

CONNECTICUT INSURANCE LAW JOURNAL

Volume 23, Number 1
Fall 2016



University of Connecticut School of Law
Hartford, Connecticut

Connecticut Insurance Law Journal (ISSN 1081-9436) is published at least twice a year by the Connecticut Insurance Law Journal Association at the University of Connecticut School of Law. Periodicals postage paid at Hartford, Connecticut. Known office of publication: 55 Elizabeth Street, Hartford, Connecticut 06105-2209. **Printing location: Western Newspaper Publishing Company, 929 West 16th Street, Indianapolis, Indiana 46202.**

Please visit our website at <http://www.insurancejournal.org> or see the final page of this issue for subscription and back issue ordering information.

Postmaster: Send address changes to *Connecticut Insurance Law Journal*, 55 Elizabeth Street, Hartford, Connecticut 06105-2209.

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Cite as CONN. INS. L.J.

CONNECTICUT INSURANCE LAW JOURNAL

VOLUME 23

2016-2017

NUMBER 1

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CONNECTICUT INSURANCE LAW JOURNAL

VOLUME 23 2016-2017 NUMBER 1

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REGULATING HOME EQUITY PROTECTION COMPANIES AND CONTRACTS: ARE STATES MAKING “THE BEST” AN ENEMY OF “THE GOOD?”

JOHN E. MARTHINSEN*

Residential homes are the largest, most leveraged assets in most U.S. families' portfolios. Home equity protection (HEP) contracts offer opportunities to safeguard these real estate interests. In the United States, each state decides if a HEP contract is financial guarantee insurance (FGI) and, therefore, regulated by the state laws and insurance commission rules, or non-insurance financial protection (NIFP), which may escape state and federal regulations. Because HEP contracts have the potential to provide substantial benefits to homeowners, their regulation should be designed to protect state residents and encourage the development of safe alternatives. This article explains HEP contracts, their development, and why states should treat those that require material interests as FGI. Particular focus is put on: (1) the advantages and disadvantages of HEP contracts that are linked to home price indices, (2) why linking these contracts to price indices should not disqualify them as FGI, and (3) how HEP companies engage in regulatory arbitrage by linking their policies to home price indices and claiming NIFP status.

I. INTRODUCTION

Since 1945, U.S. household equity in real estate has grown more than 12,600%, reaching approximately \$12.4 trillion at the end of the third quarter 2015.¹ Despite the fact that individuals may face a greater likelihood of their houses falling in value than suffering damage from fire, wind, hail,

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¹ FED. RESERVE BANK OF ST. LOUIS, ECONOMIC RESEARCH, *Households: Owners Equity in Real Estate, Level*, <http://research.stlouisfed.org/fred2/series/OEHRENWBSHNO> (accessed January 1, 2016).

lightning, theft, or vandalism, the U.S. financial and insurance markets have developed few practical ways for families to protect themselves against declining real estate prices.² Furthermore, where and when alternatives have been offered, turnover has been rather weak – even when policies were subsidized.

As their name implies, home equity protection (HEP) contracts safeguard the non-debt value (i.e., equity) of residential homes, but their particular forms can vary considerably. They could be written to safeguard only homeowners' initial down payments, but coverage could also be broadened to include home improvements, mortgage amortization, and cost-of-living adjustments. HEP contracts could be offered only on primary residences or made available for second, third, or investment homes. Maturities could be long-term (e.g., 10-to-15 years), short-term, with the expectation of rollovers every two-to-three years, or last as long as the policyholder owns a protected home. Premiums might be up-front, lump-sum payments or monthly installments. When a protected home is sold, these contracts could be assumable – or not. Contracts might restrict claims to individuals who sell their homes at a loss and move certain distances away, but they could just as easily allow claims at contract maturity or remove all limitations so that claims can be made any time the contract is in-force.

Insurance is an elusive term, which explains why it is defined in different ways by different states. In general, it (1) is a contract, (2) with consideration secured by premiums that (3) pays or indemnifies the contract owner for (4) fortuitous³ events that (5) cause financial loss. If a HEP contract is classified as financial guaranty insurance (FGI), then it is regulated by state laws and insurance commission regulations. By contrast, if the contract is classified by a state as non-insurance financial protection (NIFP), then it escapes that particular state's regulations and possibly federal regulations, as well.

