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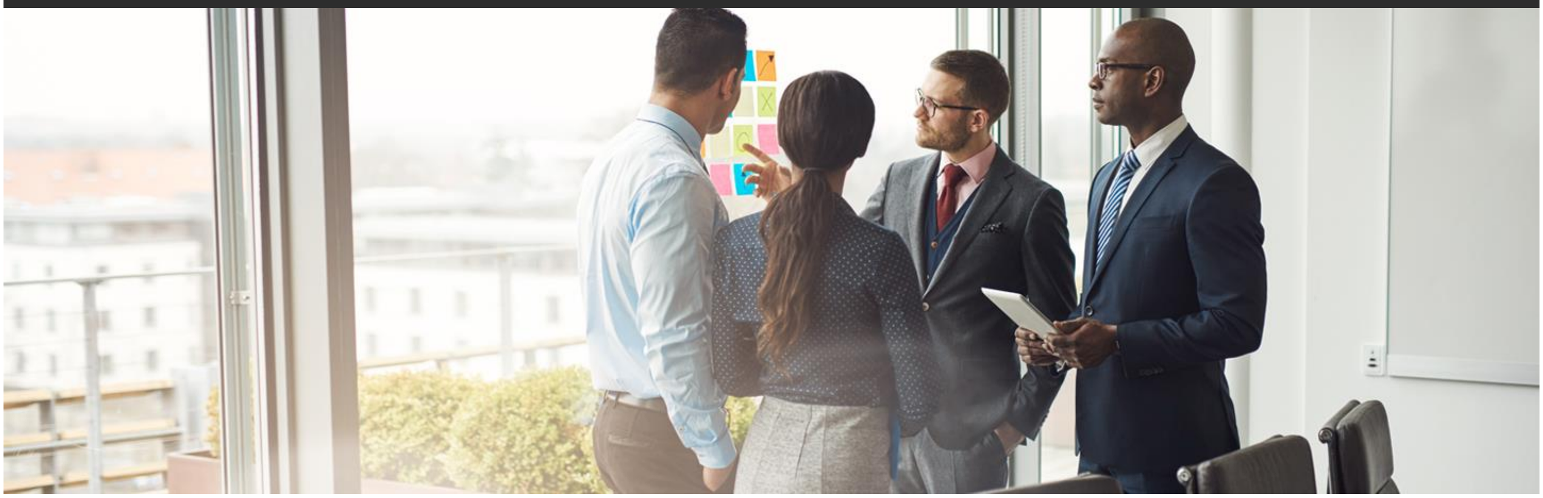

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$59 Million Settlement in Pension Plan Outdated Actuarial Assumption Litigation

For many years there has been concern that when pension plans collapse, it may in part be attributable to the failure of employer plan sponsors to conduct the selection and monitoring of actuarial assumptions in a prudent, objective manner. This is because the Employee Retirement Income Security Act of 1974 (ERISA) only requires the use of "reasonable" assumptions and "actuarial equivalents"; and because these terms are not defined in the statute, they could mean different things to different people, particularly to different actuaries.

Most recently, there have been challenges to the use of pension plan mortality assumptions and, in particular, claims alleging that the use of older mortality tables in connection with the calculation of joint and survivor benefits violates ERISA's anti-cutback rule. These cases generally are settled, since winning a motion to dismiss is difficult when alleged violations depend on the meaning of the term "actuarial equivalent," the definition of which is far from clear, and courts normally conclude that discovery is necessary before ruling on the merits of the claim.

A dramatic, recent example of this dilemma occurred in a Massachusetts district court proceeding, when an employer agreed to a $59.17 million settlement in a proposed ERISA class action accusing it of using outdated mortality rates to calculate pensions. *Cruz v. Raytheon Co.*, Mass. Dist. case number 1:19-CV-11425-PBS, Feb. 16, 2021.

