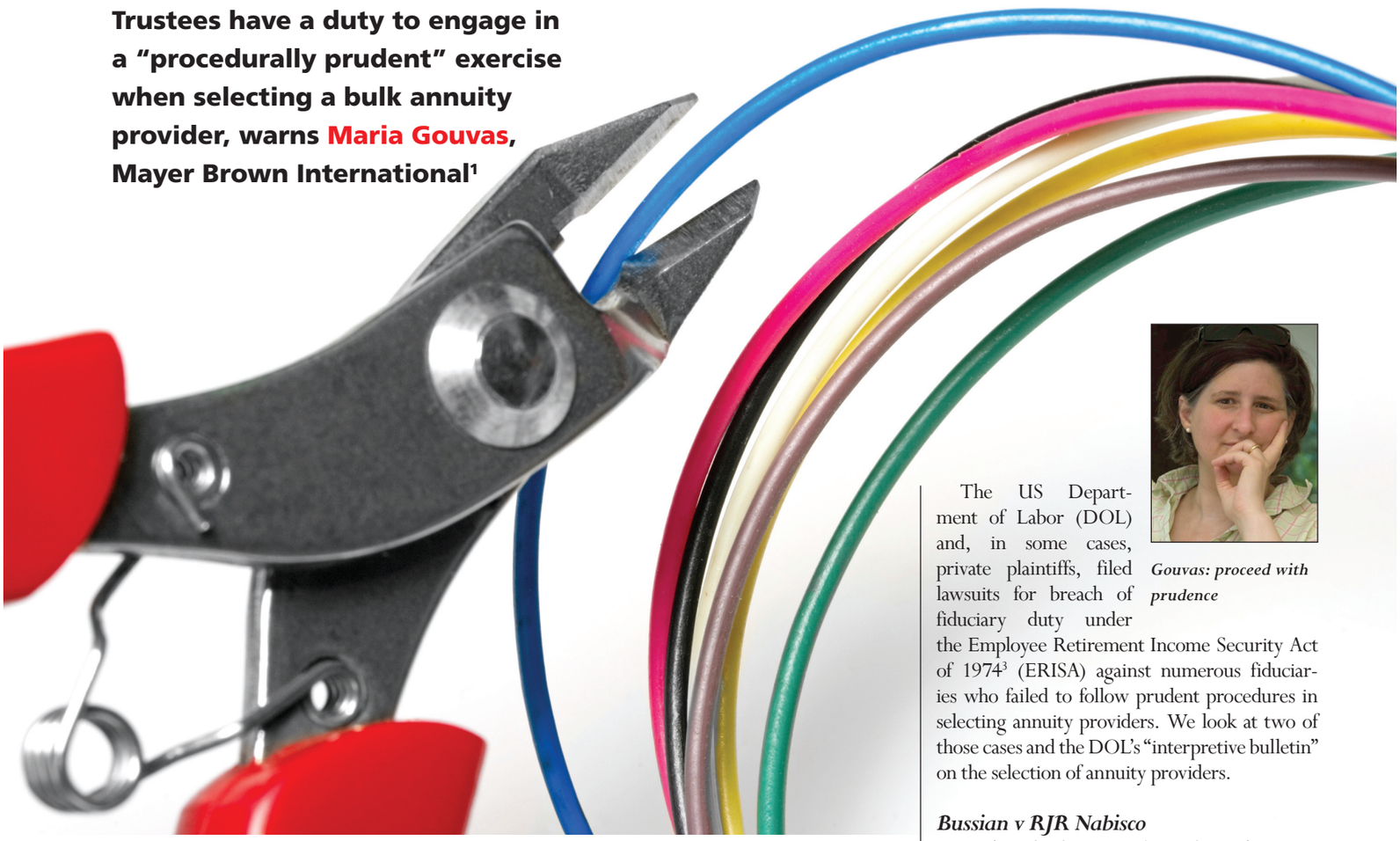
Choose with care

Trustees have a duty to engage in a "procedurally prudent" exercise when selecting a bulk annuity provider, warns Maria Gouvas, Mayer Brown International[1]



Gouvas: proceed with prudence

While the credit crunch and marketplace consolidation appear to have driven some of the new bulk annuity providers out of the market, UK trustees and sponsors have greater choice than ever in choosing a provider.

