how to incent plan sponsors to try internal strategies, a "safe harbor" approach might make the most sense.[134] Although the law governing internal de-risking is generally settled, see Part I.B., how it applies to particular de-risking choices is not. Fiduciaries uncertain about the permissibility of otherwise desirable internal de-risking strategies may instead choose to engage in otherwise undesirable external de-risking. One uncontroversial way to promote internal de-risking is to reduce litigation uncertainty associated with pursuing internal strategies. Accordingly, we suggest that if plans looking to de-risk were to pursue "internal" approaches that satisfy publically available DOL guidelines, the Secretary should not pursue civil litigation against them, and oppose private plaintiffs who do.[135] Alternatively, the DOL could urge Congress to amend ERISA to create a statutory safe harbor for particular internal de-risking approaches, like for appropriate LDI or hedging strategies.

Although we believe safe harbors (or other regulatory encouragement) for internal de-risking is an appealing reform, we do not want to overstate the case. Candidly, it is wishful thinking to believe that encouraging internal de-risking alone will curb external de-risking. The temptation to externally de-risk is high; only external de-risks offload the pension obligation from the company's books for good.[136] Because external de-risks will occur regardless of the regulatory inducements to internally de-risk, serious reform must also directly regulate external de-risking strategies.

2. Procedural Safeguards for Annuitization

A primary concern with annuitization is that the participants holding Non-ERISA Annuities are less likely to receive the pension amounts they worked their lives to obtain.[137] More rigorous regulation of the annuitization process, however, could substantially reduce the risk that the resulting Non-ERISA Annuity will be under-performing.

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[134] *See* Council De-Risking Report, *supra* note 30, at 25 (referring to a safe harbor proposal advanced by Professor Maher).

[135] *See* Maher Testimony, *supra* note 22, at 6.

[136] *See* Council De-Risking Report, *supra* note 30, at 13 (observing that only external de-risking "permanently discharg[es] the employer's obligations").

[137] *See* discussion *supra* Part II.B.

Current DOL regulations on selecting the annuity provider require the fiduciary implementing an annuitization strategy to select the "safest possible annuity" unless the interests of the beneficiaries would be served by not doing so.[138] Although fiduciaries are charged by ERISA to act solely in the interest of beneficiaries, the reality is otherwise. It has long been recognized that many ERISA fiduciaries are in practice conflicted, because they are employed, controlled, or beholden to the plan sponsor.[139] In the de-risking setting, the conflict is particularly acute, because plan assets above those needed to purchase an annuity that covers obligations to beneficiaries revert to the plan sponsor. The temptation is for the fiduciary to select an annuity that facially guarantees the proper amount of benefits to retirees but saves the plan money by being more risky. Fiduciaries are also unlikely to competently scrutinize the health and applicability of the relevant state insurance guarantee fund, which is the backstop should the annuity provider fail. As the Great Recession taught us, even sophisticated players are inclined to inappropriately plan for catastrophic default when it is in their interest to do otherwise.

Problems with fiduciary decision-making can be reduced by the use of procedural safeguards.[140] First, annuitizations should be subject to a bidding process in which at least three annuity providers are invited to submit proposals. Second, plan fiduciaries should be obligated to retain independent state experts to prepare a written report on the fitness of the individual state guarantee funds that back each bidder. Third, once a winning bid has been chosen, an enrolled actuary should certify that the annuity chosen by the plan is—as compared to the annuity offered in the other bids and those available in the market generally—the "most

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[138] *See* DOL Interpretive Bulletin 95-1, 29 C.F.R. § 2509.95-1 (1995).

[139] *See* Beverly Cohen, *Divided Loyalties: How the Metlife v. Glenn Standard Discounts ERISA Fiduciaries' Conflicts of Interest*, 2009 UTAH L. REV. 955, 974 (2009) ("[V]irtually all ERISA plan benefit claims are decided by fiduciaries that are conflicted to some extent (including employers, third-party administrators, and insurance companies providing the coverage)…"); Metropolitan Life Ins. Co. v. Glenn, 554 U.S. 105, 120 (2008) (discussing how there is a conflict of interest in most ERISA cases).

[140] Because the selection of an annuity provider is a fiduciary function (as opposed to a settlor function) the DOL has considerable freedom to promulgate regulations. *See supra* Part III.B.

protective annuity."[141] If the enrolled actuary is unable to so certify, then the plan should spell out in writing and make available to participants why, given these circumstances, it did not choose the "most protective annuity." DOL regulations should provide that, absent unusual circumstances, compliance with these steps are the minimum requirements of a fiduciary's discharge of its duties of loyalty and prudence.

