Interpretive Bulletin No. 95-1

INTERPRETIVE BULLETINS RELATING TO THE EMPLOYEE RETIREMENT INCOME SECURITY ACT OF 1974

AGENCY: PWBA, Department of Labor

ACTION: Interpretive Bulletin

SUMMARY: This document announces the Department of Labor's (the Department's) view of the legal standard imposed by section 404 (a) (1) (A) and (B) of part 4 of title I of the Employee Retirement Income Security Act of 1974 (ERISA) on a plan fiduciary's selection of an annuity provider when purchasing annuities for the purpose of distributing benefits under an employee pension benefit plan. Under this standard, plan fiduciaries choosing to purchase annuities have a duty to select the safest available annuity provider, unless under the circumstances it would be in the interests of participants and beneficiaries to do otherwise. The document also provides guidance to plan fiduciaries regarding circumstances when it may be in the interest of the participants and beneficiaries to purchase other than the safest available annuity.

EFFECTIVE DATE: The standard announced in this bulletin is effective January 1, 1975.

FOR FURTHER INFORMATION CONTACT: William W. Taylor, Plan Benefits Security Division, Office of the Solicitor, U.S. Department of Labor, Rm N-4611, 200 Constitution Ave., NW, Washington, D.C. 20210, (telephone (202) 219-9141) or Mark Connor, Office of Regulations and Interpretations, Pension and Welfare Benefits Administration, U.S. Department of Labor, Rm N-5669, 200 Constitution Ave., NW Washington, D.C. 20210, (telephone (202) 219-8671). These are not toll-free numbers.

SUPPLEMENTARY INFORMATION: In order to provide a concise and ready reference to its interpretations of ERISA, the Department of Labor publishes its Interpretive Bulletins in the Rules and Regulation section of the **Federal Register**.

Published in this issue of the **Federal Register** is ERISA Interpretive Bulletin 95-1, which describes the application of the fiduciary standards set forth section 404 (a) (1) (A) and (B) of ERISA, 29 U.S.C. **S** 1104 (a) (1) (A) and (B), in selecting an insurer to provide pension benefit distribution annuities to plan participants and beneficiaries. The Department is publishing this Interpretive Bulletin because it believes there is a need for further guidance regarding the selection of such annuity providers by plan fiduciaries.

(Sec. 505, Pub. L. 93-406, 88 Stat. 894 (29 U.S.C. 1135).)

Background

Annuities are issued by insurers in a variety of forms designed to suit different purposes. This interpretive bulletin addresses only annuities that are purchased by pension plans with the intention to transfer liability for benefits promised under the plan to the annuity provider (i.e., the insurance company). [1] Annuities designed to serve this purpose are sometimes referred to herein as benefit distribution annuities. Regulations issued by the Department explicitly recognize a transfer of liability from the plan when such an annuity is purchased from an insurance company licensed to do business in a State. 29 C.F.R. **S** 2510.3-3 (d) (2) (ii). [2] Pension plans purchase benefit distribution annuity contracts in a variety of circumstances. Such annuities may be purchased for participants and beneficiaries in connection with the termination of a plan, or in the case of an ongoing plan, annuities might be purchased for participants who are retiring or separating from service with accrued vested benefits.

The selection of annuity provider under these circumstances is a fiduciary decision governed by part 4 of title I of ERISA. Specifically, pursuant to ERISA section 404 (a) (1), 29 U.S.C. **S** 1104 (a) (1), fiduciaries must discharge their duties with respect to the plan solely in the interest of the participants and beneficiaries. Section 404 (a) (1) (A), 29 U.S.C. **S** 1104 (a) (1) (A), states that the fiduciary must act for the exclusive purpose of providing benefits to participants and beneficiaries and defraying reasonable plan administration expenses. In addition, section 404 (a) (1) (B) requires a fiduciary to act with the care, skill, prudence and diligence under the prevailing circumstances that a prudent

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[1] In particular, the interpretive bulletin does not address fiduciary responsibilities in connection with the purchase of annuities for investment purposes. *See infra* note 5.