With wider choice comes the burden of choosing from among the providers. UK trustees and sponsors can take some comfort from the UK regulatory regime, the fact that bulk annuity providers must be licensed EU insurers and must satisfy Financial Services Authority regulations, and the Financial Services Compensation Scheme's (untested) "safety net", potentially available to bought out pension scheme members holding annuities in an insolvent insurer.

But trustees should not take comfort in the UK's insurance regulatory regime alone. In the early 1990s, trustees and sponsors of US pension plans learned that insurance regulation alone is no guarantee that a bulk annuity is "safe"[2]. In April 1991, Executive Life of California (ELIC) and Executive Life of New York (ELNY), First Executive subsidiaries, ceased paying the pension benefits that plan sponsors secured through those insurers.

Breach of duty

In the late 1980s several well known US companies terminated the pension plans they sponsored, taking a refund of surplus and purchasing bulk annuities for the plans' members through First Executive. First Executive, as the public would learn later, was heavily invested in high-yield junk bonds and both ELIC and ELNY were under investigation by their respective state insurance departments.

The US Department of Labor (DOL) and, in some cases, private plaintiffs, filed lawsuits for breach of fiduciary duty under the Employee Retirement Income Security Act of 1974[3] (ERISA) against numerous fiduciaries who failed to follow prudent procedures in selecting annuity providers. We look at two of those cases and the DOL's "interpretive bulletin" on the selection of annuity providers.

Bussian v RJR Nabisco

Bussian[4] involved a sponsor's purchase of an ELIC annuity. The decision examined the sponsor's and the benefit consultant's conduct.

The consultant's selection process consisted of two steps. First, he compiled a list of providers with whom he was generally familiar, that had a reputation for good service and capacity for the placement. He did not include ELIC because he believed that its junk bond portfolio was significantly higher than its competitors. The sponsor asked him to add ELIC, arguing that if the other bidders saw it on the list, they would submit lower bids.

The consultant evaluated ELIC's solvency by reviewing the ratings agencies' reports. In April 1987 he solicited bids from 14 providers, including ELIC. Five providers (including ELIC) submitted bids and ELIC submitted the lowest bid. The sponsor selected ELIC, it claimed, because ELIC had a AAA

S&P rating, the administrative capacity, and the consultant's approval. The sponsor accepted ELIC's contract in December 1989. In April 1991, regulators placed ELIC in conservatorship and policyholders received reduced benefits.

In the ensuing litigation, the sponsor prevailed at the district court, but the appellate court reversed and remanded the case to the district court to determine whether the sponsor had violated ERISA. In the appellate court's view, the consultant's investigation was defective because: his financial analysis was limited to reviewing the rating agencies' reports; he spent more time negotiating to lower the bids than evaluating the bidders; he failed to review ELIC's financial statements, reports and disclosures; and he was unaware that regulators were investigating ELIC's reinsurance practices or that they had capped or were considering capping insurers' junk bond portfolios.

The sponsor's conduct failed because ERISA fiduciaries cannot use an independent report like a "magic wand" to wave over a transaction to fulfil their responsibilities. The sponsor should have scrutinised the consultant's reports and questioned his "analysis" of the providers' financial safety.

Riley v Murdock

The court reached a different result in *Riley v Murdock*[5]. In *Riley,* the fiduciary engaged in a "procedurally prudent" process[6]. The sponsor established a committee that engaged in an extensive independent investigation. It retained a law firm and investigated each bidder.

While ELIC ended up in the same place (insolvent and unable to pay the benefits due) in both cases, the *Murdock* defendants prevailed because they engaged in a procedurally prudent investigation. This is at the heart of ERISA's fiduciary standard. The test is not one of "hindsight". Events occurring after a decision is made will not "render a decision imprudent". The issue is whether the "fiduciary's decision was reasonable at the time it was made".

