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TOPIC: Four Recent Lawsuits Claim Large Corporate Pension Plans Violated ERISA Through Use of Unreasonable Actuarial Assumptions

MARKET TREND: In December of 2018, four lawsuits were filed naming large corporations along with their respective benefits committees and individual committee members as defendants.[1] The four lawsuits each allege that the defined benefit pension plans of those corporations have systematically relied on unreasonable actuarial assumptions when calculating alternative annuity forms and claim that this practice violates ERISA's requirements that benefits be actuarially equivalent in value. Consequently, the complaints reason, retirees have lost part of their vested retirement benefits in violation of ERISA § 203. Given (i) the short time span in which all four lawsuits have been filed, (ii) the fact that the same two firms have filed all four lawsuits, and (iii) the caliber of corporations that have been targeted, it is possible that these lawsuits represent the beginning of a new trend in ERISA litigation.

SYNOPSIS: Although ERISA largely requires that the alternative benefit forms available to participants of a defined benefit pension plan be actuarially equivalent to the plan's normal retirement benefit, there is very little guidance on what it means to be "actuarially equivalent." Defined benefit pension plans usually provide benefits as annuities, providing a stream of

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[1] The cases cited to in this article are:

- *Masten, et al. v. Metropolitan Life Insurance Company et al.*, 1:18 cv -11229, (S.D.N.Y. Dec. 3, 2018).
- *Martinez Torres, et al. v. American Airlines, Inc. et al.*, 4:18-cv-00983, (N.D.Tex. Dec. 11, 2018).
- *DuBuske, et al. v. PepsiCo. Inc., et al.*, 7:18-cv-11618 (S.D.N.Y. Dec. 12, 2018).
- *Smith, et al. v. U.S. Bancorp, et al.*, 0:18-cv-03405 (C.D. Minn. Dec. 14, 2018).

payments over a designated life or lives. Accordingly, to compare the relative value of different benefit forms, plans must calculate the present value of the future payments the participant and/or beneficiary expect to receive under each form. To calculate the present value of an annuity, a plan must rely on actuarial assumptions, typically based on an interest rate and mortality table. While ERISA and the Internal Revenue Code mandate certain interest rates and mortality tables to calculate the value of lump sum distributions for pension plans, no such mandated interest rates or mortality tables apply for other pension plan determinations, such as comparing the value of different forms of annuities or reductions to the amount of annuity payments for early commencement. The lawsuits contend that the actuarial assumptions used by each of the plans, especially older mortality tables, are inherently unreasonable. The lawsuits argue that in using unreasonable actuarial assumptions, the plans have been providing alternative benefit forms that are less valuable than the plans' normal benefit form, causing participants and beneficiaries to lose part of the benefit owed to them. The lawsuits seek both money damages, in the form of restoration of improperly forfeited benefits, and other equitable relief such as reformation of the plan provisions.

TAKEAWAYS: Plan sponsors, especially those with older pension plans that may not have revisited the plan's actuarial assumptions in many years, will want to monitor how these cases proceed and may want to consult with plan counsel and actuaries to review their actuarial assumptions.

<u>ERISA Requirements</u>

To understand the context for these recent cases, it is important to understand how the Employee Retirement Income Security Act of 1974, as amended ("ERISA") defines a participant's "accrued benefit" under a defined benefit pension plan ("DB Plan"), and how "actuarial equivalence" matters in determining the value of alternative benefit forms.

1. Participant's Accrued Benefit

In a DB Plan, a participant's accrued benefit is generally expressed as an annual or monthly benefit commencing at normal retirement age.[2] One of the qualification requirements for DB Plans is that a participant's accrued benefit be "definitely determinable."[3] To satisfy this requirement, the DB Plan must provide for a "normal form" of benefit, which expresses and determines the value of the accrued benefit.[4] For many plans, the normal form of benefit is a single life annuity—i.e., an annuity payable for the lifetime of the participant. However, the form in which the benefit is actually paid may not be the normal form.

[2] ERISA § 3(23)(A).

[3] 26 CFR § 1.401-1(b)(1)(i).

[4] ¶ 13.03[11] of Perdue / Qualified Pension and Profit Sharing Plans (WG&L).