3. Disclosure Safeguards for Lump Sums

Although the law currently requires that lump sum offers to beneficiaries be actuarially equivalent to the promised ERISA Annuity, it does not require that the two forms of benefit be *practically* equivalent. Beneficiaries should be informed of the latter.

First, while in theory a lump sum can be invested and drawn down periodically in such a way as to mimic an annuity, for a lump sum distribution to replicate what an ERISA Annuity provides, the lump sum would have to be worth *more* than the net present value of the ERISA Annuity. Benefits are merely foregone wages, and a retiring worker entitled to an ERISA Annuity of $X per year has given up sufficient wages to pay for both (1) the right to receive $X until death *and* (2) the investment services of the plan to manage the assets underlying that promise. The latter is not costless, and converting an ERISA Annuity into a lump sum immediately deprives the beneficiary of the value of those already-paid-for investment services—services that she will have to replace using her own resources. Beneficiaries should be advised accordingly.

Second, beneficiaries should be advised of the dangers of investment and longevity risk. Individual money management is costly and risky, and poor management could leave a beneficiary without sufficient income in late old age. Clear, plain-English examples of longevity risk should be required to be provided to all beneficiaries presented with a lump sum option. Beneficiaries should also specifically be informed that—because of the modest adverse selection that afflicts annuity markets—they might not be able to use their lump sum to later purchase an annuity on as favorable terms as they can get

[141] We suggest "most protective" rather than "safest" because in our view the former phrasing is more explicitly focused on ensuring that beneficiaries who are subject to the annuitization (as well as beneficiaries who remain in the plan) are not being harmed.

from the plan.[142] In addition, although lump-sum elections require spousal consent,[143] lump sum disclosures should make clear that the investment and longevity risks facing the retiree apply with additional force to the retiree's spouse.

Because lump sums must be consented to by beneficiaries to be permissible, at the time of the election the beneficiary is still owed fiduciary duties of loyalty and prudence by the plan. The above disclosures should constitute the minimum necessary to satisfy such duties, and be so codified by the Department of Labor. Tax regulations, which already provide for some disclosures—including disclosing the "financial effect" of electing an optional form of benefit—should be likewise updated.[144]

4. Restricting Lump Sum Distributions to Retirees

Although improved disclosure is likely to reduce the number of lump sum elections, there is reason to fear that improved disclosures will be insufficient to prevent lump sum elections that hurt beneficiaries. Because people generally overestimate their ability to invest wisely and overly discount their future needs, the temptation to irrationally favor the present (and thus a lump sum) is strong.[145] And other individual factors might exacerbate the difficulty of making an optimal choice—beneficiaries making these choices could be operating at diminished capacity, for example.[146] Nonetheless, however high the

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[142] *Cf.* Martin Feldstein, *Rethinking Social Insurance* 8 (Nat'l Bureau of Econ. Research, Working Paper No. 11250, 2005), *available at* www.nber.org/papers/w11250 (examining adverse selection in annuity markets).

[143] 29 U.S.C. § 1053(g)(2) (2012).

[144] 26 C.F.R. § 1.417(a)(3)-1(c)(1)(iii) (2014) requires disclosure of the "financial effect" of electing an optional form of benefit, including a lump sum. Those regulations, however, are too narrow. They arguably limit "financial effect" to mean "the amounts and timing of payments to the participant under the form of benefit during the participant's lifetime, and the amounts and timing of payments after the death of the participant." More information than that is needed to make a lump sum disclosure meaningful.

[145] *See supra* notes 86–87 and accompanying text.

[146] *See* Council De-Risking Report, *supra* note 30, at 21 (maintaining that allowing seniors with diminished capacity amounts to "corporate elder abuse"). Stein "testified that, everyone besides those who are terminally ill, or almost everyone else who

likelihood that choosing a lump sum could for many beneficiaries be the "wrong" choice, political opposition to restricting choice by regulation will likely be strong.

There is good reason to believe, however, that ERISA and the IRC contemplate, if not require, government action to head off poor choices. ERISA itself requires that a lump sum occur as the result of the "consent" of the participant.[147] Professor Norman Stein has suggested that "consent" implies more than simply a choice made after being presented with technically adequate disclosures; it implies a choice made only where the beneficiary actually understands the meaning and consequences of the options.[148] Thus, in circumstances where the DOL has reason to believe the average plan participant is unlikely to truly understand the meaning of lump sum disclosures, it could and should promulgate regulations that limit or even prohibit lump sum buyouts absent some indication that "meaningful understanding" preceded the decision.[149] One possibility for doing so is "performance-based" regulation, in which the governing regulation requires that the

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selects a lump sum, will be forfeiting a substantial portion of their retirement savings." *Id.*

[147] 29 U.S.C. 1053(e) (2014) ("consent" required for lump-sum distributions over $5000). *See also* 29 U.S.C. 1055(g) (2014) ("consent in writing" required for 1053(e) election).

