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Summary: The panelists discuss recent developments, especially government laws and rules, affecting pension plans in the U.S. that are not being covered at other sessions.

Mr. Richard G. Schreitmueller: I'm with the Alexander Consulting Group where I'm director of regulatory and legislative services, which basically means that I help them keep track of late-breaking developments. We'll discuss about eight rules and regulations from ERISA agencies and the Treasury. We also have some important court cases to talk about, plus three miscellaneous developments involving legislation or other issues.

Our main speaker is Mark Wintner. Those of you who were at the Vancouver meeting in 1995 saw the two of us conduct a similar session on late-breaking developments. They keep giving us new material, so we're back. Mark is a partner in the New York City law firm of Stroock & Stroock & Lavan, where he heads up their ERISA and employee benefits group. Mark is very active in legal consulting to corporations on a wide range of employee benefit issues, especially regarding bankruptcy reorganization. Mark did his undergraduate work at Queens College. He then attended the University of Chicago Law School and received a degree in taxation at New York University School of Law. Mark often speaks before professional groups, and this is his fourth appearance on a Society of Actuaries program.

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DEPARTMENT OF LABOR (DOL) BULLETIN ON EMPLOYEE EDUCATION

Mr. Mark Wintner: As indicated, we will discuss late-breaking developments, focusing on those from the first half of 1996. The first item on the list is the DOL interpretive bulletin on investment education. This is both new and not so new because the process really started in December 1995, when the DOL put out an exposure draft of their guideline. Doing that was somewhat unique, but in this case they clearly stated that they didn't want to first come out with a guideline and have everybody take pot shots at it afterwards.

Though it is not a regulation, and not a mandatory rule, it is an interpretive bulletin as to the difference between investment education and investment advice. Why does that even matter to anybody? The DOL, in the preamble, in background interviews, and in sessions such as this, stated that it came to their attention that some employers, or some consultants, were hesitant to give too much investment advice to participants. Here we are talking about participant-directed plans, typically a 401(k) plan, although it doesn't have to be uniquely a 401(k) plan. One of the reasons given for the hesitancy to give that advice or educational material was a fear on the part of the employers or the consultants that giving such advice would make them fiduciaries. That may or may not have been a problem a couple of years ago. I think the marketplace has probably already bypassed the DOL's concern. People are doing this, have been doing this for years, and whatever their qualms, they just swallowed it or accepted that they might be a fiduciary and so be it.

Nonetheless, the DOL did come out with this interpretative bulletin, at least in proposed form, and if nothing else, it made people feel that what they were doing was acceptable. The DOL indicated that it would not view certain activities as being investment advice, but merely investment education. Therefore, in its view, unless there was something else going on, the DOL would not raise the question about whether the person giving that education could be deemed to be a fiduciary as a result of giving that information.

The DOL structured the interpretive bulletin in terms of granting certain safe harbor activities. They said it's not exclusive, but they listed four safe harbor areas of information that could be safely provided and still be on the education side of the line, not the advice side of the line.

1. Plan information—you can give as much information as you want about how the plan works, how the elections work, and the type of returns the plan has received.

2. General financial and investment information— that would apply to giving information on what the markets are doing, what the characteristics are of certain managers and certain mutual funds or certain alternatives.

3. Asset allocation models—probably everybody has seen this, either in their own plan or in their clients' plans. And these are models that attempt to identify, based on certain characteristics in terms of age, the resources, closeness to retirement, whether there are other plans, so forth and so on. Whether or not a certain individual might get a particular model which would suggest certain ratings as between fixed-income equity, growth equity, and so forth. The use of those asset allocation models is fine.

4. Interactive investment material is a spin-off from the third. It enables the employee to make his or her own model from time to time, because even if the model works today, it may not work next month or next year when the participant has hit the lottery.

Getting back to the asset allocation model, let's suppose the model suggests that you have a certain weighting in a bond fund, and there are three different bond funds. If the consultant is going to identify that you ought to be in a bond fund, and the consultant's firm offers one of the three bond funds, then they also have to let the participant know that there are other choices under the plan. And if you don't know enough about what those choices are, you can speak to the plan administrator or someone who will give you that information.

The question is whether or not the person who is giving the information would have been a fiduciary in the first place, vis-à-vis a participant. To be a fiduciary, you not only have to give investment advice, but also you have to give it under certain circumstances such as where somebody is relying on you and is paying for that to be specific advice and not general. Probably, in most cases, much of the type of information we're talking about would not have been sufficient to make the person giving the information a fiduciary in any event. However, the litigation risks in this area are enormous. If I say that I think you might win a particular issue, if it were ever litigated, take it at that. The litigation risks in this area multiply year after year because the dollars involved will multiply year after year. Therefore, although today much of what the bulletin did was simply give people comfort about what wasn't a problem to begin with, it may be that going forward it does give them some real protection from the law veering off in the wrong direction.

DOL RULES FOR DEPOSITING EMPLOYEE CONTRIBUTIONS

The second DOL development is the proposed rules for depositing employee contributions. This one is much more heated than the first one. Probably everybody knows the background, but without the background it doesn't make too much sense. I'll also have some caustic comments for the DOL, which won't make too much sense without the background.

The background is that the DOL started investigating whether employers with 401(k) plans were withholding amounts from employees for too long a period of time. What does "too long" mean? Well, it means different things. First, there is an eight-year old regulation that addresses this. It indicates that an employer, when it withholds monies or receives checks from employees for benefit plans, should segregate those funds from its own assets and turn the money over to the plan as soon as it can reasonably do so, but not more than 90 days after the date on which it was received or withheld. The DOL quite properly noted that some employers had either misread this innocently, or misread it very aggressively and intentionally. The 90-day rule was never intended to be a safe harbor; it was intended to be a limit.

The obligation to turn it over to the plan as soon as is reasonably practicable has been there for eight years. That's not news. The Department started investigating plans and claims to have found hundreds of plans where employers were holding onto the money too long. Again, it was done either innocently or more frequently, because in the DOL's view, employees wanted to play the float and keep that money as a short-term revolving source of financing or because they were outright crooks or frauds. The DOL, with much fanfare, claimed that they had found these dozens or eventually hundreds of employers, and had recovered or were in the process of recovering $5–6 million for plans, and ultimately for the working public. The DOL said there was an immediate need to change the rules, both to protect employees so they know the money does go in eventually, and to protect employees from being caught in the middle if the employer winds up in an insolvency proceeding while the money is sitting with the employer, in which case the employees simply have a claim. Many people, myself included, think it's no accident that this happened in an election year. A $5–6 million problem in a 401(k) universe, which now is estimated to hold $800 billion to $1 trillion, should be viewed as a major success, not a minor failure.