The National Association of Insurance Commissioners (NAIC) defines FGI as a contract that protects a policyholder from “*changes in the value of specific assets or commodities, financial or commodity indices, or*

² Robert J. Shiller & Allan N. Weiss, *Home Equity Insurance*, 19(1) J. REAL ESTATE FIN. & ECON. 21 (1999).

³ In this context, *fortuitous* means that claims and the events that trigger them are independent and identically distributed (i.e., random), which implies they cannot be accurately forecasted.

price levels in general.”⁴ Despite this guidance, each state can determine whether a HEP company is engaged in *the business of insurance* and, therefore, should be regulated as an FGI company.

In the past, FGI contracts focused mainly on protecting investors from credit risks associated with interest-earning public securities, such as municipal debt obligations, and private debt obligations, such as commercial mortgage-backed securities, collateralized debt obligations, automobile loans, and student loans. Since the 1980s, many states have required FGI companies to follow monoline rules, which have forced them to separate this business from other insurance lines. Such partitioning was intended to isolate FGI risks from other insurance lines so that contagion into or out of this sector did not occur.

This article explains HEP contracts, their development, and why states should treat those that require material interests as FGI. Particular focus is put on: (1) the advantages and disadvantages of HEP contracts that are linked to home price indices, such as the S&P/Case-Schiller Index, Federal Housing Finance Administration's Index, and CoreLogic Index, (2) why linking these contracts to price indices should not disqualify them as FGI, and (3) how HEP companies engage in regulatory arbitrage by linking their policies to home price indices and claiming NIFP status.

II. WHAT ARE HEP CONTRACTS?

HEP contracts offer policyholders practical ways to safeguard the equity investments in their homes. If done correctly, these contracts can improve capital market efficiency, lower borrowing costs, and provide capital market access to borrowers with relatively low credit ratings. They can also provide social benefits, such as increasing labor mobility (e.g., accepting jobs that require relocation and the sale of homes at losses).⁵ On the negative side, HEP contracts may encourage individuals to increase debt levels to unsustainable levels; discourage routine home maintenance

⁴ See Nat'l Ass'n Ins. Comm'r, *Definition of Insurance: Definition of Insurance Working Group* (Sept. 12, 2000) (unpublished manuscript), <http://www.naic.org/store/free/DOI-OP.pdf>; see also, NAIC Financial Guaranty Insurance Guideline: § 1A (1) (e), <http://www.naic.org/store/free/GDL-1626.pdf> (accessed January 1, 2016) (emphasis added).

⁵ See Yulia Demyanyk, Dmytro Hryshko, María José Luengo-Prado, & Bent Sorensen, *Keeping the House or Moving for a Job*, 9 FED. RES. BANK OF CLEVELAND. ECON. COMMENTARY 1 (2013) (explaining doubts about this benefit).

improvements, and repairs; and induce premature home sales in declining markets, thereby accelerating systemic reductions in real estate prices.

Normally, HEP contracts have one-time costs (e.g., between 1.5% and 3.0% of a home's protected value),⁶ long-term maturities (e.g., 10 to 15 years, but they terminate when a home is sold), relatively short vesting periods (e.g., 2 years), and maximum limits on claim payments (e.g., 25% of the protected value). Other limitations often apply, such as deductibles and denial of claims on foreclosed homes.

The vesting period has two major functions. First, it discourages short-term, speculative gains by flipping homes (i.e., purchasing houses with no intention to occupy, making minor improvements, and then quickly trying to resell them at higher prices). Second, by delaying claim payments, vesting reduces the ability to forecast changes in real estate prices, which (perhaps, ironically) improves the ability to price option contracts.

A. AN EXAMPLE OF HOW HEP CONTRACTS WORK

Consider a family that purchases a home for \$100,000, with a \$90,000 mortgage loan and \$10,000 down payment. To protect its equity investment, the family purchases a HEP contract having a two-year vesting period, 10-year maturity, and maximum payout of 25%. Exhibit 1 shows the consequences if the home is sold after its value rises by 10%, stays the same, or falls by 10%, 30%, and 40%. Notice that, during the two-year vesting period, the contract pays no claims, regardless of the percentage decline in the home's sales price. Afterwards, a ceiling of \$25,000 is imposed on claims when the home's selling price falls by 25% or more. Therefore, if the price falls to \$70,000, the payout cap is surpassed and claims remain at \$25,000. Similarly, a claim floor equal to \$0 occurs when the home's price stays the same or rises. In between these limits, claim payments are linearly and inversely related to the protected home's current market value. Therefore, at market prices of \$90,000 and \$80,000, these policies pay \$10,000 and \$20,000, respectively. As Exhibit 1 shows, the wealth of a HEP contract owner can rise, stay the same, fall, and even become negative, depending on the direction and extent of home price movements. This point will be important, later, in our discussion of indemnification.