ERISA requires that the benefits of married participants be paid in the form of a qualified joint and survivor annuity ("QJSA") unless the participant, with the consent of their spouse, elects another form of benefit.[5] A QJSA is an annuity for the life of the participant with a survivor annuity for the life of the spouse which is not less than 50%, and is not greater than 100%, of the amount of the annuity which is payable during the joint lives of the participant and the spouse, and which is the actuarial equivalent of a single life annuity paid over the life of the participant.[6] A QJSA must also be at least as valuable as any other optional form of benefit available under the plan.[7] Compared to a single life annuity, the participant will receive reduced payments during his or her lifetime to account for the potential payments that will be made to the participant's spouse if the spouse outlives the participant. Plans may also offer additional forms of survivor annuities beyond the QJSA, so long as, like the QJSA, any optional survivor benefit form is actuarially equivalent to a single life annuity.

Additionally, plans may offer a form of benefit that is payable to the participant before his or her normal retirement age. But, if a participant's accrued benefit is to be determined before normal requirement age, and the participant is to receive earlier payment of their benefit, ERISA requires that the early retirement benefit be not less than the actuarial equivalent of the benefit that the participant would have received at his normal retirement age.[8] Much like the QJSA compared to a single life annuity, the payments received under an early benefit form are reduced to account for the potentially longer time that payments will be made.

If benefits will actually be paid in an alternate form, not the normal form, the plan must determine how the normal form of benefit will be converted to the alternate form while satisfying ERISA's requirement that the alternate form be actuarially equivalent to a single life annuity.

2. Actuarial Equivalence

Although ERISA is clear that alternate forms of a participant's accrued benefit be actuarially equivalent to other forms, ERISA provides little guidance on what "actuarial equivalence" means. As an initial matter, benefit forms cannot be compared without first calculating their present value . This is because (i) the amount of the payments under each form will vary and (ii) the number of total payments received by the participant and/or beneficiary, as applicable, will vary. To calculate the present value of an annuity, certain actuarial assumptions must be made with respect to both interest rate and the mortality of the annuity recipient.

The interest rate is meant to reflect the time value of money. Money received today is more valuable than the same amount of money received at some future date. Mortality matters

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[5] ERISA § 205(a).

[6] ERISA § 205(d)(1).

[7] 26 C.F.R. § 1.401(a)-20 Q&A 16.

[8] ERISA § 204(c)(3).

because annuities are paid over the lifetime of the participant and/or beneficiary. Accordingly, the projected death of the participant and/or beneficiary will affect how many payments are made as well as the amount each payment. Once present values are calculated, benefit forms can be compared, and equivalence can be assessed. The specific actuarial assumptions selected are therefore critical to these determinations.

If a plan chooses to offer lump-sum distributions as an optional benefit form to participants upon retirement, ERISA § 205(g)(3) requires that the interest rate and mortality table specified in annually updated Treasury regulations be used to determine the actuarial equivalence of a lump-sum distribution of a plan's normal form of benefit.

But ERISA mandates no such actuarial assumptions for converting a normal form of benefit to a QJSA or other annuity benefit forms, or for adjusting for early commencement of annuity benefits before the normal retirement date. Rather, relevant Treasury regulations specify only that "equivalence may be determined on the basis of consistently applied reasonable actuarial factors."[9] Other Treasury regulations provide that optional survivor benefit forms should be compared to QJSAs using "a single set of interest and mortality assumptions that are reasonable."[10] None of these regulations define what it means for a set of actuarial assumptions to be reasonable.

3. Accrued Benefits are Non-Forfeitable

ERISA also provides that a participant's right to his or her benefit under a plan, once vested, is non-forfeitable, meaning the benefit cannot be taken away or reduced.[11] The related Treasury regulations clarify that "adjustments in excess of reasonable actuarial reductions can result in rights being forfeitable."[12]

The Lawsuits

A pair of law firms filed four separate lawsuits this past December, intended to be class actions, against the DB Plans sponsored by four large employers—Metropolitan Life Insurance Company, American Airlines, PepsiCo, and U.S. Bancorp. The lawsuits name as defendants not only the plan sponsors, but also the related benefit committees and individuals serving on those committees. As detailed below, they argue that the actuarial equivalence factors used by those DB Plans are inherently unreasonable, resulting in lower annuity benefits for certain participants that violate ERISA's anti-forfeiture rules. They also claim breaches of ERISA fiduciary duties. They seek redetermination of benefits, make-whole payments for past underpayments, reformation of plan provisions, and other forms of equitable relief.