And, to give the DOL its due, it said that most employers were complying with both the spirit and the letter of the law, but some individuals pointed out the need for immediate emergency action. The DOL proposed to change the rules to require, again, that these amounts be segregated from the employer's general assets and turned over to the plan as soon as is reasonably practicable, and to change "in no event more than 90 days thereafter," to, "in no event later than the date on which the employer would have a Federal Insurance Contribution Act (FICA) or income tax withholding requirement with regard to amounts withheld from the employee."

That deadline varies depending upon the size of the employer and the size of the payroll. It could be as soon as the next day or very commonly it could be within a couple of days, or it could be the 15th day of the month following the day on which the monies are retained. The DOL did emphasize that, again, this was an absolute timetable in which to get the money in and it didn't mean that you could take advantage of it. If you could put the money into the plan sooner, you had to. And the DOL said, and again they initially announced this in the proposed regulation back in December, that they would hold hearings. The way they announced it made it sound like they weren't really interested in what anybody had to say, although eventually they were interested.

The announcement that accompanied the proposed regulation said large employers should have no problem doing this because they have computers, and if they could do it for taxes they could do it for plans. The reaction was mixed. I think everybody agreed 90 days was too long, and everybody agreed that an employer who took advantage of the 90 days when he could reasonably segregate earlier should be investigated and nailed by the DOL. However, there was widespread criticism of the degree to which the proposed regulations sought to change things. The timetables were seen as much too fast, particularly by a lot of large employers who have multiple payrolls, multiple plans, or participants making multiple elections. It's fine to say that you have to get the money out from the risk of creditors, but what do you do with it? Are you going to risk misallocating it to the wrong investment pools? Large employers also pointed out that the irony was that the DOL had trumpeted that a lot of small employers were abusing the system and large employers weren't. However, under the proposed regulations, large employers would have to pay the price by putting the monies in immediately, whereas the small employers with the small payrolls would still have the longest period of time. It was not exactly a solution meant to address the problem.

The DOL backfilled a little bit. In March they came out with a much trumpeted voluntary pension payback program, pursuant to which they said people who wanted to fix the existing problem, if there was one, could repay the plan the amounts that they should have paid over by September 7. If they do that, they will not be investigated, and will not be nailed for penalties. To cover that, the DOL had both a prohibited transaction exemption proposal and an announcement from the IRS that they will not seek to assert any penalty tax. However, and I don't know what the experience has been in that program, it is voluntary. Any employer who wants to do it must meet several conditions, among which he can't take advantage of it if he is already under investigation. If he avails himself of that program he must announce it to the DOL, and he must announce it in writing to his participants. I don't know whether or not that is going to be attractive to people, or whether any employers out there fit the profile. After the proposed regulation came out in

December, there were 500 letters of comment and two days of testimony. The DOL has announced, on several occasions, it would be coming out with a regulation, and has said the final regulation will be much softer than the proposed regulation, and they have listened to the comments and have incorporated many of the changes. We'll see.

IRS RULES ON 204(H) NOTICES

Let's now switch to the IRS. The IRS came out with two sets of proposed regulations back in December, and they are still in proposed form. The first is the 204(h) notices. The requirement is that, if an employer is going to reduce the rate of accruals, then in order for the amendment to be effective, the plan administrator has to give affected participants 15 days advance notice. That requirement was added by the single employer pension plan amendment (SEPPA) act of 1986. I think it became effective in 1987. There has been no real statutory or market change that would have prompted the IRS to get these rules out now. Maybe somebody knows why they did it, but the regulations are welcome in any event.

The proposed regulations have a couple of interesting items. They clarify that, first, from the statute itself, it's known that the only plans subject to it are defined-benefit pension plans and money purchase plans. The timetable is laid out in 204(h) of ERISA—by the way there is no parallel provision in the Internal Revenue Code (IRC), but nonetheless the IRS has the regulatory responsibility for the funding rules under both Title 1 and the Code, which is how the IRS winds up promulgating these rules. For plans that are subject to funding, the requirement is if there is a significant reduction in future accruals, then the 15-day advance notice must be given to each affected participant or alternate payee, and to any union who represents such a person. What is a significant reduction? The regulation says it depends on facts and circumstances. I don't know if that's helpful or not. I think that's where people thought it was before and maybe it just confirms that there is some leeway so that de minimus reductions don't have to be subject to a notice. However, don't ever come to me asking for an opinion as to what would be a de minimus reduction which would allow you not to give the notice, other than I guess $1. In most cases, if you are aware of the issue, it's just easier to give the notice than to worry if you have an ineffective amendment for failure to have given the notice. After the fact it might be helpful to try to defend why you didn't give the notice.

The IRS also clarifies that you only have to give the notice to affected participants. So that if there are different classes of employees covered by a plan and a particular amendment is going to affect salaried, rather than hourly, or people at one location and not another, or people who became participants after a certain date and not before, and so forth, it's only the affected class that has to get the notice. You don't have to give notice to everybody. Whether you want to or not is an administrative issue.

The IRS also indicated that in the future it can relieve plan administrators of the burden of having to give the notice, if the reduction is required by a change in law and if the IRS has given advance notice by a revenue ruling or other notice which is published in the *Bulletin.* You can't get retroactive relief from the IRS on a case-by-case basis that way.

Two items are interesting from the proposed regulation. One is the IRS gives a little leeway on de minimus failures, and they clarify what the effect is of a failure that is not de minimus. Let's say you have given notice to most of the affected participants, but you have failed to give it to, what they call, a de minimus percentage of employees. Again, I would never do this ahead of time in terms of planning, but after the fact sometimes you do discover that you've missed people. If the people who didn't get the notice and should've gotten them are a de minimus percentage, and the plan administrator can show that it was a good faith failure, then the amendment is effective as to the entire class, even those who failed to get the notice. If, on the other hand, the failure to the group who failed to get the notice is more than de minimus under the proposed regulation, then the amendment will be effective as to those people who got the notice, but will not be effective as to those people who don't get the notice until such time as the notice is furnished.