⁶ Premium differences may be based on geographical location and individual considerations.

Exhibit 1						
HEP Claims and Fluctuations in Household Equity Due to Home Price Changes*						
Initial Position						
Purchase Price ... Protected Value	\$100,000	\$100,000	\$100,000	\$100,000	\$100,000	\$100,000
Mortgage Loan	-\$90,000	-\$90,000	-\$90,000	-\$90,000	-\$90,000	-\$90,000
Down payment ...Initial Equity	\$10,000	\$10,000	\$10,000	\$10,000	\$10,000	\$10,000
Percentage Change in Home's Market Price						
	+10%	0%	-10%	-30%	-40%	
Years 1 and 2						
Sales Price	\$110,000	\$100,000	\$90,000	\$70,000	\$60,000	\$60,000
Mortgage Loan	-\$90,000	-\$90,000	-\$90,000	-\$90,000	-\$90,000	-\$90,000
HEP Claims	\$0	\$0	\$0	\$0	\$0	\$0
Equity in Year 1 or 2	\$20,000	\$10,000	\$0	-\$20,000	-\$30,000	-\$30,000
Years 3 to 10						
Sales Price	\$110,000	\$100,000	\$90,000	\$70,000	\$60,000	\$60,000
Mortgage Loan	-\$90,000	-\$90,000	-\$90,000	-\$90,000	-\$90,000	-\$90,000
HEP Claims	\$0	\$0	\$10,000	\$25,000**	\$25,000**	\$25,000**
Equity in Years 3 to 10	\$20,000	\$10,000	\$10,000	\$5,000	-\$5,000	-\$5,000

* Assets and claims are positive values; Liabilities are negative values. This example ignores mortgage amortization.

** Claims are limited to 25% of the protected value.

B. BRIEF HISTORY OF HEP CONTRACTS IN THE UNITED STATES

The first U.S. experiment with HEP contracts was a Department of Defense program for military personnel in the mid-1960s, followed by a municipally sponsored program in Oak Park, Illinois during the mid-to-late 1970s. Thereafter, in 2002, Yale University's International Center for Finance collaborated with the Syracuse Neighborhood Initiative in Syracuse

N.Y. to create a non-profit HEP program, called Home HeadQuarters.⁷ Its purpose was to reinvigorate home ownership in depressed Syracuse neighborhoods. For the Oak Park experiment, claims were based on transaction prices (i.e., purchase and sale prices), while claims for the Syracuse experiment were based on changes in a price index. In 2011, Ohio-based EquityLock Solutions Inc. began offering HEP contracts that also linked claims to changes in local price indices.

Until relatively recently, U.S. housing busts were mainly regional, but the Great Recession (2007 – 2009) changed that, causing many to believe that this severe and prolonged compression of real estate prices might pave the way for tandem increases in the supply of and demand for innovative HEP contracts. Greater demand was expected from: (1) homeowners, seeking to safeguard the real estate values of their portfolios, (2) mortgage lenders, seeking protection from worrisome loan-to-value ratios, (3) investors, seeking synthetic real estate returns via futures and credit instruments, (4) developers, seeking protection from declining real estate values for projects under construction, (5) insurers, seeking hedges against mortgage defaults, and (6) realtors, real estate brokers, mortgage brokers, and home sellers, seeking ways to safeguard potential home buyers from further real estate price erosion.

On the other side of the HEP market, greater contract supply was expected from professional investors, seeking to increase their real estate exposures via financial products, instead of investing in physical properties. As well, insurance companies were expected to create new HEP products to meet the needs of homeowners, whose equity stakes were ravaged by the Great Recession.

Despite this initial optimism, the U.S. market for HEP contracts has been relatively weak. New alternatives have been slow in developing, and liquidity in existing markets has been shallow.