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[9] 26 C.F.R. 1.401(a)-11(b)(2).

[10] 26 C.F.R. 1.417(a)(3)-1(c)(2)(iv)(B)

[11] ERISA § 203(a).

[12] 26 C.F.R. §1.411(a)-4(a).

1. *Allegations of Outdated Mortality Tables*

The complaints in both Torrez v. American Airlines, Inc. and Masten v. Metropolitan Life Insurance Company focus on the specific mortality table identified in the plan to be used in calculating the plan's joint and survivor annuity. Under American Airlines' DB Plan, as described in the complaint, participants accrue benefits in the form of a single life annuity, but the plan also offers joint and survivor annuities to participants. When calculating the amount of those benefits, the plans specify that a 1984 mortality table and a 5% interest rate should be used. In the case of the Metropolitan Life Insurance Company DB Plan, the complaint similarly describes actuarial equivalence under plan terms using a 1971 mortality table and an interest rate of 6%.

Since using higher interest rates can counterbalance outdated mortality assumptions, given their opposite affect on the present value calculation, both complaints acknowledge that mortality tables and interest rates must be viewed together to see if reasonably equivalent benefits can result. However, even in accepting that the interest rates used by the American Airlines plans and the Metropolitan Life Insurance plan were not unreasonable, the complaints allege that the use of mortality rates from 1971 and 1984 could not be remedied by merely reasonable interest rates. The complaints state that the unreasonable conversion factors resulted in participants who elected to receive joint and survivor annuities receiving lower payments than they would have received had a more current mortality table assumption been used.

2. *Allegations of Unreasonable Conversion Factors Absent Specific Interest Rate or Mortality Table Assumptions*

The PepsiCo. Salaried Employees Retirement Plan, as described in DuBuske v. PepsiCo, Inc., provides for a single life annuity as the normal benefit form that is based on wages and years of service. When benefits are to be paid as a joint and survivor annuity instead of a single life annuity, the plan sets a conversion factor for each category of joint and survivor annuity that is based on unidentified actuarial assumptions. Despite not knowing the actuarial assumptions actually relied on in setting the conversion factors, the complaint contends that the conversion factors themselves are lower than those that would be generated if reasonable actuarial assumptions had been used. The complaint does not identify what would constitute reasonable actuarial assumptions, but concludes that the plan could not be using reasonable actuarial assumptions.

The U.S. Bank plan targeted by the Smith v. U.S. Bancorp complaint is comprised of many DB Plans. Participants who accrue benefits under a "final average pay" formula, which utilizes average pay and years of service as earning factors, are given the option of early retirement. As discussed above, to account for the increase in expected payment dates that come with an early benefit, the normal benefit must be reduced upon early retirement. To make such a reduction, the plan relies on an early commencement factor which applies directly to the normal retirement benefit without specifying the actuarial assumptions used to generate such early commencement factor. Like in PepsiCo., the U.S. Bancorp complaint alleges that the early retirement commencement factor must necessarily have used unreasonable assumptions, for reliance on reasonable actuarial assumptions produces larger annuity amounts on early commencement. Unlike in PepsiCo., the complaint's drafters identify the actuarial assumptions they have relied on for sake of comparison. In so doing, they suggest that even allowing for some flexibility in the definition of "reasonable" actuarial assumptions, U.S. Bancorp has fallen outside of the realm of "reasonableness."

Looking Forward - What Plan Sponsors Should Do Now

While most of the ERISA litigation focus for the past several years has been on 401(k) and other defined contribution plans, these cases show that DB Plans are not immune from litigation risk. Sponsors of older DB Plans, especially plans with older mortality tables, should track how these cases proceed. Plan sponsors and their benefit committees may want to consult with their legal counsel and plan actuaries to take a fresh look at the actuarial assumptions used by their plans and at least consider whether any updates might be appropriate.