That raises all sorts of interesting questions in terms of funding, and uniformity, and discrimination, none of which are addressed by this particular proposed regulation. Again, if you are aware of the problem, the best way to avoid the problem is to give everybody notice upfront. It's only after-the-fact problems that, perhaps, can be alleviated by these rules. IRS has indicated that they will try to finalize this regulation in 1996.

IRS RULES ON PLAN LOANS

Next is IRS plan loan rules. Although the handout lists this as 401(k) plan loan rules, the plan loan rules are actually broader in the real world universe, I suppose 401(k) plan loans are between 90–100% of plan loans. Again, the IRS was unprompted by any recent specific development, but it's helpful to have the proposed regulations. Here they addressed rules that have been in the statute starting with the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) in 1982, although they have been amended and modified several times since. As IRS indicated in the preamble as well as in speeches and informal talks since then, these were consciously not addressing all plan loan rules that are out there, and that, indeed, they welcome comments as to other issues they might address in subsequent proposed regulations.

They did focus on a couple of deemed distribution problems under Section 72(p), governing plan loans. Section 72(p) was enacted in reaction to a perception that loans were being used as an abusive way of getting monies out of a plan, in what were truly nonloan situations. It starts with the premise that if you have a loan that doesn't meet all of Section 72(p), it will be treated as a deemed distribution and immediately taxable. Therefore, if you can't show that you meet 72(p), the participant who thinks he has a tax-free loan actually has a taxable distribution.

The proposed regulation focused on three requirements. One is the repayment term loan; that is, it must be repayable by its terms within five years, unless it's for the purpose of a principal residence, in which case there is no per se term limit, and must actually be repaid within the five years. That is, you have to do it in your documents and you have to do it in actuality. Second is that the loan has to call for level amortization with payments being made at least quarterly. Third, and somewhat surprisingly, is one that we often find in the real world but not everybody focuses on it, although everybody probably takes it for granted. There has to be a real enforceable agreement. A loan, even if you comply with everything else, if you didn't do the paperwork, you have a taxable distribution, not a loan.

The proposed regulation puts some meat on the bones of each of those. What's most interesting, from my experience, is that the regulation provides two grace period rules that people have talked about and, in the real world, have probably been relying on for some time. But for the first time, it is in writing and official from the Service. The problem with grace periods, of course, is it is nice to have them, but then you can't go beyond them.

The first grace period would indicate that, for a participant who has a loan and fails to repay it during a leave of absence without pay for up to one year, a plan administrator can treat that as not putting the loan in default, and therefore, not in violation of the level amortization rules that otherwise would require quarterly payment. That probably, again, conforms to most people's understanding of what has been the IRS's unofficial position anyway. The IRS also makes it very clear (and I think everybody was aware of this) that you can't use the one-year grace period to go beyond the five-year limit. It's merely an exception to the quarterly amortization requirement, not the five-year term.

The second grace period that the regulations would allow is if a loan is in default, it would allow the administrator to give up to one quarter of grace. That is, assuming you miss the payment on June 28, if that was the required due date, then an administrator, if he wants to not declare it in default, can allow that delinquency to be cured up until September 30, the end of the next quarter. These are permissive, and plans don't have to take advantage of them, but they can if they want.

The regulation also, very importantly, distinguishes between what it calls deemed distributions for failures to meet these Section 72(p) requirements, and what it calls actual distributions, but that's a misnomer. It's another type of deemed distribution. Those come about if a plan seizes upon the security in the form of a plan interest, and in effect, seeks to offset a delinquent loan against an employee's plan interest. In some plans and under some circumstances you can do that. But if the employee is under 59½, and you're talking about a 401(k) plan, and the employee has not terminated employment, then while you can have the security in place, you can't seize upon it merely because the loan is delinquent. If you have a defined-benefit plan, and the employee is not of retirement age, you can't seize upon it simply because he is delinquent. You could if he terminated employment, but not simply because the loan is callable. In those circumstances, what the IRS calls actual distributions (although they really are a different type of distribution), will be treated as an actual distribution and will call into question qualification issues for the plan.

Failing to meet the Section 72 requirements for repayment by level amortization and having an enforceable agreement, even if violated, will simply be tax problems for the individual participant, not problems for the plan, from a qualification standpoint. If any of those are triggered, then the individual participant may have ordinary income tax. He presumably will, assuming he is in a tax-paying position. If he's under 59½ he may have a 10% penalty tax and depending upon the totality of distributions, he may or may not have an excess distribution tax. I think the hearing is supposed to be very soon.

Before we move on to the next point, I just wanted to add two things on the IRS proposed rules for plan loans. As always, when you talk about plan loan rules, it is important to remember that there are at least two, probably four, bodies of law that apply here, and you always have to look at all of them. You never just look at the IRS regulations, even when they're final, without looking also at the DOL rules. You also have to be aware of whether or not the truth-in-lending rules apply to the information given to the participant at the time of the loan. You also have to be aware of whether or not you can have a payroll deduction under the state labor laws if applicable. I'm not going to answer those issues, they're just issues that have to be looked at. You can't stop with the IRS loan rules.

Second thing I want to mention, and it really has nothing to do with the loan rules, is a recent marketing development which I found quite interesting. With much fanfare, BancOne has announced the availability of plan loans through credit cards. This is purported to solve all of the DOL and IRS questions which might arise from loans. I've seen their program at the public level, but not behind the scenes. It's quite elaborate and answers a lot of questions, but I'm not sure on the face of it, it answers all the questions I would have. If anyone is aware of it, it might be an interesting discussion. But if they are out there in the market, you can be sure they don't have a proprietary protection over that idea. Other people are going to be out there and unless the IRS or DOL does have major problems with it, it's probably a new development that's going to be on the next agenda.