⁷ This contract had a 30-year maturity and one-time, up-front premium equal to about 1.5% of the protected value. Its creators felt that charging annual fees would encourage customers to drop this insurance if their home prices increased, thereby leaving the policyholder pool with only high-risk families. The loss of customers in this way could also decimate the HEP company's ability to pay claims due to the diminishing pool of invested funds.

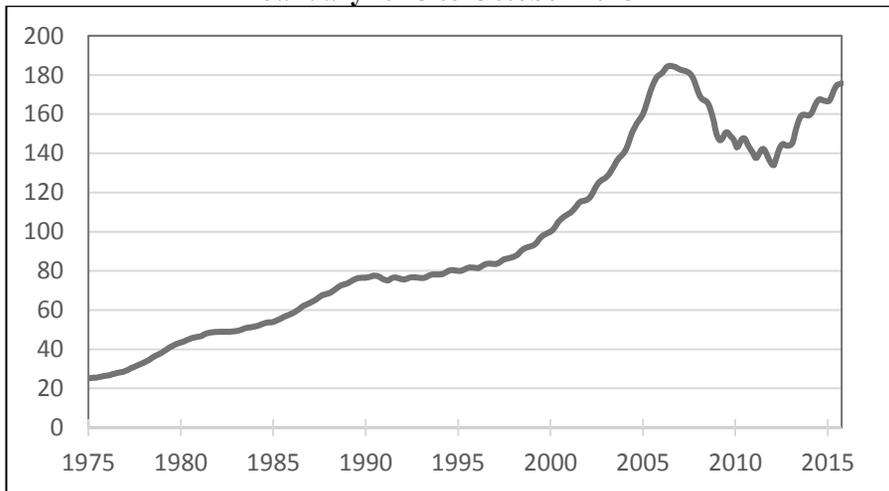
III. WHAT ACCOUNTS FOR WEAK HEP DEMAND AND SUPPLY?

HEP markets grow fastest when there are simultaneous increases in both the supply of and demand for these contracts. Unfortunately, problems on both sides of the market have been evident.

A. REASONS FOR WEAK HEP DEMAND

HEP demand is inversely related to home price expectations.⁸ It rises when expected home prices fall, due to the clear and present danger of wealth erosion, and falls when expected home prices rise, causing these fears to diminish. As Exhibit 2 shows, during the past 40 years, home prices have increased more often than they have decreased.

Exhibit 2
S&P/Case-Shiller Home Price Index
January 1975 to October 2015



⁸ William N. Goetzmann, Andrew Caplin, Eric Hangen, Barry J. Nalebuff, Elisabeth Prentice, John Rodkin, Matthew I. Spiegel, & Tom Skinner, *Home Equity Insurance: A Pilot Project* 4, 9 (Yale Int'l Ctr. for Fin., Working Paper No. 03-12, 2003).

Federal Reserve Bank of St. Louis, Economic Research, *Households: Owners Equity in Real Estate, Level*, (2014), accessed January 5, 2016, <https://research.stlouisfed.org/fred2/series/CSUSHPINSA/downloaddata>.

Lackluster demand for HEP insurance contracts has also been caused by sluggish home sales in the particular communities where they have been offered. Because these contracts are likely to be purchased at the same time as homes, their demand should rise and fall with home sales.⁹ Therefore, factors that reduce the demand for homes also lessen the demand for HEP insurance contracts. Among these reasons are recessions, burdensomely high real interest rates, high property tax rates, demographic changes, and financial disincentives, such as the availability and cost of land, which cause residents to move from urban neighborhoods, where HEP experiments have been tried, to rural areas.

The demand for HEP *financial* products, such as options, forward, and futures contracts, has been as weak as the demand for HEP *insurance* products. A major cause of this weakness can be traced to homeowners' concerns about and unfamiliarity with the risk-return tradeoffs of derivative markets.

B. REASONS FOR WEAK HEP SUPPLY

HEP contracts are mainly supplied by investors and speculators who want to increase their real estate exposures. Insurance companies that are willing and able to manage real estate price risks are also potential suppliers. Part of the uninspired increase in HEP supply can be attributed to internal problems related to suppliers' strategies and management, but relatively high real estate transaction costs, regulations, and perceived risks are also to blame.

