ERISA Procedural Prudence: The Appropriate Standard for Selecting an Annuity Provider

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Selecting an annuity provider begins with evaluating the ability of potential providers to meet the ERISA fiduciary standards for procedural prudence as outlined by the Fifth Circuit, and not the minimum standards of DOL Interpretive Bulletin 95-1. It is the process, not the result that counts.

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Department of Labor Interpretive Bulletin 95-1—Safest Available Annuity

The failures of major life insurers during the early 1990s placed plan trustees in a quandary when shopping for closeout annuities to preserve pension benefits for plan participants, as there was little published guidance on selecting an annuity provider. The failures of Executive Life and Mutual Benefit were widely known; both companies had been rated AAA by Standard & Poor's (S&P's) rating agency and A+ by A.M. Best & Co. (A.M. Best). After receiving a number of inquiries, the Department of Labor (DOL) issued Interpretive Bulletin 95-1 as a response to the concerns expressed about insurance company insolvencies. [Interpretive Bulletin Relating to the Fiduciary Standard Under ERISA When Selecting an Annuity Provider, 29 C.F.R. § 2509.95-1(c) (1995)] Consistent with DOL procedures, the bulletin was published without the notice and public comment required for regulations.

The bulletin develops several guidelines to be considered by a plan fiduciary when selecting an annuity provider:

1. The quality and diversification of the insurer's investment portfolio;
2. The size of the insurer relative to the proposed annuity contract;
3. The level of the insurer's capital and surplus;
4. The lines of business of the insurer and other indications of an insurer's exposure to liability;
5. The structure of the annuity contract and guarantees supporting the annuities, such as the use of separate accounts; and
6. The availability of additional protection through state guaranty associations and the extent of the guarantees.

The bulletin encourages fiduciaries to apply these guidelines to meet the "safest available annuity" standard.

Inadequacies of the Bulletin

Many ERISA [Employee Retirement Income Security Act of 1974] fiduciaries and consultants were cautious in applying the bulletin to the purchase of closeout annuities; they relied instead on credit analysis as the touchstone to evaluate competing providers. As credit analysis was supplanted by the bulletin, several inadequacies in the bulletin came into focus.

First, the bulletin encourages fiduciaries to select the "safest available annuity." However, the use of the

superlative "safest" becomes unworkable in the context of selecting from a field of large, established, and highly rated insurers. By labeling the standard as the "safest available annuity," fiduciaries began to follow public ratings from recognizable firms (i.e., Moody's Investor Services (Moody's) and S&P). Concerns over insurer solvency also resulted in fewer insurers being awarded or able to maintain AAA ratings from the agencies. (The top ten Moody's ratings are: Aaa, Aa1, Aa2, Aa3, A1, A2, A3, Baa1, Baa2, and Baa3. The top ten S&P ratings are: AAA, AA+, AA, AA-, A+, A, A-, BBB+, BBB, and BBB-.) Additional confusion arose from the text of the bulletin:

> A fiduciary may conclude, after conducting an appropriate search, that more than one annuity provider is able to offer the safest annuity available.

[29 C.F.R. § 2509.95-1(c)]

Second, the bulletin introduced the notion that quality may have no price limitations, even if the price may be considered exorbitant. In pertinent part, the bulletin provides that

> A fiduciary may not purchase a riskier annuity solely because there are insufficient assets in a defined benefit plan to purchase a safe annuity. The fiduciary may have to condition the purchase of annuities on additional employer contributions sufficient to purchase the safest annuity.

[29 C.F.R. § 2509.95-1(d)]

Without additional information it is not known, for any given placement, whether a "riskier" annuity, measured against the "safest available annuity" standard, is indeed a safe annuity and an appropriate purchase.

Third, the bulletin, while rightfully concerned with accountability, opens the door to hindsight, based upon the ultimate financial outcome of the annuity contract. For example, if a fiduciary did not seek additional employer contributions in acquiring the "safest available annuity," the DOL would have a clear path to holding the fiduciary accountable for the purchase of an annuity that may, after insolvency, be found to have been a "riskier annuity."