[2] This regulation defines the term “participant covered under the plan” for certain purposes under title I of ERISA. The Department notes that the regulation was issued primarily to define the class of participants entitled to receive copies of certain plan documents without charge and without request under ERISA sections 101 (a) and 104 (b) (1), 29 U.S.C. **SS** 1021 (a) and 1024 (b) (1). 40 F.R. 24649 (June 9, 1975), 40 F.R. 34528 (Aug. 15, 1975). A premise of the regulation was that, by using the term “participant covered under the plan,” Congress had provided a ground for distinguishing between the class of all participants within the meaning of ERISA 3 (7) and participants entitled to receive copies of plan documents without charge and without request. 40 F.R. 24649 (June 9, 1975). Thus, the regulation is not intended to define the term “participant” or “beneficiary” for all purposes under ERISA, and, in particular, is not intended to define these terms for purposes of standing to bring a civil action under ERISA section 502 (a), 29 U.S.C. **S** 1132 (a).

person acting in a like capacity would use.[3]

Several developments over the past few years have resulted in questions being raised about the security of the pension benefits promised to participants and beneficiaries under benefit distribution annuity contracts purchased on their behalf. In particular, concerns have been expressed about the ability of certain insurance carriers to satisfy their annuity liabilities because their investment portfolios contain or contained substantial amounts of high-risk, high-yield debt securities (also knows as "junk bonds") or troubled real-estate loans, or a combination of both. The basis for such concerns is best exemplified by the well-publicized developments involving the Executive Life Insurance Companies of California and New York. State regulators in both California and New York were forced to take control of the operations of the Executive Life companies, whose poor financial condition is principally attributable to substantial investments in high risk bonds. In response to such developments, the Department has acted in the following areas to enforce ERISA's fiduciary standards and determine whether additional regulatory action is warranted.

Litigation

Subsequent to the failure of Executive Life, the Department's enforcement activities have centered on, among other things, the process by which plan fiduciaries selected annuity providers. The Department has filed lawsuits against numerous companies whose plans purchased annuities because the plan fiduciaries who, acting in their fiduciary capacities, failed to follow adequate procedures designed to select the safest available insurance carrier when choosing an annuity provider. Cases have been brought against several companies which purchased annuities from Executive Life including Pacific Lumber Co., Magnetek, Inc., Smith International, Inc., Geosource, Inc., American National Can Company, AFG Industries, Inc., and Raymark Industries, Inc. as well as against the Strouse Adler Company which purchased annuities form Presidential Life Insurance Company. It is the Department's position that these fiduciaries breached their fiduciary

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[3] On March 13, 1986, the Department released an information letter addressed to John N. Erlenborn, who was then the Chairman of the Advisory Council on Employee Welfare and Plans. In the letter, the Department stated in pertinent part:

> Consistent with the functional analysis of fiduciary activity, the choice of an insurer wold appear to involve the type of discretionary authority over the disposition of plan assets covered in section 3 (21) (A) [of ERISA]. . . . Therefore, it appears that the fiduciary provisions of ERISA, including the prudence requirement of section 404 (a) (1) (B), will apply to the choice of an insurer to issue annuities upon plan termination.

responsibilities under ERISA in connection with their selection of annuity providers.[4] Consent orders settling the Secretary's claims have been entered in certain of these cases.

Regulatory Action

In addition to its enforcement activities, the Department and the Pension Benefit Guaranty Corporation (PBGC) sought to determine if, in addition to and independent of ERISA's fiduciary standards, minimum standards for annuity providers would be appropriate and necessary in order to ensure a reasonable likelihood that participants or beneficiaries on whose behalf annuities are purchased will receive their promised pension benefits. It was anticipated that such modification might be effected by amending the minimum standards which already exist under the regulation at 29 C.F. R. **S**2510.3-3 (d) (2) (ii). On June 21, 1991, both the Department and the PBGC published advanced notices of proposed rulemaking (ANPRMs) in the **Federal Register** (56 FR 28638 and 56 FR 28642 respectively) soliciting information and comments from the public as to whether regulatory action relating to the purchase of annuity contracts was necessary and if so, what form such action should take.

After receiving over thirty letters in response, the Department reviewed the comments and, after extensive deliberation, the Department has determined that no regulatory action should be taken at this time to amend the minimum standards under the regulation at 29 C.F.R. **S**2510.3-3 (d) (2) (ii). More generally, the Department has decided not to promulgate any regulation limiting the circumstances under which the purchase of an annuity will be considered a full distribution of benefits for a participant or beneficiary such that the plan's and the employers' obligations to pay benefits have been severed.

The following interpretive bulletin concerns solely the fiduciary standard and is published in addition to and independent of the regulatory minimum standard at 29 C.F.R. **S**2510.3-3 (d) (2) (ii).