[148] *See generally* Norman P. Stein, *Pension Plan Derisking: Is It Bad, Is It Legal, Can It Be Stopped, Slowed or Moderated?* (working paper on file with authors).

[149] In a development with which we disagree, the IRS has issued a number of Private Letter Rulings (PLRs) over the last few years which allow retirees in paid status to accept lump sums as long as they are consistent with minimum distribution requirements under 26 U.S.C. § 401(a)(9) (2012). In PLR Numbers 201422028, 201422029, 201422030 and 201422031), the IRS held that in certain circumstances the payment of lump sums to retirees currently receiving annuities did not violate the minimum distribution rules. This is because "the ability to select a lump sum will only be available during a limited window, [and] the increased benefit payments will result from the proposed plan amendment and, as such, are a permitted benefit increase under [the regulation]." *Id.* at PLR 201422028, at 6, *available at* www.irs.gov/pub/irs-wd/1422028.pdf. Although PLRs only apply to the particular parties that ask for the IRS' guidance, *id.* at 7 ("This letter is directed only to the taxpayer who requested it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent."), we believe these rulings are unwelcome and could give Plans additional incentive to provide lump sum buyout to retirees who may be unable to appreciate the true consequences of their decisions.

company's disclosures lead to a specified level of consumer comprehension.[150]

A related approach would be to adopt a suitability or "know your customer rule" that the Securities & Exchange Commission, for example, used to employ for broker-customer relationships. Although now rescinded, that suitability rule required:

> Every nonmember broker or dealer and every associated person who recommends to a customer the purchase, sale or exchange of any security shall have reasonable grounds to believe that the recommendation is not unsuitable for such customer on the basis of information furnished by such customer after reasonable inquiry concerning the customer's investment objectives, financial situation and needs, and any other information known by such broker or dealer or associated person.[151]

The DOL could establish by regulation that plan fiduciaries consider whether a lump sum is not suitable for retirees in paid status because of that person's "investment objectives, financial situation and needs, and any other information known" to the broker.[152] The fiduciary would not need to be prescient in such matters; only make a reasonable inquiry before offering the lump sum to the retiree. Such a rule would help many retirees avoid making a monumental mistake with their retirement savings.

CONCLUSION

Because previously-promised DB pensions have been an expensive and uncertain proposition for many employers, it is not surprising that they have responded by seeking to offload their pension obligations to

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[150] *See generally* Lauren Willis, *Performance-Based Consumer Law*, 82 U. CHI. L. REV. (forthcoming 2015), *available at* http://ssrn.com/abstract=2485667 (describing the utility of "performance-based" regulation).

[151] 17 U.S.C. § 240.15b10–3 (titled "Suitability of recommendations") (rescinded 1983).

[152] *See* Biagenek v. Wilson, 642 F. Supp. 768, 772 (N.D. Ill. 1986) (SEC suitability standard "provided a basis for relief against certain broker dealers who made trades not reasonably suited to the customer's financial objectives.").

insurance companies or individuals. That such employer maneuvering is understandable, however, does not mean it advances the social goal of retirement security. To the contrary: it undermines it.

Sensible regulation of pension de-risking can substantially reduce its dangers. A modest step that we propose is to incent employers to undertake internal de-risking strategies. Internal de-risking is preferable because it preserves ERISA's protections and PBGC termination insurance (which protects pension plan participants in case the plan fails).

Encouraging internal de-risking, however, will likely be insufficient. External de-risking will still occur, and additional regulatory steps will be needed to meet that challenge—of which we suggest three here. First, annuitizations should be regulated so as to increase the likelihood that the private annuity that replaces the beneficiary's pension is equally likely to be paid. Second, lump sum elections should be accompanied by meaningful disclosures that effectively inform the beneficiary of the consequences of choosing cash today over a lifetime of income. Third, regulators should be aggressive in construing the language of ERISA to limit lump sum buyouts where there is reason to believe the beneficiary does not understand the consequences of trading a pension for cash. These steps will significantly reduce the chance that external pension de-risking will imperil the retirement security of millions of elderly workers and retirees.