In summary, guidance intended by the bulletin results instead in an ambiguous standard that may lead to flawed conduct. Although the bulletin may have been issued with the best intention, the bulletin's standard can hardly be followed as it is written. While it is helpful that the bulletin prescribes six guidelines to be examined when selecting an annuity provider, the predominant use of public ratings for performance assessment has proven far too narrow. The rating agencies themselves caution that the use of ratings alone for such a limited purpose may not be appropriate.

On August 14, 2000, in *Bussian v. RJR Nabisco, Inc.* [223 F.3d 286 (5th Cir. 2000)], a Fifth Circuit ruling provided a significant departure from the guidelines expressed in the bulletin. In *Bussian* the court found that the bulletin was, at best, "instructive." The *Bussian* decision noted that the bulletin focuses on the outcome, but the court focuses on the process used by fiduciaries for selecting the annuity.

The *Bussian* Case

RJR Nabisco, Inc.'s involvement in *Bussian* came about through its purchase, in 1976, of Aminoil USA, Inc. (Aminoil), a Houston-based oil company. Aminoil administered a pension plan for its employees that was governed by ERISA. RJR sold Aminoil in 1984, and the purchaser assumed the pension obligations for all then-current employees. RJR retained the obligation of administering pension benefits for former employees under an ERISA defined benefit pension plan (the plan).

On October 16, 1986, RJR's board of directors approved resolutions authorizing the termination of the plan and several other plans of former RJR subsidiaries. Members of RJR's Pension Asset Management Department were given the responsibility of selecting an annuity provider. In October 1986, RJR hired Buck Consultants, Inc. (Buck), to assist in the endeavor. Buck was told that its role in the transaction was to identify potential insurance companies. Buck would also provide those companies with appropriate information in order to solicit the best bid from each carrier interested in the business. In turn, RJR could select the company that was appropriate to fulfill its needs. Buck compiled an initial list of insurance companies that could provide the annuity. That list included providers with which Buck was familiar, that had a reputation for providing good service to their clients, and that would have the capacity for a placement covering approximately 10,000 individuals. Executive Life was brought into the bid process as part of a strategy to render the bids more competitive. To satisfy itself of Executive Life's financial health, Buck reviewed the reports and ratings of four rating agencies: S&P, Moody's, A.M. Best, and Conning & Company.

Sometime prior to August 1987, Buck learned that Moody's had given Executive Life a rating of A3, which was two grades below the S&P AAA rating for the company. During this period Buck viewed Executive Life as working harder and asking more

questions during the bid solicitation process than the other companies. Buck reexamined the ratings and the rating agency reports and concluded that Executive Life should remain on the bid list.

Final bid day was set for August 12, 1987. On that day, Buck met with representatives of RJR to review the preliminary bids. The sole documentation RJR had comparing providers was a listing of the final companies' ratings and their initial bids. Buck did not recommend any particular company; instead, it saw each of the four remaining companies as qualified and competent to provide the annuity. As a result, Buck saw its role on final bid day as obtaining from each company its best (lowest) bid. Executive Life presented the lowest bid. After a final examination of ratings, Executive Life was awarded the RJR annuity closeout business.

In April 1991, Executive Life was declared insolvent by the California Insurance Commissioner, and ultimately annuitants entitled to benefits under the RJR closeout annuity did not receive their full benefits. These participants sued RJR and its employee benefits committees, alleging various ERISA fiduciary violations. The trial court granted summary judgment in favor of RJR in connection with the ERISA complaints. On appeal, the court in *Bussian* addressed the issue of fiduciary responsibility as it relates to the purchase of a closeout annuity.

The *Bussian* Holding

The DOL intervened in the *Bussian* case, advocating the application of the bulletin to determine whether RJR had satisfied its ERISA obligation to plan participants. The court took notice of the bulletin, but based its analysis of the fiduciary standards in ERISA as the standards to be applied to RJR's circumstances.

In summary, *Bussian* held as follows:

1. The bulletin may be looked to as a persuasive guide to the court, but is not binding on the court. Moreover, the court was critical of the safest available annuity standard, recognizing that, in any instance, it may not be possible to determine a single insurer as having met the superlative standard.