PENSION BENEFIT GUARANTY CORPORATION (PBGC) ASSUMPTIONS FOR SPINOFFS

Next, a quick mention of the problems that came up with the PBGC concerning plan spinoffs and the use of certain assumptions. Is this a new issue? Well, it is in the real world and it is legal for some reasons, and for other reasons it is really a very old issue which has just surfaced. Plan spinoffs have been around for a long time, and so have Section 414(l) rules. However, recent legislation made spinoffs a reportable event, and therefore, notice of it now has to go to the PBGC. We don't know whether it's the notice requirement that triggered the PBGC's interest in this or is just another area in which the PBGC has decided to become more pro-active, and less passive than in the past.

At the end of 1995 it came to everybody's attention that upon receiving notice and becoming aware of a particular transaction, the PBGC had questioned whether or not the assumptions used in a plan spinoff were reasonable, and, in effect, moved to block the particular spinoff in question. It's important to focus on the facts of the case, and although this was, in effect, a private negotiated deal, the facts came out through a series of letters that were released to the public. Whether those are the true facts or just tailored facts, who knows? You had a fairly major deal, a buyer and a seller, and you had a single plan that was overfunded, with over $100 million in assets and liabilities. According to the PBGC, it was characterized as being overfunded by more than $30 million. You then had the seller saying to the buyer that there was going to be a split of the plan, with a portion of the plan going over to the buyer. The PBGC said that 414(l) allows you to use either the PBGC termination assumptions, in which case you are fine as far as they're concerned, or reasonable assumptions. You don't have to use the PBGC assumptions. But the PBGC says that if you use reasonable assumptions, it will take a look to see whether they are reasonable. And if it concludes that they are not reasonable, then it may take action to seek to block it. In this case, the PBGC concluded, from its actuarial review, that the spunoff plan, in their view, was going to be underfunded by $20 million on a termination basis. So they are going from a situation where they have one plan with a $30 million cushion, in their eyes, to a situation where there are two plans and one of those plans has a potential $20 million underfunding.

Now we all know the way the PBGC views underfunding is beyond worst case. Nonetheless, it is there and it can't be ignored. You can argue with it, but it is there. In this case they said that they gave the actuaries in question an opportunity to demonstrate to them that you could go out and buy annuities and pay lump sums without the plan being underfunded on a hypothetical basis. Failing to get such information, the PBGC went ahead and told the trustee of the plan that if the trustee went ahead with this split the PBGC would view it as a breach of fiduciary duty and would refer the matter over to the DOL and the IRS for further investigation. Not surprisingly, the trustee doesn't get paid enough to run a multimillion dollar risk on that basis; therefore, both refused to go ahead or indicated it was going to take a long time studying the matter. Since Wall Street doesn't like to hold up deals for months or years at a time, the deal was recut, and it never really came to a head. Nonetheless, the PBGC has reiterated that it will continue to take that position in deals that are coming down the pike. The PBGC has often indicated that in addition to whether or not there are fiduciary breaches, if it views a transaction as one that will put a plan in jeopardy, it may use its involuntary termination powers under 4042. In this case it didn't get that far because the trustee blinked.

We've also been told that other deals have had to be recut or restructured to avoid similar results because people would rather do deals than argue with the PBGC for months or years. There's no right or wrong to it. I would say, again, that the PBGC is often far too conservative and protective of its own turf in how it measures these things. On the other hand, the sense or the smell of it is that in this particular deal it did have a bad flavor to it because it appeared that people were using the over-funding asset to help set the price of the deal. And that, in effect, probably did raise legitimate concerns at the PBGC, not merely overcautious concerns.

The other thing to note forever: people like us and like you have bemoaned the fact that government agencies are often run by people who haven't been out there in the real world—who are very bright, but sometimes have spent their entire careers in agencies and don't know what it's like to do deals. In this case, that cuts both ways. The head of the negotiating team for the PBGC in this area is a former Wall Street partner who is an ERISA attorney (who used to cut deals like this every day of the week or month) as well as an investment analyst who used to work at Salomon. And, while they are no doubt very protective of the PBGC's turf, in this case understanding how these deals get cut wasn't necessarily good for the buyer and seller. It may work against the buyer's and seller's interest.

Mr. Schreitmueller: Before giving you the actuarial portion of the rules and regulations, I want to add a word or two to what Mark said about this PBGC issue. The AA and the SOA, ever since the PBGC came out with their position on spinoff assumptions, are putting some effort into studying ways it might be possible to give all of us professionals some support in finding ways to do these deals without necessarily using the PBGC's assumptions, which everyone recognizes are conservative.

IRS RULES FOR CASH-BALANCE PLANS

We have another couple of rules from the IRS that have been out a little while and fall within the scope of our session, so we'll discuss them briefly. First is IRS Notice 96-8, which came out around January 1996 regarding cash-balance-plan accruals and lump sums. This is long, long awaited. Cash balance plans have been around for ten or more years, and a task force has been studying these issues for about four years. Many consultants, probably some in this room, are working with the IRS trying to resolve some of this. The problem, of course, is that a cash-balance-plan looks like a defined-contribution plan, but all the rules you have to apply are defined-benefit rules, so you're trying to fit a round peg into a square hole. The IRS finally came out with preliminary guidance that's a precursor of a proposed rule.

Ideally, what everyone in the private sector would like the rules to say is that you can pay a lump sum equal to the employee's account balance. That, of course, is what you do under a defined-contribution plan. But under defined-benefit plans you have this accrued benefit at 65 to worry about, so you carry the account balance forward and backward and quite often you get a different number if you follow the usual defined-benefit rules.

These suggested rules, which are still being negotiated informally behind the scenes, get into the concept of front-loaded versus back-loaded cash-balance plans. When someone terminates before retirement age, the question is whether the account balance is frozen at that point or whether the plan provides for carrying it forward with interest. If the plan says you will carry it forward with interest, that becomes a front-loaded plan, to use IRS terminology, and these regulations deal with it. Basically they provide safe harbors for front-loaded plans whereby, if the rate of interest you're crediting is based on Treasury rates plus a limited margin or spread over and above the Treasury yield, then you can pay the account balance.

Or you can specify the consumer price index (CPI) increase plus a spread up to 3%. But if you do something outside that range, then you have a potential problem because it's one of these cases where no generous act goes unpunished. The higher your interest rate is, the more trouble you may be in. You may have to, as some plans are doing now, compare your lump sum with the present value of the accrued benefit. Anyway, that process is moving forward and there is a good deal of hope that the IRS will come out with sensible rules.