C. INTERNAL HEP COMPANY PROBLEMS

Managerial ineffectiveness and poorly constructed business plans result in over-priced policies, high administrative costs, bureaucratic red tape (e.g., causing delays in vetting claims), and contracts excessively loaded with

⁹ When a home is purchased, individuals have legal counsel and the advice of friends and family, which could be used to make knowledgeable decisions about these contracts. Focus groups have confirmed that potential customers feel the most important time to purchase a HEP contract is when a home is purchased. *See Id.*

unattractive features, such as high deductibles, long vesting periods, and severe restrictions on claims.

D. HIGH REAL ESTATE TRANSACTION COSTS

Due to the high transactions costs associated with buying and selling homes, such as brokerage fees, closing costs, and moving expenses, residential real estate markets are highly inefficient relative to their counterparts in the commodity, currency, equity, and debt markets.¹⁰ Professional investors are likely to shun exchange-traded and over-the-counter (OTC)-traded HEP financial instruments due to their lack of sufficient liquidity. Among the reasons for these shallow markets are the (1) lack of readily available homes that can be inventoried and sold at a moment's notice, (2) relatively unknown relationships between residential real estate returns and those on other portfolio assets, (3) relatively high real estate price volatility, (4) paucity of hedging alternatives, and (5) inability to derive meaningful option prices due to the problematic relationship between most option pricing models and the real estate market. These markets violate important assumptions that lie behind popular contingent option pricing models, such as the Black-Scholes-Merton formula. For example, real estate: (1) prices do not move randomly – especially in the short term,¹¹ (2) transactions are not costless, (3) markets are not liquid, and (4) cash market prices and derivative market prices are difficult or impossible to arbitrage.¹²

¹⁰ If enough people participated, exchange markets in HEP contracts could help predict future real estate prices.

¹¹ Residential home prices display a significant degree of autocorrelation (i.e., inertia), which improves short-term forecasts but reduces the accuracy of option pricing models. See Robert J. Shiller, *Derivatives Markets for Home Prices* 4 (Nat'l Bureau of Econ. Research, Working Paper No. w13962, April 2008).

¹² Nevertheless, pricing models have been developed, which try to overcome these obstacles. See Robert A. Jarrow, *A Simple Robust Model for Cat Bond Valuation*, 7 FIN. RES. LETTERS 72 (2010); ALEXANDER MELNIKOV, RISK ANALYSIS IN FINANCE AND INSURANCE (Chapman & Hall 2004); James A. Boness, *Elements of a Theory of Option Value*, 72 J. POL. ECON. 163 (1974); Paul A. Samuelson, *Rational Theory of Warrant Pricing*, 6 INDUS. MGMT. REV. 13 (1965); George Constantinides, *Market Risk Adjustment in Project Evaluation*, 33 J. OF FIN. 603 (1978); Robert J. Shiller, *supra*, note 11; 3 JONATHAN E. INGERSOLL, J. E., THEORY OF FIN. DECISION MAKING (Rowman & Littlefield 1987).

E. REGULATION AND PERCEIVED RISKS

The existence of high regulatory costs and perceived risks also explains the slow growth of HEP insurance contracts. Regulatory costs deter start-up companies from entering markets and, for those that already offer these contracts, compliance costs can substantially reduce profits. On the positive side, regulations may increase consumer confidence, thereby encouraging HEP companies to offer supervised contracts. State laws and insurance commission rules regulate companies that offer FGI contracts. As a result, an FGI company must be licensed and comply with the rules and regulations of each state in which it operates.

Expensive regulations could cause the failure of HEP insurance companies, which means a company that offers FGI contracts and fails might have survived and thrived, in the same state, if it had been permitted to offer unregulated NIFP contracts. Due to the relatively small historical sample size and multitude of possible causes of HEP company failures, econometrically pinning success or failure on differences in regulation is challenging.

Colorado-based Home Value Insurance Company (HVIC) and Ohio-based EquityLock Solutions, LLC (ELS) help frame the FGI-versus-NIFP issue. Both companies began operations in 2011, offered similar HEP contracts, and neither of them had legacy policies from the pre-Great Recession years. One major difference was HVIC was regulated as an FGI company and ELS escaped state regulation because it was deemed to offer NIFP. Despite seemingly favorable market conditions, HVIC suspended policy sales in August 2012 and received court-approved dissolution the following December. By contrast, ELS was still a going concern, as of January 2016. Differences in regulations may or may not have been a major cause of ELS's survival and HVIC's demise, but over-regulation carries associated costs, and under-regulation carries potential risks to consumers. Therefore, determining the basis on which HEP companies should be regulated has important implications.