IB 95-1

The DOL learned the lesson from the ELIC litigation and issued an interpretive bulletin to guide fiduciaries in selecting an annuity provider.

1) IB 95-1's application Interpretive Bulletin 95-1 (IB 95-1) applies to annuities purchased with the intention to transfer liability for the provision of benefits to the insurer[7]. The selection of a provider and the purchase of an annuity are fiduciary acts that must comply with ERISA.

2) Prudence under IB 95-1 Prudence requires, at a minimum, that "plan fiduciaries conduct an objective, thorough and analytical search for the purpose of identifying and selecting providers from which to purchase annuities".

3) Factors to consider in choosing a provider A fiduciary should evaluate the potential provider's "claims paying ability and credit worthiness". The fiduciary cannot satisfy the prudence requirement by relying upon rating services alone. It should consider:

- the quality and diversification of the provider's investment portfolio
- the insurer's size relative to the contract
- the insurer's capital and surplus
- the provider's business lines and other indications of its exposure to liability
- the structure of the annuity contract and guarantees supporting the annuities, such as the use of separate accounts
- the availability of additional protection through state guaranty associations and the extent of their guarantees.

4) Use of an independent expert The fiduciary should obtain advice from a "qualified, independent expert" if it does not have the requisite knowledge.

5) Is it always in the members' interest to purchase the "safest available annuity"? IB 95-1 identifies limited situations where it may not be in the members' interest to purchase the "safest available" annuity[8]. This could be where the safest available annuity is only "marginally safer" but "disproportionately" more expensive; where the members are likely to receive a "substantial share of the cost savings"; or where the provider lacks administrative capability.

6) Limitations on sponsor choices A fiduciary would violate his duties under ERISA to act "solely in the interest of the participants and beneficiaries" if he chose to purchase a riskier, lower priced annuity to maximise the sponsor's reversion of surplus in an overfunded plan.

7) Additional employer contributions may be necessary A fiduciary may not purchase a riskier annuity solely because there are insufficient assets to purchase a safer annuity. Here, the fiduciary may have to "condition the purchase of an annuity on additional employer contributions sufficient to purchase the safest available annuity".

"Insurance regulation alone is no guarantee that a bulk annuity is 'safe' "

Spectacular collapse

The US experience demonstrates that where fiduciaries fail to engage in proper due diligence, they do so at their peril and that of the scheme's members. Given the similar standard of care required of a UK trustee and a US fiduciary, IB 95-1 is a sensible model for UK trustees and sponsors. PW

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Notes

1 The author is grateful to Mayer Brown International partners Anna Rogers (London) and Maureen Gorman (Palo Alto) for their comments.

2 US insurance companies operate according to laws set in each state and each state sponsors a guaranty regime.

3 ERISA governs private pensions in the US and was one of the models Professor Goode considered when he made the recommendations outlined in *Pension Law Reform: The Report of the Pension Law Review Committee* which eventually led to the (UK) Pensions Act 1995.

4 21 F. Supp. 2d 680 (S.D. Tex 1998), rev'd in part, vacated in part, 223 F.3d 286 (5th Cir 2000).

5 890 F. Supp. 444 (EDNC 1995), aff'd 1996 US App. LEXIS 9964 (4th Cir. Apr 30, 1996) (unpublished).

6 The phrase "procedural prudence" grew out of case law interpreting ERISA's standard of care. Section 404(a)(1)(B) of ERISA.

7 IB 95-1 applies to DB schemes. The DOL issued separate guidance for DC schemes.

8 More than one annuity provider may satisfy the safest available annuity test.

In a nutshell

- UK trustees and sponsors have greater choice than ever in bulk annuity providers
- but they should not take comfort in the UK's insurance regulatory regime alone
- US experience demonstrates the necessity of conducting a procedurally prudent investigation.