2. In rejecting the "safest available annuity" as the ERISA fiduciary standard of conduct when a closeout annuity is being purchased, the court held that fundamental ERISA prudent man standards apply. In pertinent part, the court said:

> …we are not persuaded that § 1104(a) imposes on fiduciaries the obligation to purchase the "safest available annuity" in order to fulfill their fiduciary duties. We hold that the proper standard to be applied to this case is the standard applicable in other situations that involve the potential for conflicting interests: fiduciaries act consistently with ERISA's obligations if "their decisions [are] made with an eye single to the interests of the participants and beneficiaries.

[Bussian, 223 F.3d at 298 (citing Donovan v. Bierwirth, 680 F.2d 263, 271 (2d Cir.), *cert. denied*, 459 U.S. 1069 (1982)); *see, e.g.*, Metzler v. Graham, 112 F.3d 207, 213 (5th Cir. 1997); Pilkington PLC v. Perelman, 72 F.3d 1396 (9th Cir. 1995); Reich v. Compton, 57 F.3d 270, 291 (3d Cir. 1995); Deak v. Masters, Mates & Pilots Pension Plan, 821 F.2d 572, 580 (11th Cir. 1987), *cert. denied*, 484 U.S. 1005 (1988); Leigh v. Engle, 727 F.2d 113, 125 (7th Cir. 1984) (Leigh I). That standard does not require that a fiduciary under the circumstances of this case purchase the "safest available annuity." *Cf.* Riley v. Murdock, No. 95-2414, 1996 WL 209613, at *1 (4th Cir. Apr. 30, 1996) (unpublished) (rejecting the standard advocated by the DOL)]

3. In applying ERISA fiduciary standards to RJR, the court rejected the "quality of the annuity" analysis, choosing instead to examine the conduct of the fiduciary. In pertinent part, the court said:

> The bulletin's standard focuses on the quality of the selected annuity. The standard we apply focuses instead on the fiduciary's conduct. It requires that fiduciaries keep the interests of beneficiaries foremost in their minds taking all steps necessary to prevent conflicting interests from entering into the decision-making process.

[Bussian, 223 F.3d at 298; *see* Metzler, 112 F.3d, at 213 (noting that steps necessary to reduce the effects of potential conflicts are dependant upon the circumstances); Bierwirth, 680 F.2d, at 276 (stating that the conflicted trustees "were bound to take any feasible precaution to see that they had carefully considered the other side")]

4. In determining whether fiduciary conduct satisfies ERISA fiduciary standards, the court focused on methods to be applied by the fiduciary. In pertinent part, the court said:

> In determining compliance with ERISA's prudent man standard, courts objectively assess whether the fiduciary, at the time of the transaction, utilized proper methods to investigate, evaluate and structure the investment; acted in a manner as would others familiar with such matters; and exercised independent judgment when making investment decisions.

> [ERISA's] test of prudence…is one of conduct, and not a test of the result of performance of the investment. The focus of the inquiry is how the fiduciary acted in his selection of the investment, and not whether his investments succeeded or failed. Thus, the appropriate inquiry is whether the individual trustees, at the time they engaged in the challenged transactions, employed the appropriate methods to investigate the merits of the investment and to structure the investment.

[Bussian, 223 F.3d, at 299, *cited* in Laborers Nat'l Pension Fund v. Northern Trust Quantitative Advisors, Inc., 173 F.3d 313 (5th Cir.), *cert. denied sub nom*, Laborers Nat'l Pension Fund v. American Nat'l Bank & Trust Co., 120 S. Ct. 406 (1999)]

We refer to the examination of method as *procedural prudence*. In selecting an expert advisor, the court recognizes that a fiduciary is not expected to become an expert, but is required to adopt prudent methods by which to select the expert advisor and to interact with the expert advisor sufficiently to determine the extent to which a recommendation can be relied upon. This process is outlined below.

Procedural Prudence

In selecting an annuity provider for a closeout annuity, a fiduciary must determine whether the process of selection is consistent with ERISA standards for procedural prudence. This means that documentation pertaining to the selection process must be comprehensive and well thought out. It is clear from *Bussian* that reliance on ratings alone is insufficient. As well, the mere collection of data and tables or ratios, without expert advice, is likely to be inadequate.

