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Structuring ERISA-Compliant Retirement Buyouts

Navigating Design Considerations, Funding Options and Qualification Rules for Defined Benefit Plans

THURSDAY, OCTOBER 9, 2014

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

Today's faculty features:

Michael Collins, Partner, **Gibson Dunn & Crutcher**, Washington, D.C.

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Structuring ERISA-Compliant Retirement Buyouts

Navigating Design Considerations, Funding Options and Qualification Rules for Defined Benefit Plans

Michael J. Collins | mcollins@gibsondunn.com

Defined Benefit Plan “De-Risking”
Alternatives

What is Driving the Concern with Pension Liabilities?

- Changes in accounting rules
- New mortality table (potential large increase in plan liabilities)
  - Probably not effective until at least 2016 for plan funding/lump sums though (this is one factor driving lump sum alternative, TBD)
- Pension Protection Act funding rules
- Volatile financial markets
- Access to capital/strong balance sheets
  - “Fund up” the plan while the going is good
- Higher PBGC premiums (Pension Protection Act)

What are the "Risks" with DB Plans?

- Interest rate risk
- Investment risk
- Longevity risk
- Inflation risk
- Legal (funding) and accounting risk

Potential Risk Strategies

- Asset/Investment-Based:
  - Liability-driven investments (risk mitigation)
  - Increase contributions above ERISA minimum (risk mitigation)
  - Purchasing annuity contracts as plan investment (risk mitigation)
- Liability-Based:
  - Plan freeze (risk mitigation)
  - Lump sum distribution “windows” (risk transfer)
  - Transfer obligations to insurance company (risk transfer)
  - Plan termination (risk transfer)

Liability-Driven Investments

- Attempts to match duration of investments with liabilities
- Hedging plays a major role
- DOL Advisory Opinion 2006-08A made clear that "nothing in ERISA limits a [fiduciary's] ability to take into account the risks associated with benefits liabilities."
- ERISA fiduciary standards apply to investment choices
- Like other asset/investment-based strategies, no positive impact on PBGC premiums

Increased Funding

- Increase contributions above ERISA minimum
  - Balance sheet and future ERISA funding benefits
- Often done by borrowing since that can be done cheaply
  - Interest rates substantially below projected returns on plan assets
  - Prominent example is Ford in the mid-2000s
- Can backfire: UPS/Central States analogy
- Like other asset/investment-based strategies, no positive impact on PBGC premiums

Purchasing Annuity Contract as Plan Investment

- In consultation with plan investment advisor, make an annuity contract a large plan investment
  - Low-risk: Backed by state insurance funds
  - Can match liabilities better than most other investments
- Serves as a good hedge to avoid funding fluctuations (the contract generally cannot lose value)
- Like other asset/investment-based strategies, no positive impact on PBGC premiums

Plan Freeze

- Two types:
  - “Soft freeze” – no new participants
  - “Hard freeze” – no new accruals
- A recent Aon study estimated that 1/3 of DB plans have been “hard frozen”
- Benefit is that liabilities do not increase directly (although they can increase due to discount rate fluctuations, changes to mortality table, etc.)
- Still have potential funding fluctuations, although they are mitigated somewhat by not adding new liabilities going forward
- No positive impact on PBGC premiums with respect to remaining participants (although they will decline over time as the “frozen” group passes on)

Insurance Company takes over Liabilities

- Under this alternative, an insurance company takes the responsibility to pay the benefits of some (but not all) participants
  - All liabilities are transferred for this group, along with an agreed-to amount of assets
  - They are no longer participants in the plan, so decreased funding volatility/PBGC premiums
  - ERISA fiduciary requirements for selecting carrier
    - See Interpretive Bulletin 95-1
    - Executive Life example from early 1990s
  - Key benefit – no participant consent/action required
  - Some costs:
    - Pricing may be prohibitive (additional contributions)
    - Potential impact on funding of retained part of the plan
    - Settlement accounting
  - Verizon and GM have done recently (2012) - $30-$40 billion total
    - Verizon was sued
    - GM’s was in conjunction with its lump sum program TBD

Plan Termination

- All liabilities are eliminated in a standard termination
  - Through purchase of annuity contract(s) and, possibly, lump sum offers (anyone declining offer has benefits assumed by insurance company)
- Some procedural hoops (PBGC notices, etc.)
- Fiduciary issues with selection of insurance carrier
- No more balance sheet/funding exposure
- Can be prohibitively expensive

The Lump Sum Approach

Who has used this approach?

