Recent Trends In Pension Buyouts And Lump Sum Offers

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Several sponsors of defined benefit plans, also known as pension plans, have taken steps to reduce the size of their pension liabilities since 2012. First, several plan sponsors have executed pension “buyouts” involving the purchase by a defined benefit plan of a group annuity from a life insurer for certain plan participants. The group annuity effectively replaces the plan’s obligation to pay benefits to specified plan participants. Second, increasingly sponsors have offered participants lump sums of cash in satisfaction of lifetime benefits.

After some members of Congress inquired whether the process by which lump sum offers were being effected provided adequate information to offerees, the U.S. Government Accountability Office recently weighed in on this subject. The GAO report[1] sets out recommendations to the U.S. Department of Labor, U.S. Department of the Treasury, Pension Benefit Guaranty Corporation and pension plans with respect to the information defined benefit plan participants should receive when deciding whether to accept lump sums.

This article will highlight salient deal points of two recent jumbo pension buyouts involving Kimberly-Clark Corp. and Motorola Solutions Inc.,[2] and review recent developments with respect to lump sum offers.

Pension Buyouts

The jumbo pension buyout deals that have been announced since 2012 include the following:
The most recent jumbo transaction was announced by Kimberly-Clark on Feb. 23, 2015: a $2.5 billion pension buyout involving 21,000 plan participants.[3] As indicated in Kimberly-Clark’s press release, for the first time in a jumbo pension buyout, two insurers will provide the group annuity: The Prudential Insurance Company of America and Massachusetts Mutual Life Insurance Company. In jumbo deals, an independent fiduciary is relied on to determine the “safest available annuity.”[4] In the Kimberly-Clark transaction, State Street Global Advisors “evaluated the insurance companies that were available to provide annuities and the potential annuity structures. Based upon a number of factors, including the financial strength of insurers, SSGA determined that a transaction split between Prudential and MassMutual was the safest available annuity structure to provide retiree benefits.”[5]

Motorola

The Motorola pension buyout and lump sum offer reduced Motorola’s U.S. defined benefit plan liabilities by about 50 percent and its U.S. plan population by 40,000 to 50,000 from a total of about 80,000. Motorola estimated at the time the deal was announced that its plan liabilities were equal to $8.4 billion. The purchase of the group annuity reduced liabilities by about $3.1 billion, and Motorola’s lump sum offer reduced liabilities by about $1.1 billion more.

Factors Driving Pension Buyouts

Prior to 2014, one reason an increasing number of U.S. corporations executed pension buyouts is that the post-financial crisis rally in U.S. equities had resulted in more defined benefit plans being fully funded, or nearly fully funded, enabling such plans to cover most of the cost of a group annuity without triggering a large incremental contribution by the plan sponsor. The higher a plan’s funded ratio, the lower the cost to the sponsor of purchasing a group annuity. However, due in part to the rally in U.S. treasuries in 2014, funded ratios in 2014 dropped from an average of approximately 95 percent at the end of 2013 to an average of approximately 87 percent at the end of 2014.

While a defined benefit plan might face a lower funded ratio this year, pension experts nonetheless anticipate that an increasing number of companies can be expected to execute pension buyouts — not only jumbo buyouts, but also midsized and smaller buyouts.

There are several drivers of increasing pension buyout activity:
The cost of staying in the defined benefit plan business continues to rise, including for “frozen” plans. For example, the Society of Actuaries’ updated mortality tables, which the SOA released in the fourth quarter of 2014, are expected, according to actuarial consultants, to result in a 3 to 8 percent increase in defined benefit plan liabilities, depending on a plan’s demographics. Based on its past practice, the Internal Revenue Service is expected likewise to update the mortality table used for minimum funding purposes under the Internal Revenue Code. According to a spokesperson for Kimberly-Clark quoted in The Wall Street Journal, the higher mortality charges “highlighted the volatility of sponsoring a large pension plan and played a part in our decision.”[6]

Pension funding requirements that may increase significantly depending on the level of U.S. treasuries or the S&P 500 result in pension-driven earnings volatility and make balance sheet management difficult. The 2014 rally in U.S. treasuries triggered significant increases in funding requirements for some companies, since fund liabilities increase as interest rates decrease. According to The Wall Street Journal, updated mortality assumptions or lower interest rates resulted in fourth-quarter pretax charges of $7.9 billion for AT&T Inc. and $7 billion for Verizon Communications Inc.[7] And sponsors vividly remember the sharp equity markets drop in 2008, which for some sponsors resulted in a sudden increase in defined benefit funding requirements in a very difficult environment for raising capital.