The employer had argued in its motion to dismiss that the retirees failed to make the case that the plan violated ERISA by unreasonably using a mortality table created in 1971 and a 7% interest rate to calculate retirees' alternative annuity benefits it said would be "actuarially equivalent" to the plan's benefits. The employer argued that its conversion factors for determining the alternative annuity benefits were reasonable and that the retirees were attempting to force their own arbitrary actuarial assumptions. The employer further asserted that under ERISA, employers sponsoring pension plans have wide discretion in determining which actuarial assumptions or conversion factors can be used, requiring only that the single life annuity (SLA) normal form of benefit is equivalent by actuarial standards.

The lead named plaintiff retiree in this proposed class action claimed that because of the use of the 7% interest rate and out-of-date mortality rates, he received $57 less per month and had his benefits slashed by $10,741. The plaintiff also said the employer knew the mortality rates were outdated, because the employer included a 2014 mortality table in financial statements filed with the U.S. Securities and Exchange Commission, and recognized the improvements to mortality.

Background

Plaintiff filed the proposed class action on behalf of participants and beneficiaries receiving pension benefits in the form of a Joint and Survivor Annuity (JSA) or Pre-Retirement Survivor Annuity (PSA) from the employer's Salaried and Hourly Employees, Bargaining and Non-Bargaining Retirement Plans and other plans (Covered Plans). Plaintiff argued that ERISA requires that JSAs be at least the "actuarial equivalent" of the SLA that the participant could have taken when he or she began to receive benefits and that PSAs be equal to the survivorship portion of a hypothetical JSA that is actuarially equivalent to an SLA.

Two benefit forms are "actuarially equivalent," the plaintiff said, when they have the same present value, so long as the present values of both benefits are calculated using the same, reasonable actuarial assumptions. The actuarial assumptions that are used to calculate present values for purposes of determining actuarial equivalence involve mortality and interest rates. Mortality assumptions, which are generally based on a mortality table, estimate how many benefit payments will be made, based on the ages of the participant and (in the case of JSAs), the beneficiary. Interest rate assumptions discount the value of expected future payments to present value. When payments under one benefit option are likely to extend longer than those under another option, the monthly payments under the first option will be lower, to account for the likelihood that more payments will be made. For example, the plaintiff said, the monthly benefit payments for a JSA will be lower than an SLA because of the possibility that the beneficiary will receive benefits after the participant's death. But, the present values of those two streams of benefits must be the same, to satisfy actuarial equivalence.

Plaintiff alleged that the employer calculated JSA and PSA benefits using outdated mortality and interest rate assumptions, which caused benefit payments to be less than an "actuarially equivalent" amount. In other words, the plaintiff argued, the present values of JSA and PSA benefits generally were less than what they were entitled to pursuant to ERISA's actuarial equivalence requirements. Also, the plaintiff alleged that the plan in which he participated used the same 0.9 conversion factor regardless of whether a participant began receiving benefits at age 55 or age 70. Because younger people have lower mortality rates than older people, the result of using a single factor resulted in participants who retired below the average age subsidizing those who retired above the average age. Thus, for some participants, the amount of this age-based subsidy resulted in the calculation of a JSA or PSA benefit that was greater than it would have been had reasonable actuarial assumptions been applied.

The employer filed a motion to dismiss the complaint, which was denied by the district court. Subsequent to the denial, the parties moved for summary judgment. While the motions were pending, the parties entered into a settlement agreement, which was approved by the district court.

Settlement Terms

The material terms of the Agreement are summarized below.

Settlement Class: The Settlement Class includes (1) each participant in a Covered Plan who began receiving a JSA as of June 27, 2013, or later, and who received a monthly payment of that JSA benefit from such Covered Plan in December 2020; (2) each beneficiary of a participant in a Covered Plan, where such participant began receiving a JSA from such Covered Plan as of June 27, 2013, or later, and such beneficiary received a monthly payment of the survivor component of such JSA from such Covered Plan in December 2020; and (3) each surviving spouse of a participant in a Covered Plan, where such participant died on or after June 27, 2013, before the participant began to receive benefits from such Covered Plan, and such surviving spouse received a monthly payment of a PSA from such Covered Plan in December 2020.