The key direction derived from the bulletin and *Bussian* is that ERISA fiduciaries must take steps "calculated" to conclude the annuity provider selected is suitable to the needs of the plan on whose behalf the closeout annuity is being purchased. Therefore, the documentation should demonstrate a thorough and conclusive process of evaluating, which annuity providers are, or may be, qualified to serve the plan. Additionally, the process should demonstrate an evaluation of the issuers using data gathered from varied sources.

How can plan fiduciaries reasonably be expected to perform this exhaustive task if they are unfamiliar with the plan termination process? Plan fiduciaries may rely on expert advice. But what kind of outside expert should be chosen? There are a number of elements to consider when selecting an expert—primarily, technical expertise, experience, and method of operation.

The process actually begins with a fiduciary evaluation of outside professionals. Fiduciaries should focus on the process to be utilized by the expert in fulfilling the procedural prudence standard, particularly when that expert is going to make the annuity provider selection.

Applying Procedural Prudence

In the context of an ERISA fiduciary retaining and interacting with an annuity service provider, applying the *Bussian* standard requires more than conformity to the bulletin.

The documentation developed by an annuity service provider should guide a specific process for analyzing issues for a particular client setting. The process should examine a number of factors, including those outlined in the bulletin, and must go far beyond the mere collection of tables of data, assembling ratings reports, and the organization and reporting of financial data. An annuity service provider should generate detailed information and documentation that is oriented directly to each annuity selection and placement and it should be supported by a comparability analysis. Some of the more relevant points to be covered in a process that is designed to conform to *Bussian* are the following:

1. Annuity Bid

Development of the information begins with drafting thorough bid specifications created from underwriting the plan document and amendments, and reviewing the latest actuarial valuation and current participant census. The bid specifications are submitted to potential annuity providers. Terms and conditions for arranging the various benefits and structure of contract are included in the submittal.

2. Review of Proposals

The annuity intermediary should provide a detailed analysis and evaluation of the proposals from each annuity provider. It is important to have written clarification to deviations from the specifications. The documentation should provide a detailed review of the manner in which benefit provisions have been applied by the plan administrator. The analysis should include an audit of participant data and control totals.

3. Conditions to Placement

The analysis should establish a methodology for analyzing all of the relevant contractual issues involved in the purchase of a group annuity contract. It is helpful to outline the procedures required in order to create a binding contractual agreement between the plan

trustee and the annuity provider. There should be attention to the details of the contract jurisdiction, acceptance date, funds transfer date, and other terms or conditions that may affect the transaction.

4. Financial and Qualitative Analysis

The financial and qualitative documentation should examine a number of financial factors for the life companies being considered. The documentation must be comprehensive and include financial data, current rating reports, and a relevant analysis of life company financial information. That information must be analyzed as part of the *process*. The manner of reviewing these quantitative factors should enable the user to structure a process to produce reliable conclusions regarding the weighing of information presented. It is important that the qualitative aspects of the analysis be conclusive and that a method be devised to categorize the various issuers for their respective quality.

5. Assessing Comparability

Comparability as introduced in *Bussian* should be fully analyzed and developed. In order for the analysis to become a *process* that is compliant with ERISA, it must be comprehensive and it must be conclusive. In order to develop a comparability analysis, it is important to identify the differentiating characteristics of various life insurance companies and to weigh the potential impact of these differences among those issuers being considered.

6. Defining the Methodology

A qualitative scoring system should be used as a basis to develop the theory of comparability. The theory of comparability serves as the rationale for determining which issuers may be preferred annuity providers. The scoring system should examine key financial ratios and then illustrate some comparison to an industry universe or composite. The scoring system and analysis process should become a method of identifying and reviewing the most relevant factors for determining quality. In its closing stage, the process should lead to conclusions and recommendations of annuity providers and the selection of the final annuity provider. If at all possible, pricing should be considered only during this last phase.

7. Applying the System

A process should also examine whether it is reasonable to determine if there is one obviously superior issuer among all others. It should address the question of how to demonstrate that there is one generically safest annuity provider. The process should consider a variety of factors beyond the limited number outlined in the bulletin. Conclusions reached regarding one issuer in a particular set of individual circumstances may be different than for any other transaction.