- Ford
- GM
- NCR
- New York Times
- Sears
- Visteon
- ADM
- J.C. Penney
- Many others

Who will be offered the opportunity?

- Approach may make sense for plans that do not currently offer lump sums (or did not when participants retired)
- Totally voluntary (no ability to "force out" lump sums)
- Possibilities include
  - Deferred vested only [Most common]
  - Deferred vested and retirees
  - Deferred vested, retirees, and alternate payees/survivors
- Need to estimate expected "take rate" – one reason to consider multiple "windows"
  - Varies by plan – estimate is typically in the 30%-50% range

Legal Concerns?

- Tax Code:
  - First offerings for participants in pay status were in 2012 – Ford & GM
    - IRS issued PLRs
    - Main concern was Code section 401(a)(9) "nonincreasing annuity" requirement for participants in pay status
      - IRS concluded that lump sum was a benefit "increase" so exception available
  - No new PLRs until earlier this year; IRS apparently was reconsidering the issues in light of concerns expressed by AARP and others
    - Several new PLRs issued in 2014, suggesting IRS is comfortable with approach
  - Inclusion of early retirement subsidies in lump sum calculation – controversial issue
    - Consider ERISA fiduciary concerns
  - Code section 415 – rerun at new annuity starting date
- Title I of ERISA
  - ERISA Advisory Council considered in 2013 and recommended participant protections
  - Offering lump sums is a settlor function; implementation is a fiduciary function

Why Popular Now?

- PPA interest rate (Code section 417(e) change)
- Forthcoming mortality table (likely effective 2016 for lump sums)
- Cheap money from financial markets
- General concern with impact on financial results

Key Design Considerations

- Who is eligible?
  - For most, deferred vested participants only
- Cap on lump sum (e.g., $50,000)?
  - Most appear to have not had caps
- Permanent program or window?
  - Most have had one or more windows
- Post-window funded status of plan
  - "AFTAP" funding level cannot fall below 80% as a result
- Nondiscrimination testing issues
  - IRS rules and "traditional" (ADEA, etc.) concerns
- CBA issues

Implementation Considerations

- Calculating the lump sum
  - Code section 417(e) (corporate bond rates fully phased in 2012; forthcoming mortality tables will make more expensive)
- ERISA disclosure requirements
  - Relative value, spousal consent, etc.
    - “New” QJSA must be offered in conjunction with lump sum
    - Spousal consent for both spouse at original annuity starting date and new one, as applicable
    - Tax disclosures too – potential 10% penalty if younger than 59-1/2
- Quality of data
  - Bad quality data can preclude effective implementation and/or lead to lawsuits
  - May be especially problematic with lots of merged plans
- Communication Process – informed choices by participants (fiduciary duty concerns)
- Ability to roll over (except for portion that is MRD)
- Huge resource commitment! Consider use of TPAs
- Settlement accounting –in general only if total lump sums for year exceed sum of service cost and interest cost for the plan
  - More likely to be an issue for frozen plans

Potential Lawsuits

- Fiduciary breach/disclosures
- Disputes over timing of submissions (i.e., whether they were within window)
  - Should have clear rules on when an application is deemed complete
  - Especially likely if participant died before application deemed complete
- Errors in communications to participants
  - Simple mistakes in calculations
  - Incorrectly including QDROs
- Plan language/communications unclear

What About Active Participants?