CHANGES OF FUNDING METHOD

Another one that came out around year-end has to do with automatic IRS approval of changes in funding methods. There was a hiatus of a couple of years where we didn't have the old IRS rules on that subject, which were in the old Revenue Procedure 85-29. That Revenue Procedure, which had been extended year after year, said that under a wide range of conditions you had an automatic approval of your new funding method. Well, 1994 came and went and that Revenue Procedure did not get extended, so if you wanted to change your funding method in 1994 and you were playing by the rules, you had to request specific IRS approval of the change.

Finally, at the end of 1995, the IRS came out with Revenue Procedure 95-51, which has new rules for getting automatic approval of funding method changes. It's more detailed and specific, with a number of changes from the old rules. If you want a detailed summary, apart from what's in the Revenue Procedure itself, the *Enrolled Actuaries Report* for February 1996 had a table by Gene Fife comparing the old and new rules point-by-point. I'm not going to try to cover all of that, but briefly, the Revenue Procedure describes what are some acceptable methods, and this does include many of the ones you would want to use. It does not include the frozen attained-age method. You have to get individual approval for that.

Similarly on asset valuation methods there has been some changes. You can use straight market value, or there's an average value that you can use. Those get automatic approval, but if you use something else you have to get individual approval. Finally, if you're changing your valuation date, it's OK if you're using the first day of the plan year, but if you're using something else, you have to go in for approval. It's not much fun to follow all the procedures and go in for approval, but that's the way they have it set up. There are also new rules about how you amortize any bases that you have to set up because of the change in funding method. Again, if you want more on that, you can look to the *Enrolled Actuaries Report.*

INFLATION-LINKED TREASURY BONDS

Our last set of rules came out from Treasury a few weeks ago regarding inflation-linked bonds. These rules are summarized in our handout titled "Treasury to Issue Inflation-Linked Bonds" which is getting published in the *Pension Section News*, so we won't go through all that but will touch on highlights.

Last year there was an editorial in *The Actuarial Update*, a newsletter of the AAA, in which the editor, Adam Reese, made a few suggestions for public policy. Adam is originally from the U.K., and his idea was for the U.S. issued bonds to instead of paying a fixed rate of interest such as 7%, pay amounts geared to the CPI. The interest rate would be only 3% or 3.5%, something on that order, but the principal would go up with the CPI so that interest payments would go up with it and protect people against inflation. The following issue of *The Actuarial Update* published two letters. One letter by me said this is a very good idea and listed several advantages. The other letter by another actuary said Reese must be crazy. The Washington air must be getting to him, because why would anyone want inflation-indexed bonds? So Reese published another explanation, expanding on what he had said the first time about why this really did make sense, because other countries were doing it and so forth. Of course, none of us knew that within a year Treasury was going to make a very serious proposal to do just what Reese suggested.

After the announcement last month, I spoke to a man at the Treasury Department who said they'd been working on it for 15 years. He was pretty thrilled that his "baby" was going to be born. They are going to be issuing these bonds in about six months, by year-end. They have a number of details to work out. But, from our point of view, the issue is, what are the possible uses of these new bonds? To me, the most obvious one is that, if you work with an insurance company, you might be thinking hard about developing an indexed-annuity product. That would seem to have a lot of use. I'm not suggesting that everyone will rush out and buy one, but there must be some takers out there, and if the insurer has a government bond to invest in, it becomes a safe product to issue. The duration of these government bonds will probably be limited to 30 years, but I would think an insurance company could see its way clear to issuing immediate life annuities invested in that type of security.

Treasury is hoping to issue some of these bonds to individuals. If you took a 30-year inflation-indexed bond, you could strip the coupon from the principal. The principal part of that becomes a zero-coupon bond and would have some appeal to nonretired people who are saving for retirement. It's fully indexed to the CPI. You can put it in an IRA or defined-contribution plan or your college fund or whatever you're investing for, and it's a nice inflation hedge if you believe that the CPI, or whatever index they're going to use, is geared to inflation.

On the other hand, a retiree who's in the payout phase might like the other half of that security, the coupon part. The retiree could take just the coupons, and if he thinks he has about 30 years to live, that could be a very good place to put some of his money. So I believe there are going to be retirement products developed using those new securities, either free-standing or through insurance companies or through pension funds, including both defined-benefit and defined-contribution plans. There are other insured products that might be able to make some use of these bonds, which we won't get into here.

A few weeks ago, *Pensions & Investment* magazine said that the defined-benefit pension fund at U.S. West, the big telephone company, invests in foreign bonds that are indexed to inflation. Inflation-linked bonds have different investment characteristics that are different from conventional bonds, and evidently the fund managers like those characteristics. If interest rates go up, the market values don't necessarily go down; they might go sideways or even go up a little. So, for a defined-benefit pension fund, these new bonds have some uses. That concludes our discussion of rules and regulations, and now Mark will tell us what has been happening in the courts.

CF&I BANKRUPTCY CASE

Mr. Wintner: I will discuss three court cases and each of them is important. In addition, there's a truly late-breaking development. I've been waiting about three months for the Supreme Court to decide a case called *CF&I*, which it has done in the last 24 hours. So, although it's less important, it's more late-breaking, and I'll start off with it.

CF&I is a bankruptcy and excise case. It grows out of a situation in which *CF&I*, which was a steel company in Colorado, had several defined-benefit pension plans. When *CF&I* went into bankruptcy, it had missed a couple of contributions, so ultimately it also had underfunding problems with the PBGC. But here we're simply talking about the Section 4971 first-tier excise tax for failure to meet the minimum funding contribution requirement, which apparently was triggered before *CF&I* filed its bankruptcy petition. The bankruptcy case goes along, *CF&I* winds up selling off its assets, and it does not internally reorganize, and it exists solely for the purpose of ultimately paying out a claim to its creditors. The IRS comes in and asserts, in addition to a lot of other IRS claims, that with regard to this Section 4971 first-tier excise tax, that it has an excise tax.