8. Manner of Presentation

Fiduciaries must review the manner in which the documentation is presented. Merely assembling tables of facts and figures without an accompanying analysis leaves the selection open to ambiguity. The preferred method of presentation would entail a written report that would capture the basis for the conclusions developed in supporting an annuity selection. The report should demonstrate that a completely open platform was created for interaction between the annuity service provider and the plan fiduciary. The plan fiduciary is then able to examine and scrutinize the rationale supporting the conclusions and opinions made by the service provider. The ability to meet the rigors for procedural prudence rests upon the ability to demonstrate the expertise that is developed in the analysis and applied in the selection process.

Definitive Process Becomes a Model

A fully developed process would potentially become a business practice model, which would meet the procedural prudence requirement of ERISA. Such a model would be exhaustive and proprietary. It would be conclusive to the specific circumstances of each client. The model would be designed specifically to satisfy procedural prudence and the annuity service provider would be capable of demonstrating that to a potential client.

The model ought be consistent with *Bussian*, which states in pertinent part:

> A determination whether a fiduciary's reliance on an expert advisor is justified is formed by many factors, including the expert's reputation and experience, the extensiveness and thoroughness of the expert's investigation, whether the expert's opinion is supported by relevant material, and whether the expert's *methods and assumptions* are appropriate to the decision at hand.
>
> ...a conflicted fiduciary need not become an expert." "But the fiduciary is required to make an honest, objective effort to read the valuation, understand it, and question the methods and assumptions that do not make sense. The goal is not to duplicate the expert's analysis, but *to review that analysis to determine the extent to which any emerging recommendation can be relied upon.*

[Hightshue v. AIG Life Ins. Co., 135 F.3d 1144, 1148 (7th Cir. 1998); *cf.* Donovan v. Cunningham, 716 F.2d

1455, 1474 (5th Cir. 1997) (holding that fiduciaries, who had information available to them indicating that assumptions underlying an expert's appraisal were no longer valid, breached their duties under ERISA by not analyzing the effect of changes on those assumptions)]

An ERISA-compliant model would be designed to be interactive with the plan fiduciary. It would allow the plan fiduciary to challenge the findings and question the conclusions at any time during the process. Therefore, the model itself becomes the process for developing an annuity selection within the framework of ERISA fiduciary standards for procedural prudence.

Conclusion

The "safest available annuity" standard was the DOL's approach to satisfying a demand by plan fiduciaries for direction. *Bussian* has grasped the real issue of ERISA fiduciary standards by applying the proper standard for procedural prudence. The ultimate outcome of the solvency or insolvency of a particular annuity provider is not a workable standard. ERISA standards for procedural prudence focus on fiduciary conduct; the bulletin has erroneously focused on the ultimate outcome.

The defined benefit plan termination process is a series of decisions leading to an "end game" strategy in which trustees acquire group annuity contracts to meet plan benefits. These contracts are structured according to the plan document and reflect how the plan has been administered over time. Although following the guidelines prescribed by the bulletin for selecting an annuity provider may seem adequate, they are not. For plan fiduciaries, this should evoke a degree of concern whenever an annuity purchase is considered and whether or not a plan is terminating.

How does a fiduciary fulfill the new procedural prudence standard? A plan fiduciary must determine whether an annuity intermediary or other consultant develops a process that is designed to follow the bulletin or whether the services are designed to be consistent with *Bussian*.

How does a plan fiduciary conclude that a service provider is compliant with the ERISA fiduciary standard? Trustees must determine, for themselves, whether the course taken is consistent with ERISA standards for procedural prudence. A fiduciary's responsibilities are best satisfied and participant interests are best fulfilled when ERISA standards for procedural prudence are applied. It is crucial that plan fiduciaries seek service providers capable of demonstrating an ability to meet the ERISA fiduciary standards for procedural prudence and not merely standards outlined in the bulletin. A history of a volume of transactions by a service provider does not assure a fiduciary that procedural prudence is fulfilled. The fiduciary process begins with the proper examination of the potential service providers and, most important, their ability to fulfill ERISA fiduciary standards for procedural prudence as outlined in *Bussian*, and not the minimum standards of the bulletin.