IV. THREE REGULATORY ALTERNATIVES FOR HEP CONTRACTS

HEP contracts are hybrids, having both insurance-like and financial-product-like features, which explains inconsistencies between states in determining the regulatory status of HEP companies and why states vary their positions over time. Currently, U.S. companies wishing to sell HEP contracts face the three major regulatory alternatives. First, if a state decides that the contract is *permissible* FGI, then the company is regulated as an

insurance company. If the contract is deemed *impermissible* FGI (i.e., not on the list of state-approved FGI contracts), then the company is prohibited from selling this product in that state, and attempts to do so would be met with cease-and-desist orders. Finally, if a state decides that the contract is NIFP, then it escapes state insurance regulations and may also escape federal regulations. The dilemma with classifying an HEP contract as *impermissible FGI* is that it inhibits the development of a market with potentially high value to the average resident homeowner. By contrast, the problem with classifying it as an NIFP product is companies offering contracts on OTC markets may avoid all regulation, thereby, leaving state residents unprotected from illicit companies and policies.

The experience of New York State's Department of Financial Services (NY DFS) provides an example of the difficulties that regulators may encounter when they try to classify HEP contracts. In 2002, NY DFS ruled that a proposed HEP contract "does not constitute insurance and contracts entered into with homebuyers pursuant to the Program will not be viewed as insurance contracts."¹³ About four-and-a-half years later, in 2008, NY DFS changed its opinion and ruled that these contracts are impermissible FGI.¹⁴ Subsequently, this new ruling was reinforced by opinions published on 2008¹⁵ and 2011.¹⁶

The locus of regulatory authority for NIFP contracts depends on whether they are exchange-traded or OTC-traded products and whether they are securities or derivatives. Companies that offer exchange-traded securities or options on securities are regulated by the Securities and Exchange Commission (SEC). Those offering exchange-traded derivatives are regulated by the Commodity Futures Trading Commission (CFTC), and finally, companies that offer OTC financial contracts escape federal regulations. Rather, the rights of NIFP buyers and sellers are protected mainly by commercial law through the courts. In cases where there are disagreements as to the locus of regulatory authority, the courts decide, and

¹³ See N.Y. DEP'T FIN. SERV., *Re: Home Equity Protection Program*, <http://www.dfs.ny.gov/insurance/ogco2002/rg205012.htm> (accessed Jan. 1, 2016).

¹⁴ See N.Y. DEP'T FIN. SERV., *Re: Home Equity Protection Plan Proposal* (2008), <http://www.dfs.ny.gov/insurance/ogco2008/rg080111.htm> (accessed Jan. 1, 2016).

¹⁵ *Id.*

¹⁶ *Id.* This decision focused on a HEP contract offered by a non-profit organization. The ruling confirmed that the contract was, indeed, insurance.

they have relatively wide discretion in determining what is and is not an insurance product.

FGI companies must meet all state licensure requirements and obey the statutes and rules that are passed by state legislatures and, subsequently, promulgated and enforced by state insurance departments/commissions.¹⁷ Among the most important requirements are minimum capital and contingency reserve levels, aggregate and single counterparty risk limitations, and exposure-to-equity ratios. Even though HEP companies that offer OTC products may escape almost all regulations, their policyholders have enforceable rights under state and federal contract laws, making courts and the nation's judicial system (rather than insurance commissions) the major checks and balances on these NIFP-types of HEP contracts.

V. MATERIAL INTEREST¹⁸: RISK TRANSFER VERSUS RISK TRANSFORMATION

HEP contracts can be used to transfer or transform fortuitous risks. *Transferring* home price risk means *buying* protection against home price reductions. *Transforming* it means *buying and/or selling* this price protection to increase, decrease, eliminate, or otherwise alter the risk-return tradeoffs of residential real estate exposures. Transferring risks implies possession of an underlying material interest, but material interest has an important added function, which is to prevent Individual A from purchasing an insurance policy on Individual B's home, which would allow Individual A to benefit from Individual B's misfortune and, possibly, incentivize Individual A to cause the misfortune.