It is called an additional tax in Section 4971. And excise taxes on transactions occurring during basically the three years preceding a Chapter 11 filing are entitled to a priority treatment under the Bankruptcy Code. There had been a host of cases over the last 10–15 years involving various fact patterns and various different excise taxes. All were variations on the question of whether something that is called an additional tax or an excise tax should be treated as such where its purpose is penal and not economic. We all know that the excise tax on failure to fund is a penalty. It is not called that under the IRC, but the purpose is penal, and the way it's figured is penal. It's a percentage of the amount that was not contributed to a plan, and is a potential 100% if it's not corrected. It has always been described as a penalty to force an employer to make a contribution, and therefore, a line of cases have gone off on whether or not for bankruptcy purposes, you can treat it as a penalty and not an excise tax. If it is a penalty, then it is not entitled to priority; it becomes a general unsecured claim of the IRS. Most courts have said that the bankruptcy court could look beyond the label to see the purpose, and if it was a penalty, treat it as such, not as an excise tax. The IRS disputed that and had several decisions going its way as well.

The Supreme Court has now decided in the *CF&I* case that this type of excise tax is not entitled to priority as an excise tax, and for bankruptcy purposes you can look to the underlying nature of the excise tax. The significance really comes in if you have a plan with minimum funding contribution requirements and it does wind up filing for Chapter 11. There is always the question, do you meet minimum funding or not? If you don't, do you have excise penalties to pay, or is everything put on hold until the Chapter 11 case is decided? And if there's going to be a reorganization, do you know how much other creditors are going to be paid? This case would indicate that bankruptcy courts can look beyond the label to that purpose. By the way, this again, involved a prepetition claim. It probably doesn't decide what happens if it arises postpetition, although many of the factors and legal considerations ought to be the same. Without having seen the case, I hesitate to draw a conclusion yet.

THREE OTHER RECENT CASES

Let's get back to the agenda. Each of the three cases, as I indicated, are important. By necessity, we'll hit highlights. In each case, understanding the facts is very important. Indeed, cynics like myself, would say the facts are probably more important in figuring out how the courts got to where they did, than the legal considerations. They often read as if they knew where they wanted to get and then spent 30 pages justifying how they got there. Some lawyers often say bad facts make for bad law, and a lot of these cases have that consideration.

Second, the *UNISYS* case is a third circuit case; the other two are Supreme Court cases, and therefore, are more binding and more broad based. Nonetheless, *UNISYS* is important, even though it doesn't have the weight and authority of a Supreme Court case.

Third, when we talk about *Varity Corp.* vs. *Howe* and *Lockheed Corp.* vs. *Spink*, you will get the sense that they were written by different Supreme Courts. That is, they don't exactly contradict each other, and they are not inconsistent with each other, but they have very different views of the world, such that you would almost think that when they decided one, they forgot that they had decided the other. And, indeed, Justice Thomas is increasingly becoming "Mr. ERISA" on the Supreme Court, for better or worse. He has written a couple of good decisions, but he's writing for the court in *Lockheed Corp.* vs. *Spink* and he's writing the dissent in *Varity Corp.* vs. *Howe*.

UNISYS

In the UNISYS case we have three considerations: fiduciary responsibility, employee communications, and 404(c). First, it is important to note that UNISYS is not ultimately a decision on the merits. It came up to the Third Circuit on a motion to dismiss, which the lower court gave to UNISYS and against the plaintiff. Although a lot of the discussion is terribly favorable to the plaintiff participants and terribly negative to UNISYS, the employer, and the fiduciary, nonetheless, the Third Circuit doesn't decide ultimate liability in this case but simply suggests that there may be ultimate liability here. I don't know what UNISYS is doing in terms of the remand.

UNISYS, as most of you probably know, grows out of a failure of Executive Life GICs, which were in the UNISYS 401(k) plan. UNISYS had a 401(k) plan that offered at least six different investment alternatives. It had a bond fund or a GIC fund, which included more than just Executive Life GICs, which were a meaningful percentage of that fund. It was participant-directed, giving employees the ability to change from time to time, although the extent of that ability was part of what the court considered.

Much of the concern over the UNISYS decision focuses on both what it said and what it held, as well as a lot of its discussion on fiduciary responsibility. The UNISYS court says that in making its decision to invest, the financial people at the company were acting in a fiduciary capacity. Nobody's going to quarrel with that. They then said a fiduciary doesn't have to be an expert, subject to the general prudent man standards of ERISA. Nobody objects to that. How they apply those general standards, however, is fairly horrific for anybody who is a nonprofessional.

First, UNISYS went out and hired a consultant, Johnson & Higgins, to advise on whether or not this was a good GIC. This was back in 1986 or 1987 when Executive Life had the highest rating from two rating agencies and a lower rating from a third agency. As a factual matter the advice was somewhat equivicable, although generally favorable. Johnson & Higgins, at this point, also got dismissed, which further clouds the factual contents of this case. The court addressed the issue of relying on Johnson & Higgins' advice to invest in Executive Life. Johnson & Higgins had certain qualifications to advise, and was a consulting firm, but not itself a rating agency. The fiduciaries at UNISYS making the decision did not fully understand all of the considerations that went into either the rating or Johnson & Higgins' advice. So the court went on to say they encourage people to go out and hire consultants, and they don't want to force everybody to duplicate or triplicate work that those consultants are doing. They could not, as a matter of law, find without further investigation that what UNISYS did met its fiduciary standard requirements of fact-finding.

I've got to tell you, what UNISYS did was probably what more than two-thirds of the people did back in 1986–87, and is probably what they are doing today. How many times did people make decisions to offer mutual funds or various investment pools that look fine on the surface? How far do you have to go? UNISYS would, at a minimum, suggest that if you don't have full-time investment professionals in your own organization, you ought to seriously consider having, not merely investment managers or mutual funds, but investment consultants who can evaluate those investment managers or those investment funds. Is it going to be an added expense to the plan? You bet. If you are a fiduciary, are you going to feel comfortable without that added layer of protection? You're not going to feel as comfortable as you did before the *UNISYS* case.

Again, I don't want to belabor the factual content, but it is important. Part of the problem is that there are a lot of little nuggets in this 30-page decision. Although, it ultimately does not appear in the court's consideration of what were the proper factors, the court did note in passing that at the same time UNISYS was buying Executive Life GICs for the fund, it also got rid of an Executive Life contract that was backing up the chairman's individual supplemental executive retirement plan (SERP) and replaced it with another insurance policy from another insurance company. Let me put it another way: it was that allegation. And, again, this case is not deciding the facts, it's just deciding what facts; might make a difference.