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[4] The Pension Annuitant's Protection Act of 1994, Pub. L. No. 103-401, 108 Stat. 4172 (1994) amended section 502 (a) of ERISA to clarify the standing of pension annuitants to bring actions for fiduciary breaches that occurred. In addition, the Act specifies that a court may order appropriate relief to assure the annuitant's receipt of the amounts provided or to be provided by the annuity, plus reasonable prejudgment interest. The amendments made by the Act apply to any legal proceeding pending, or brought, on or after May 31, 1993.

The Interpretive Bulletin

The interpretive bulletin explains that, when choosing an annuity provider for purposes of a benefit distribution whether for purposes of separation or retirement of a participant or upon termination of a plan, compliance with ERISA's fiduciary rules 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. In conducting such a search, a fiduciary must evaluate a potential annuity provider's claims-paying ability and credit-worthiness because the participants and beneficiaries whose entitlement to benefits will be transferred to the annuity provider have a paramount interest in the ability of the provider to make those payments. As a result, the interpretive bulletin states that a plan fiduciary choosing an annuity provider for the purpose of making a benefit distribution must take steps calculated to obtain the safest annuity available, unless under the circumstances, it would be in the interests of the plan participants and beneficiaries to do otherwise.[5] The Department recognizes that, in many circumstances likely to arise under existing law, the interest of the plan participants and beneficiaries may require the selecting fiduciary to consider the cost of the annuity (to the extent that the cost is borne by the participants and beneficiaries) in addition to the annuity provider's claims-paying ability.[6] Cost consideration may not, however, justify purchase of an unsafe annuity.

The interpretive bulletin also explains that an annuity provider's claims-paying ability and credit-worthiness should be evaluated on the basis of a number of factors. Although ratings provided by insurance rating services may be a useful factor in evaluating a potential annuity provider, reliance solely on such ratings would not be sufficient to meet the requirement of a thorough and analytical search for an appropriate annuity provider.

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[5] This standard does not apply to the purchase of annuities for plan investment purposes. As with any other ordinary investment decision, ERISA's fiduciary duty of prudence requires that the risk attendant to such products, in the context of the plan's investment portfolio, and its funding, liquidity and diversification needs, must be weighed against the promised return. Thus, fiduciaries may select such investments that involve greater risks, but that also provide an expected investment return that is commensurate with that greater risk. In this regard, the Department notes that in an investment contract with an annuity option, the standard described herein, while not applicable to the decision to invest in the investment product, nonetheless applies to the fiduciary's decision to exercise the annuity option.

[6] Under IRC **S** 4980, an excise tax of up to 50 percent may be imposed on the amount of any employer reversion from a qualified plan unless the employer establishes and maintains a qualified replacement plant to which assets are transferred, or provides certain benefit increases for participants.

List of Subjects in 29 CFR Part 2509

Employee benefit plans. Pensions. For the reason set forth in the preamble, Part 2509 of Title 29 of the Code of Federal Regulation is amended as follows:

PART 2509-- INTERPRETIVE BULLETINS RELATING TO THE EMPLOYEE RETIREMENT INCOME SECURITY ACT OF 1974

1. The authority citation for Part 2509 is continues to read as follows:

Authority: 29 U.S.C. 1135. Section 2509.75-1 is also issued under 29 U.S.C. 1114. Sections 2509.75-10 and 2509.75-2 are also issued under 29 U.S.C. 1052, 1053, 1054. Secretary of Labor's Order No. 1-87 (52 FR 13139).

2. Part 2509 is amended by adding a new **S** 2509.95-1 to read as follows:

S2509.95-1 Interpretive Bulletin relating to the fiduciary standard under ERISA when selecting an annuity provider.

a. Scope. This Interpretive Bulletin provides guidance concerning certain fiduciary standards under part 4 of title I of the Employee Retirement Income Security Act of 1974 (ERISA), 29 U.S.C. **SS** 1104-1114, applicable to the selection of annuity providers for the purpose of pension plan benefit distributions where the plan intends to transfer liability for benefits to the annuity provider.

b. In General. Generally, when a pension plan purchases an annuity from an insurer as a distribution of benefits, it is intended that the plan's liability for such benefits is transferred to the annuity provider. The Department's regulation defining the term "participant covered under the plan" for certain purposes under title I of ERISA recognizes that such a transfer occurs when the annuity is issued by an insurance company licensed to do business in a State. 29 C.F.R. **S** 2510.3-3 (d) (2) (ii). Although the regulation does not define the term "participant" or "beneficiary" for purposes of standing to bring an action under ERISA **S** 502 (a), 29 U.S.C. 1132 (a), it makes clear that the purpose of a benefit distribution annuity is to transfer the plan's liability with respect to the individual's benefits to the annuity provider.

