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ACA/APL Presentation

"Procedural prudence" in buy-outs and buy-ins: a legal view

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Introduction

Two broad goals for this evening:

- Discuss the litigation which ensued in the States when a well known US bulk annuity provider, Executive Life, went into insolvency
- Consider, as a group, whether the US experience can help us think about the way we manage risks inherent in the process of advising our clients on the selection of bulk annuity providers, both the:
  - Risks to scheme members; and
  - Risks to the professional advisers, in particular the EBCs

Points we will cover in this talk

- Is the US model applicable to the UK?
- The US cases:
  - *Bussian v RJR Nabisco*, 21 F. Supp. 2d 680 (S.D. Tex 1998), rev'ed in part, vacated in part, 223 F.3d 286 (5^{th} Cir 2000); and
  - *Riley v Murdock*, 890 F. Supp. 444 (EDNC 1995), aff'd 1996 U.S. App. LEXIS 9964 (4^{th} cir. Apr 30, 1996) (unpublished)
- IB 95-1: The "safest available annuity standard"
- Implications for the UK

Is the US model applicable to the UK?

- Pensions Regimes in the US and the UK
- Insurance regimes in the US and the UK

Pensions regimes in US and UK

- Based on same underlying principles
- DB schemes set up under trust with a fiduciary looking after members' best interests
- ERISA was a model for the Pensions Act 1995
- Standard of care governing fiduciary's conduct:
  - A fiduciary should act "*with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims"* Section 404(a)(1)(B) ERISA
  - "It is the duty of a trustee to conduct the business of the trust with the same care as an ordinary man of business would extend toward his own affairs" Bartlett v Barclays Bank [1980] Ch 515 at 531.
- US courts interpreting ERISA make reference to English trust law antecedents
- PBGC was a model for the PPF.

Insurance regimes in the US and the UK

- US insurance providers
  - Must be licensed by the state in which they do business
  - Subject to supervision by state insurance regulators
  - Must satisfy applicable financial safety standards
  - State guarantee associations potentially available to “bought out” pension scheme members holding annuities in insolvent carrier
- UK insurance providers
  - Must have FSA or EEA “permission” to carry out insurance contracts
  - Subject to supervision by FSA
  - Must satisfy applicable financial safety standards
  - FSCS “safety net” potentially available to “bought out” pension scheme members holding annuities in an insolvent carrier.

A bit of background to Bussian

- Late 1980s days of surplus
- US companies terminated plans and purchased annuities taking a refund of surplus
- First Executive ("junk bonds") and its California and NY subsidiaries under investigation by their respective state insurance departments
- US Department of Labor responsible for enforcing ERISA proceeded against imprudent fiduciaries who chose ELIC annuities on two fronts:
  - Litigation: often criticised for making its views known through litigation
  - Regulation: IB 95-1 "safest available annuity" standard

Bussian v RJR Nabisco

- Sponsor purchased an ELIC annuity and took a reversion of the surplus.
- EBC's due diligence exercise:
  - Compiled a list of providers with whom he was familiar, that had a reputation for good service, capacity for the placement.
  - Didn't include ELIC junk bond ratio higher than its competitors.
  - Sponsor asked EBC to add ELIC to influence other bidders.
  - EBC added ELIC to the list after he: reviewed ratings agencies reports (good ratings), resolved the junk bond issue (even though high, its investments were diversified).
  - Moody's downgraded ELIC (ELIC assured EBC that Moody's did this for publicity, it was new to the ratings business and needed to gain some attention by taking this bold step).
- Sponsor chose ELIC.
- ELIC went into insolvency.
- Members' benefits shortfall.

Bussian at the 5th Circuit Court of Appeals

- Sponsor breached its fiduciary duty:
  - It relied on a defective EBC report and a defective EBC investigation.
  - While a fiduciary is not required to become an expert, he can't use a report alone to fulfil his responsibilities.
  - A fiduciary must investigate the expert's qualifications; give him complete and accurate information, ensure that his reliance is reasonable.
  - A fiduciary is not expected to duplicate the expert's analysis, but to analyse it critically.
- EBC's due diligence was defective:
  - Limited financial analysis, too much reliance on ratings agencies.
  - Spent more time negotiating to lower the bids than evaluating bidders.
  - Failed to review ELIC's financial statements, reports disclosures.
  - Unaware that regulators were investigating ELIC's reinsurance practices and that they were considering capping insurers' junk bond holdings.