The premiums charged by the PBGC, which guarantees the payment of most defined benefit plan benefits, are increasing, in turn raising the total cost of pensions. The PBGC fixed and variable rate premiums will rise sharply in 2015 and 2016 for all defined benefit plans under changes adopted in the 2013 budget agreement and following the recently enacted Multiemployer Pension Reform Act of 2014.

Meanwhile, the concern that litigation might arise from jumbo buyouts may be lessening. In February 2015, the Fifth Circuit heard oral arguments in Lee v. Verizon (Case No. 14-10553), after the lower court, the U.S. District Court for the Northern District of Texas, had for a third time dismissed the arguments made by plan participants in a class action against Verizon related to its jumbo buyout. The largest obstacle to a successful appeal is the lower court’s statutory-based ruling that a plan sponsor’s decision to enter into a buyout is done in a “settlor capacity,” which permits deference to business decisions, rather than in a “fiduciary” capacity. Plaintiffs’ arguments on appeal appear to be policy-based — that allowing buyouts undermines the protections to participants under the Employee Retirement Income Security Act. The Fifth Circuit’s decision is pending.

Lump Sum Offers

A plan sponsor can also reduce defined benefit plan liabilities by offering participants lump sum payments of the estimated present value of their lifetime benefits. In connection with lump sum offers, sponsors present certain plan participants with a choice, to be exercised within a limited “window” period, of keeping their lifetime annuity or taking the lump sum amount. Motorola, for example, made a lump sum offer to 32,000 separated participants and paid a total of $1 billion to certain offerees who chose a lump sum payment during a window from Oct. 1 to Nov. 7, 2014. This reduced Motorola’s
pension liabilities by about $1.1 billion.[8]

The GAO report analyzed available information about lump sum offers implemented by plan sponsors in 2012 and identified 22 plan sponsors that offered lump sums resulting in payouts totaling more than $9.25 billion. According to the report, most lump sum payouts went to separated participants — vested terminated employees not yet receiving benefits (i.e., not yet in “pay status”) — but some went to participants already in pay status. The GAO report made recommendations to the DOL and Treasury Department aimed at ensuring that federal regulators have better information about lump sum windows and that participants have ready access to key information they need to make a decision when presented with a lump sum offer.[9]

**GAO Recommendations to the DOL**

The DOL should, according to the GAO report, “[r]equire plan sponsors to notify the DOL at the time they implement a lump sum window offer, including the number and category of participants being extended the offer (e.g., separated vested; retiree) as well as examples of the materials provided to them.”[10] It is worth noting in this connection that the PBGC has revised the 2015 premium filing procedures and instructions to introduce after-the-fact reporting requirements with respect to certain derisking transfers through lump sum windows and annuity purchases.

The GAO report also recommended that the DOL “[c]oordinate with the IRS and PBGC to clarify the guidance regarding the information sponsors should provide to participants when extending lump sum window offers” and that “[g]uidance should include clear and understandable presentations of information, such as the relative value of the lump sum, the role and level of protections provided by PBGC, and the positive and negative ramifications of accepting the lump sum.”[11]

The DOL “generally agreed” with the recommendations of the GAO report.[12] The DOL noted, however, that “ERISA does not clearly grant the DOL the authority to require that the DOL be notified at the time a plan sponsor implements a lump sum window offer” and that it would be necessary for the Employee Benefits Security Administration to determine whether the DOL has such authority.

**GAO Recommendations to the Treasury Department**

According to the GAO report, “to provide participants with useful information and to provide for lump sums that are based on up-to-date assumptions,” the Treasury Department should “[r]eview its regulations governing the information contained in relative value statements to ensure these statements provide a meaningful comparison of all benefit options, especially in instances where the loss of certain additional plan benefits may not be disclosed.”[13] The GAO report also recommended that the Treasury Department review the applicability and appropriateness of allowing sponsors to select a “lookback” interest rate for use in calculating lump sums and establish “a process and a timeline for periodically updating the mortality tables used to determine minimum required lump sums.”

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**DISCLOSURE:** Sutherland Asbill & Brennan served as insurance regulatory counsel to Kimberly-Clark and Motorola in the transactions summarized here and, accordingly, those summaries are based solely on information made public by Kimberly-Clark and Motorola.

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[4] DOL interpretive bulletin relating to the fiduciary standards under ERISA when selecting an annuity provider for a defined benefit pension plan, 29 CFR § 2509.95-1.


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