Increased Benefit Payments. The Covered Plans will be amended and the benefits of participants or beneficiaries who were injured will receive an increase to their future benefit payments. The amendment is intended to provide class members with an increase in their benefit payments equal to 40% of the calculated shortfall in their past and future benefit payments, less any amounts awarded by the court for attorneys' fees and expenses, as well as any case contribution award for the lead plaintiff. The shortfall calculation uses the methodology for selecting actuarial assumptions set out in the Plaintiff Expert's Report (the Plaintiff Expert's Assumptions).

The Plaintiff Expert's Report identified the following actuarial assumptions as reasonable: (a) the RP-2014 mortality table referenced in the employer's 10-K Benefit Plans 715 Report (blended 50% male and 50% female) for the year ending before the class member retired; (b) the discount rate on Dec. 31 before the class member retired, based on the FTSE Above-Median Index (which closely tracks the rates in the employer's 715 reports for the class member's plan); and (c) using multiple annuity conversion factors based on actual retirement age and not a single factor for all class members.

Example: The named plaintiff retired on Nov. 1, 2015, and began receiving his pension benefits in the form of a 50% JSA that pays $1,021.33 each month. The SLA that he could have selected when he retired would have paid $1,135.82 each month. Using the Plaintiff Expert's Assumptions to convert the $1,135.34 SLA, the 50% JSA would pay $1,066.31 each month. The difference between the $1,066.31 JSA calculated with the Plaintiff Expert's Assumptions and the $1,021.33 the Named Plaintiff is currently receiving is $44.98 (Monthly Shortfall).

With respect to the adjustment for past benefit payments, as of Dec. 31, 2020, the named plaintiff had received 62 benefit payments; the total shortfall over that period ($44.98 x 62 months) was $2,788.76. Adding interest of 2.82%, the named plaintiff's Past Shortfall Amount as of Jan. 1, 2021, was $3,005.42. Based on the current ages of the named plaintiff and his wife and using the Plaintiff Expert's Assumptions to annuitize the $3,005.42 Past Shortfall Amount, the named plaintiff's additional prospective increase to future benefit payments is $13.00.

The sum of the named plaintiff's Monthly Shortall and his additional prospective increase is $57.98. Applying the reduction factor of 40%, the named plaintiff's gross benefit income (GBI) would be $23.19. The present value of the named plaintiff's GBI is $13,012.

According to the Court, the *average* benefit increase under the settlement is $21.40 each month, and the present value of the average class member's net benefit under the settlement is $4,737. Based on the Plans' records, there are over 10,000 class members.

Litigation Trend

Other lawsuits have accused employers of violating ERISA by using outdated actuarial information to calculate pension benefits.[1] This may only be the tip of the iceberg, potentially marking the beginning of a litigation trend by ERISA class-action attorneys.

Employers must be able to substantiate the reasonableness of the actuarial assumptions used to calculate plan liabilities, if they are significantly different than the assumptions used for financial reporting purposes. These assumptions include mortality, discount rate, and annuity conversion factors, which should be based on actual retirement age.

Implementation of an independent, robust, and prudent process to ascertain the reasonableness of actuarial assumptions is a strong line of defense. Employers sponsoring pension plans may wish to perform a risk assessment by notifying the plan actuary to begin a review process and consider retaining an outside actuary to provide a second opinion. This review process should be conducted by outside independent ERISA counsel on a privileged basis. It is an important matter to have on record if litigation is filed.

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[1] *See*, e.g., Pepsico (*DuBuske v. Pepsico, Inc.*, 7:18-CV-11618, SDNY, 11/22/19); American Airlines (*Torres v. American Airlines*, 4:18-CV-983-0, ND TEX., 8/7/19); Bancorp (*Smith v. US Bancorp*, 219 U.S. Dist LEXIS 107481, D. Minn, 6/26/19); Partners Healthcare (*Belknap v. Partners Healthcare System*, No.1:19-CV-11437-FDS D. Mass 1/24/20).