Pursuant to ERISA section 404 (a) (1), 29 U.S.C. **S** 1104 (a) (1), fiduciaries must discharge their duties with respect to the plan solely in the interest of the participants and beneficiaries. Section 404 (a) (1) (A), 29 U.S.C. **S** 1104 (a) (1) (A), states that the fiduciary must act for the exclusive purpose of providing benefits to the participants and beneficiaries and defraying reasonable plan administration expenses. In addition, section 404 (a) (1) (B), 29 U.S.C. **S** 1104 (a) (1) (B), requires a fiduciary to act with the care, skill,

prudence and diligence under the prevailing circumstances that a prudent person acting in a like capacity and familiar with such matters would use.

c. Selection of Annuity Providers. The selection of an annuity provider for purposes of a pension benefit distribution, whether upon separation or retirement of a participant or upon the termination of a plan, is a fiduciary decision governed by the provisions of part 4 of title I of ERISA. In discharging their obligations under section 404 (a) (1), 29 U.S.C. **S** 1104 (a) (1), to act solely in the interest of participants and beneficiaries and for the exclusive purpose of providing benefits to the participants and beneficiaries as well as defraying reasonable expenses of administering the plan, fiduciaries choosing an annuity provider for the purpose of making a benefit distribution must take steps calculated to obtain the safest annuity available, unless under the circumstances it would be in the interests of participants and beneficiaries to do otherwise. In addition, the fiduciary obligation of prudence, described at section 404 (a) (1) (B), 29 U.S.C. **S** 1104 (a) (1) (B), 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. In conducting such a search, a fiduciary must evaluate a number of a factors relating to a potential annuity provider's claims paying ability and credit worthiness. Reliance solely on ratings provided by insurance rating services would not be sufficient to meet this requirement. In this regard, the types of factors a fiduciary should consider would include, among other things:

(1) the quality and diversification of the annuity provider's investment portfolio;

(2) the size of the insurer relative to the proposed contract;

(3) the level of the insurer's capital and surplus;

(4) the lines of business of the annuity provider 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;

(6) the availability of additional protection through state guaranty associations and the extent of their guarantees.

Unless they possess the necessary expertise to evaluate such factors, fiduciaries would need to obtain the advice of a qualified, independent expert. A fiduciary may conclude, after conducting an appropriate search, that more than one annuity provider is able to offer the safest annuity available.

d. Costs and Other Considerations. The Department recognizes that there are situations where it may be in the interest of the participants and beneficiaries to purchase other than the safest available annuity. Such situations may occur where the safest available annuity is only marginally safer, but disproportionately more expensive than competing annuities, and the participants and beneficiaries are likely to bear a significant portion of that increased cost. For example, where the participants in a terminating

pension plan are likely to receive in the form of increased benefits, a substantial share of the cost savings that would result from choosing a competing annuity, it may be in the interest of the participants to choose the competing annuity. It may also be in the interest of the participants and beneficiaries to choose a competing annuity if the annuity provider offering the safest available annuity is unable to demonstrate the ability to administer the payment of benefits to the participants and beneficiaries. The Department notes, however, that increased cost or other considerations could never justify putting the benefits of annuitized participants and beneficiaries at risk by purchasing an unsafe annuity.

In contrast to the above, a fiduciary's decision to purchase more risky, lower-priced annuities in order to ensure or maximize a reversion of excess assets that will be paid solely to the employer-sponsor in connection with the termination of an over-funded pension plan would violate the fiduciary's duties under ERISA to act solely in the interest of the plan participants and beneficiaries. In such circumstances, the interests of those participants and beneficiaries who will receive annuities lies in receiving the safest annuity available and other participants and beneficiaries have no countervailing interests. The fiduciary in such circumstances must make diligent efforts to assure that the safest available annuity is purchased.

Similarly, 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 available annuity.

e. Conflicts of Interest. Special care should be taken in reversion situations where fiduciaries selecting the annuity provider have an interest in the sponsoring employer which might affect their judgment and therefore create the potential for a violation of ERISA **S** 406 (b) (1). As a practical matter, many fiduciaries have this conflict of interest and therefore will need to obtain and follow independent expert advice calculated to identify those insurers with the highest claims-paying ability willing to write the business.

Signed at Washington, DC, the 28th day of February, 1995.

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Olena Berg
Assistant Secretary for Pension and
Welfare Benefits, U.S. Department
Of Labor.

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