The court also indicated (and this is very important) that even if the first investigation was adequate, and the court is suggesting it may not have been adequate, that when the same people went ahead and purchased a second Executive Life GIC six months later, that unless they redid their investigation from scratch, they couldn't simply say that if it was acceptable in June, it ought to be acceptable in December. That's fine in theory, but think of the additional cost that is going to impose on plans in the real world. The court says over and over again, it's simply going with the general ERISA fiduciary standard; it is not imposing any 20/20 hindsight requirements. I'm not so sure about that. In any event, it's there, and it has a lot of people worried about acting individually as fiduciaries if they are not professionals.

Although we are not dealing with it today, what goes hand-in-hand with that court case is letters from the DOL and the Comptroller of Currency, involving derivative investments, which make the same point. If you are not a professional and don't fully understand the risk of what you're investing in, you may have very significant fiduciary risks. What's worse is if you hire somebody to do it and you don't fully understand whether they know what they're doing, then you still have a fiduciary risk. So, I'm not sure how many levels of fiduciary professionalism will have to be imposed before a fiduciary feels totally comfortable that he's insulated. I don't know if there are enough levels. But, as a result of this case and some of the DOL announcements, many fiduciaries are taking a look at whether or not they need more professionals in there.

Another important issue is employee communications, and we'll see this again in Varity. UNISYS gave employees information, as required, concerning each of the investment alternatives. Executive Life started falling apart; it didn't do so overnight but probably over a 12–15-month period. In 1990 it started announcing writeoffs with assurances that it was doing fine and could handle those writeoffs. Executive Life gave public assurances. It went around over a 12–15-month period and met with people like UNISYS who had large contracts. However, that unraveled to the point where in April 1991 the California Insurance Department took it over. At that point, anybody who had Executive Life GICs wound up being frozen for a couple of years. Ultimately those things did get repaid in substantial portion, but not without some risk and loss of principal, and a lot of loss of interest. UNISYS did put out special information in 1990. After this hit the papers, people were getting nervous. UNISYS emphasized that everybody was always at risk on anything, including Executive Life GICs. But they did not give any special warnings or sound any special alarms with regard to the Executive Life GICs.

Again, there are some factual nuggets in the first part of the decision. I don't know about you guys, but when we do deals or when we have major projects, everybody carefully keeps their handwritten drafts, sends them to file and if you don't get it back within a week you can never find it again. Not true here. Bless their little hearts, somebody kept real good records, because it appears there were initial drafts which fully highlighted some of the problems with Executive Life GICs, and some of the people in UNISYS crossed those out and handwrote notes about how this will cause a panic, or it will get everybody worried. The version that went out wasn't a whitewash, but it was certainly blander. There is certainly reason to think it was done, perhaps paternalistically but nonetheless knowingly, to prevent people from fully understanding the types of risks facing them. The court went on to say that when UNISYS acted in that capacity, it was a fiduciary, (which is pretty clear in this case) and a fiduciary cannot miscommunicate.

It leaves many questions open about how much information you have to give, or do you have to give any to begin with. Do you have an obligation to furnish information and are you, in fact, furnishing information that can't be misleading. The court didn't say it was misleading, but said we can't decide it on the papers and therefore we need more facts.

Lastly, UNISYS said, but hold on, guys, this is a 404 participant-directed plan. And even if we did everything wrong up to this point, 404 says that a fiduciary will not be held liable under a participant-directed account for investment decisions made by the participant. The court concedes that, and the court says specifically that, yes, that protection contemplates that the fiduciary did something wrong in the first place, or he wouldn't need that protection. They reiterated that a fiduciary doesn't lose the protection merely by having breached a fiduciary duty. However, the court goes on to say that a fiduciary can only avail himself of that protection if 404 has been satisfied in all of its aspects. Those aspects include providing adequate information to the participants so that they can control their investment decision.

This case, by the way, precedes the current DOL regulations, so that some of the concepts are what's in the regulations but in a different form. Did employees fully understand how frequently they could move in and out of these GICs, and did they fully understand the choices available to them under the plan? Again, the court did not say that UNISYS doesn't have 404 protection; it just said to send the case back for further fact-finding. If I were at UNISYS, I would not be real happy about where that's headed. Again, the case makes fiduciaries very nervous about how professional you have to be as an amateur fiduciary, and still be prudent. And it makes them very nervous about how much information you have to give. Do you have to scare the pants off of your employees, or else run the risk of a fiduciary breach? I'm not so sure anymore. While 404 gives you protection, are you going to worry that every time you need it, there's going to be litigation over the facts and no real assurance or safe harbor that you can say that you've met those requirements? Again, this is pre-DOL regulation, so maybe things aren't quite that bad, but people are nervous.

Varity Corp.* vs. *Howe

Now turn to *Varity Corp.* vs. *Howe*. Now we're in the Supreme Court. You can't appeal from the Supreme Court; that's why they are called the Supreme Court. *Varity Corp.* vs. *Howe* also comes up on a horrible fact basis. It starts off with findings by two lower courts that the employer had deliberately and knowingly and fraudulently misrepresented facts to the employees, who thereby relied on it to their detriment. So we are starting off with some very bad guys before the Supreme Court. And the Supreme Court is deciding a couple of issues.

Varity owned some good companies and some bad companies. And Varity put all of its bad investments into a new company, and tried to cram as many underfunded pension and retiree benefit plans as they could (some people might call it benefit dumping), into this company and sent it off on its way. It would no longer be part of Varity, which was keeping the good companies and keeping the good plans. That new company did not tank immediately. With hindsight everybody agrees, or at least the record books of the Supreme Court show, that it was probably insolvent from day one, and it would go into Chapter 11 within 18 months. It eventually tanked.

Varity held a meeting with a group of about 1,500 employees, before all this happened, and at the point it was creating this new entity, Varity told them that there was going to be this new entity. It had great hopes for it. It had a hard road in the mid-1980s in rust-belt America, but if the employees did what they were capable of, there was no reason that this company couldn't make it and the benefits at this new company were going to be the same as they were at the old company. We now know none of that happened. And the court is led to believe that Varity didn't believe it would happen, and that it knew that, barring a miracle, this company was going to sink sooner or later.