Riley v Murdock: a prudent investigation

- The court reached a different result in *Riley v Murdock* because the sponsor fiduciary engaged in a procedurally prudent investigation.
- Why was this investigation prudent?
  - The sponsor established a committee that engaged in an extensive independent investigation.
  - Retained a law firm and investigated each bidder by:
    - Undertaking a thorough financial and administrative analysis.
    - Contacting the providers' senior management.
    - Reviewing financial statements, quarterly reports and other financials.
    - Consulting with a specialist insurance evaluator and others who purchased ELIC annuities.

What do Bussian and Murdock teach us?

- While ELIC ended up in the same place (insolvent and unable to pay benefits due) in both cases, the *Murdock* defendants prevailed because they engaged in a procedurally prudent investigation.
- The test of prudence is not one of "hindsight".
- Events occurring after a decision is made will not "render a decision imprudent". The central issue is whether the "fiduciary's decision was reasonable at the time it was made".
- Post Script: Hydra-headed state guarantee association litigation.

IB 95-1: Interpretative Bulletin Relating to the Fiduciary Standard Under ERISA When Selecting an Annuity Provider

- Prudence under IB 95-1 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”.
- A fiduciary should evaluate the potential provider’s “claims paying ability and creditworthiness”. Don’t rely on ratings services alone, do consider:
  - the quality and diversification of the provider’s investment portfolio;
  - The insurer’s size relative to the proposed contract;
  - The insurer’s capital and surplus;
  - The provider’s business lines and other indications of its exposure to liability;
  - The structure of the annuity contract and guarantees supporting the annuities, such as the use of separate accounts;
  - The availability of additional protection through state guaranty associations and the extent of their guarantees.

UK Implications

Broadly, there are two categories of implications flowing from what I've said this evening:

- The implications on the steps UK trustees should take in conducting a procedurally prudent process in selecting a bulk annuity provider.
- The implications for EBCs and other professionals whose advice has led his client to choose an annuity in an insurance carrier that becomes insolvent and whose insolvency leaves scheme members with a shortfall in their expected pension benefit.

Let's look first at the implications for the EBCs.

Implications for EBCs

- A variety of discharges will be available to the trustees depending upon whether the transaction was a buy-out, partial buy-out, or a buy-in (buy-ins are different, the annuity becomes an asset of the scheme).
- Jonathan Moody is publishing a very detailed paper on the discharge issues.
- This means that members who have suffered a loss will be looking for someone other than the trustee to make good the loss.
- Risk of a negligence action in tort against the EBC under the *Hedley Byrne* principles.
- Broad outline of *Member suffering a pension shortfall v EBC*:
  - The member would need to show that the EBC owed the member a duty of care, that the EBC breached his duty, and that the breach caused harm to the member.
  - Broadly, to show that the EBC owed the member of duty of care in tort, the court considers 3 issues:
    - Was the damage suffered foreseeable?
    - Was there proximate cause between the negligent behaviour and the cause of the harm to the member?
    - Would it be just and reasonable to impose such a duty?

Implications for the conduct of a procedurally prudent process in selecting a bulk annuity provider in the UK

- Read the expert testimony in the *Bussian* case
- What does your firm do?
- Does your firm have an internal panel which reviews insurance companies?
- Do you commission an independent report from a specialist insurance valuator?
- Do the trustees you advise read the reports?
- Do the trustees meet with the valuator?
- Do you meet with the valuator?
- Do you probe the valuator's report?
- Do you know what the source of the financial information in those reports is based upon?
- Do you know how old the information is in the reports?
- Do you determine what charges the insurance company is subject to?
- Do you meet with the providers themselves?
- Do you seen any Implications for auctions?
- Chance for us to think about this now that there is a "pause" in the market.