- Although not legally required, it is common to add a lump sum distribution feature for all active participants
- There is no immediate liability reduction, but it may cause morale problems if actives do not have the same lump-sum right as retirees and deferred vested participants
- Consider impact of new mortality tables

Impact on the Remaining Plan

- Funding requirements
  - Needs to be very carefully evaluated by the plan actuary
- Duration of liabilities
  - Likely will decrease; may impact asset allocation going forward
- Lower plan expenses in the medium-term and long-term
  - May have lower asset management fees (lower assets) and plan administration fees
  - PBGC premiums
    - Both because fewer participants and, perhaps, because lower unfunded vested benefits

Sample 10-K Disclosure (ADM)

- From ADM's most recent Form 10-K:
  - In September 2012, the Company amended its U.S. qualified pension plans and began notifying certain former employees of its offer to pay those employees' pension benefit in a lump sum. This lump sum payment offer expired in December 2012. Former employees eligible for the voluntary lump sum payment option were generally those who were vested traditional formula participants of the U.S. qualified pension plans who terminated employments prior to August 1, 2012 and who had not started receiving monthly payments of their pension benefits. The voluntary lump sum payments which amounted to $134 million reduced the Company's global projected benefit obligations by $174 million, resulting in a net improvement of its pension underfunding by $40 million. The Company incurred a non-cash pre-tax charge of $53 million as a result of the requirement to expense the unrealized actuarial losses recognized in accumulated other comprehensive income (loss) pertaining to the liabilities settled at December 31, 2012.

Early Retirement Incentives

Early Retirement Windows

- A well-funded corporate pension plan can be used to offer early retirement “windows” as part of workforce reduction programs
- Typically includes enhanced benefits (e.g., early retirement subsidy)
  - Can also include additional credited service
- May include a lump sum alternative that is not generally available

Early Retirement Windows

- Generally ok to require a waiver of claims against the plan sponsor (“incidental” benefit that does not violate exclusive benefit rule)
- IRS nondiscrimination rules need to be considered – offered to nondiscriminatory group
- ADEA and other laws need to be considered as well
- Could also include retiree medical benefits offered through pension plan 401(h) account/420 transfer
  - This is somewhat inconsistent with pension “de-risking”, of course
- One big issue with any early retirement window is when it is under “serious consideration”; at that point, at a minimum, employers cannot lie to employees who ask whether a window program may be offered
- Need to be careful about frequent windows – may be deemed a permanent amendment to the plan protected by the anti-cutback rule

Early Retirement Incentives – Without Use of Qualified Plans

- These typically involve payments of lump sums from corporate assets, with no special enhancement of pension benefits
- May include retiree medical benefits
  - The law on when retiree medical benefits are protected from future cuts is extremely complex and varies by U.S. circuit court of appeals
- ADEA/OWBPA is the key legal issue with these programs

Use of Nonqualified Plans

Nonqualified Plans/Early Retirement Incentives

- It is permissible to offer enhanced benefits under nonqualified plans to incentivize early retirement.
  - For example, could increase benefit accruals
- However:
  - Section 409A of the Code generally would prohibit changing payment form (e.g., from an annuity to a lump sum) with respect to prior accruals
  - In order to avoid coverage under Title I of ERISA (e.g., funding requirements), the plan must be limited to a “top-hat” group
    - That means that, in general, only top management participates, which makes it a less-than-ideal vehicle for early retirement incentives

Nonqualified Plans/Derisking

- Because of Section 409A of the Code and Title I of ERISA, the options to "de-risk" nonqualified plans are much more limited than with qualified plans
  - Generally can't change distribution timing; one exception is plan termination
    - Distributions paid out 1-2 years after action terminating plan is taken; no new plan of the same type for 3 years; not taken in connection with a financial downturn for the plan sponsor
  - Can hedge risk by having the plan sponsor purchase appropriate investments, and hold them either directly or through a "rabbi" trust

Conclusion

- There are many opportunities to de-risk retirement plans and to provide retirement incentives to employees
- They raise a number of legal issues, but most can be overcome with good legal guidance
- The practical issues generally are more important; in particular, the impact on the company going forward
  - Not inconceivable that there will be additional regulation (likely disclosure requirements) in light of ERISA Advisory Council recommendations