The legal issues, however, which are of great importance are as follows: When the officers from Varity held that meeting, were they the employer or a fiduciary? Varity said they were an employer talking to employees about employment conditions and about what was going to happen. They had the ability to simply terminate those retiree medical plans, but they didn't. They had this new company provide plans so that employees had a chance, although it didn't work out. The Supreme Court said, siding with the lower court, that when the company held that meeting it was a fiduciary and the administrator of the plan. It was wearing both hats, and this is what probably has more people upset than anything else. Reasonable employees could have concluded from that meeting that you were wearing your plan administrator hat when you communicated that everybody would be fine with regard to their benefits by going with the new company. It's one thing to say that Varity may have been the plan fiduciary when it undertook that, although that, in itself, is fairly horrific if you think about how many times an employer talks about benefits and doesn't think it's acting as the administrator. Even worse is that the reasonable employee's perception is a standard rather than the court's perception. It has a lot of people wondering whether it's a good idea anymore to name the company as the administrator of the plan, as is frequently the case. The alternatives are not so great either, but at least it's something that almost everybody should be examining.

Another question is whether individual participants could bring a breach of fiduciary duty action and claim equitable relief in the form of being restored to the old plan under ERISA. In a very important case about ten years ago, *Mass Mutual* vs. *Russell*, the Supreme Court said that for breaches of fiduciary duty under 502(a)(2) of ERISA (which is there to protect the plan), not to give individual participants benefits. Individual participants can always sue for plan benefits if they have been denied, but that wasn't the problem. The problem was that the employer had gone under and there was no longer a plan at the new company, and these people were no longer in the old plan. The right to sue for benefits wasn't getting them anywhere.

Another very disturbing aspect of *Varity Corp.* vs. *Howe* is that the Supreme Court was very conscious in saying that from now on participants (this gets a little technical) can bring a breach of fiduciary duty action under 502(a)(3), which was not addressed in the *Mass Mutual* vs. *Russell* case. They reached that decision in part because, without that, employees would not have had any relief under ERISA, and they did not want to leave employees in that position. That undoes a lot of learning in the ten years since *Mass Mutual* vs. *Russell*. It's not so much that it is a terrible result, but it comes close to overruling *Mass Mutual* vs. *Russell*, but not quite. Since *Varity Corp.* vs. *Howe* came out, as predicted, a lot of people who previously had filed cases under 502(a)(2) have simply amended them to file under 503(a)(3) against the fiduciaries. We'll see how far this case goes.

Lockheed Corp. vs. *Spink*

Lockheed Corp. vs. *Spink* involves an allegation on an early retirement window, where an employer placed a condition on the ability to get additional service under the window on the employees' providing releases from possible liability for age discrimination—a very common fact pattern for early retirement windows. The employee sued claiming a breach of fiduciary duty because the employer was using the plan assets to secure for itself a release of liability under the Age Discrimination in Employment Act of 1967 (ADEA). It was thereby using the assets of the plan for its own benefit. The same Supreme Court that decided *Varity Corp. vs. Howe* now decides that when it acted in that capacity the employer was the employer, not a fiduciary. Having benefit plans always has an incidental benefit to employers in terms of happy and satisfied employees. That's why those benefit plans are there to begin with. But that in the manner in which it amended it to add this early requirement window, the company was not acting as a fiduciary; it was acting as a settlor or as an employer. The court reiterated that in the Curtiss-Wright decision, which was last year's case that applied to amendment or termination of a welfare plan, this holds true for pension plans as well.

This case also decided an issue with regard to crediting retroactive service, which the lower court had decided on a basis I can't imagine. When the Congress said that the Omnibus Budget Reconciliation Act (OBRA) 87 change, which in effect said you couldn't deny benefit accruals on account of age, was to apply for years after January 1, 1988 to employees who worked after January 1, 1988, the Congress meant it. You also couldn't force employers to give retroactive service to people who happened to be there on January 1, 1988.

PENSION SIMPLIFICATION AND FINANCIAL ACCOUNTING STANDARD (*FAS) 87/106* SURVEY

Mr. Schreitmueller: Let's push on with the tax bill. There are over 40 employee benefit provisions of this bill by chapter and verse. Starting out with nonpension provisions, we first have the one about employees versus independent contractors. This issue has been around for many years. The IRS has been getting increasingly tough, and so this provision in the Senate bill, if it goes all the way, is going to be helpful to employers both in clearing things up and in being a little gentler than the IRS has been.

By the way, I should give you my prediction on this bill, which I think is consistent with what the panelists said yesterday at the session on pension simplification. It's not a sure thing, not a done deal, but it looks like there's a better than 50/50 chance that the bill will get through the Senate in July and get signed into law before Congress goes home in early October. There are maybe two chances out of three that that will happen.

Next is employer-provided educational assistance. I'm sure many of you have run into this in your consulting, where employers are paying tuition for employees and the tax break was not extended past 1994. Well, what they are going to do here if they can pass this law, is they will extend that retroactive to 1995, and the details are spelled out fairly well.

The next major item is about the law regarding veterans' re-employment. This is a major issue because it affects almost every plan. There has been a law on the books for almost two years which says you have to give certain extra benefits. Meanwhile, the Revenue Code says you're violating the Code if you do this. The veterans' law says you must make these changes, although perhaps not the plan amendments, by October 1996, and that date is looming closer. If they can pass this law, there's going to be a scramble to comply. If they can't pass this law or something like it, no one is sure of what's going to happen. It's not going to make folks inside the Beltway look very good.

The next item is about minimum required distributions at age 70½. They are going to give plans a little bit of a break. The Code now requires that you pay benefits to employees who are over age 70½ even if they continue to work. This bill says you can defer paying benefits; however, if it's a defined-benefit plan, you have to give an actuarial increase unless it's a governmental or church plan.

By the way, my list leaves out a lot of these niche items about governmental plans, church plans, 403(b) plans, and so forth. There's a lot of good stuff in there but this is more from the viewpoint of a large, single employer. Simplified employee plans are changed in this bill, and it's hard to say how important that's going to be, but it's very big politically. The so-called simple plan has Dole's fingerprints on it. There's also the NEST plan with Clinton's fingerprints on it. They are almost the same but the one difference is a 1% automatic contribution. This bill has the simple version, and Clinton would rather see his version, but it's doubtful that will happen.