FGI products are designed to *transfer* home price risks from customers to insurance companies, which concentrate the risks of dispersed

¹⁷ Most state regulations focus on insurance sellers, but policy buyers also have responsibilities, such as disclosing all risks that are known at the time a contract is initiated. Publically traded companies that issue financial instruments do not face this requirement.

¹⁸ The origins of material interest can be traced to the 18th and 19th centuries, when Anglo-Saxon nations created legislative restrictions on gambling. For years prior to that, contracts did not require material interests or indemnification to qualify as "insurance." See Tom Baker, *On the Genealogy of Moral Hazard*, 75 TEX. L. REV. 237 (1996), <https://www.law.upenn.edu/fac/thbaker/Tom-Baker-On-the-Genealogy-of-Moral-Hazard.pdf>; see also Geoffrey W. Clark, *Betting on Lives: The Culture of Life Insurance in England: 1695 – 1775* (Manchester Univ. Press, 1999).

policyholders and then manage them, in aggregate, mainly by means of policy diversification (geographic, demographic, and temporal), reserve provisions, owners' equity, reinsurance, derivatives, deductibles, and managed pools of invested premiums. Most FGI customers: (1) have relatively unsophisticated financial skills, (2) infrequently (if ever) mark their insurance contracts to market, (3) rarely make decisions about whether to hedge or unhedged their home equity positions, and, (4) generally, want to free themselves from frequent investment decisions regarding their homes. Paying insurance premiums allows these individuals to protect their equity stakes against downside home price risks while simultaneously enjoying the benefits of upside price potential.¹⁹ In this respect, FGI contracts are like financial put options.

By contrast, NIFP contracts are designed for investors and speculators who wish to *transform* home price risks. In contrast to insurance companies, which concentrate risks, NIFP companies widely distribute them among financial counterparties. Risk transformers are best viewed in the context of optimizing the return on diversified portfolios of assets, which means they are not the focus of state insurance commissions.

VI. FGI, INDEMNIFICATION, AND THE USE OF PRICE INDICES

Ideally, an FGI contract should fully indemnify the contract holder for fortuitous losses, while simultaneously offering no opportunities to earn profits or incur net losses. This goal can only be accomplished if the contract ties customer claims to the fair market purchase and sales prices of a home, but doing so creates problems that could threaten the financial sustainability of any company offering HEP contracts, which would curtail the growth of this industry. In short, states that require full indemnification for a HEP contract to be considered FGI could be making "the best" an enemy of "the good."

HEP companies, such as EquityLock Solutions, argue that the use of price indices is evidence that its policies are financial (not insurance) contracts because homeowners can have material interest in their homes but not in real estate price indices. They buttress this argument with the fact that full indemnification cannot be guaranteed because it is possible for a protected home's price to change independently from the housing price index.

These arguments are unconvincing on four grounds. First, a declining local real estate price index implies relative reductions in the value

¹⁹ Shiller & Weiss, *supra* note 2.

of all properties in that area. Even homes that appreciate in value (e.g., due to renovations, refashioning, improvements, enlargement, or historical significance) when price indices fall are affected by declining average home values because their sales prices would have been higher in rising markets.²⁰ Second, because they have maximum payouts, even HEP contracts that tie claims to transactions prices fail to fully indemnify contract holders, once the maximum payout is exceeded (more about this later). Therefore, only contracts with no maximum payouts can fully indemnify customers under all price-change scenarios. Third, each homeowner has, at least, a partial material interest in a local price index. Finally, the use of transaction prices encourages collusion, deceit, and asymmetric information problems between homebuyers and sellers, which could lead to the failure of companies offering these contracts (more about this later). As a result, states that automatically classify contracts offering price-index-linked HEP claims as *NIFP* emasculate their abilities to protect residents from ill-conceived and illegitimate providers.

A. A CLOSER LOOK AT HEP INDEMNIFICATION

Exhibit 3 shows payoff profiles for an individual who has a long real estate position and owns a HEP contract with a 25% cap on claim payments. This position is equivalent to owning a hybrid security with a (1) long home position, (2) long, at-the-money put option, and (3) short, out-of-the-money (by 25%) put option. For a homeowner, the short put is the speculative part of this financial hybrid, and it is technically inconsistent with, what is normally thought of as, *insurance*. The short put's purpose is mainly to reduce potential claims facing FGI companies and, also, to reduce the policy premium. To minimize the importance of this speculative component, the short put's strike price would be set as low as possible.

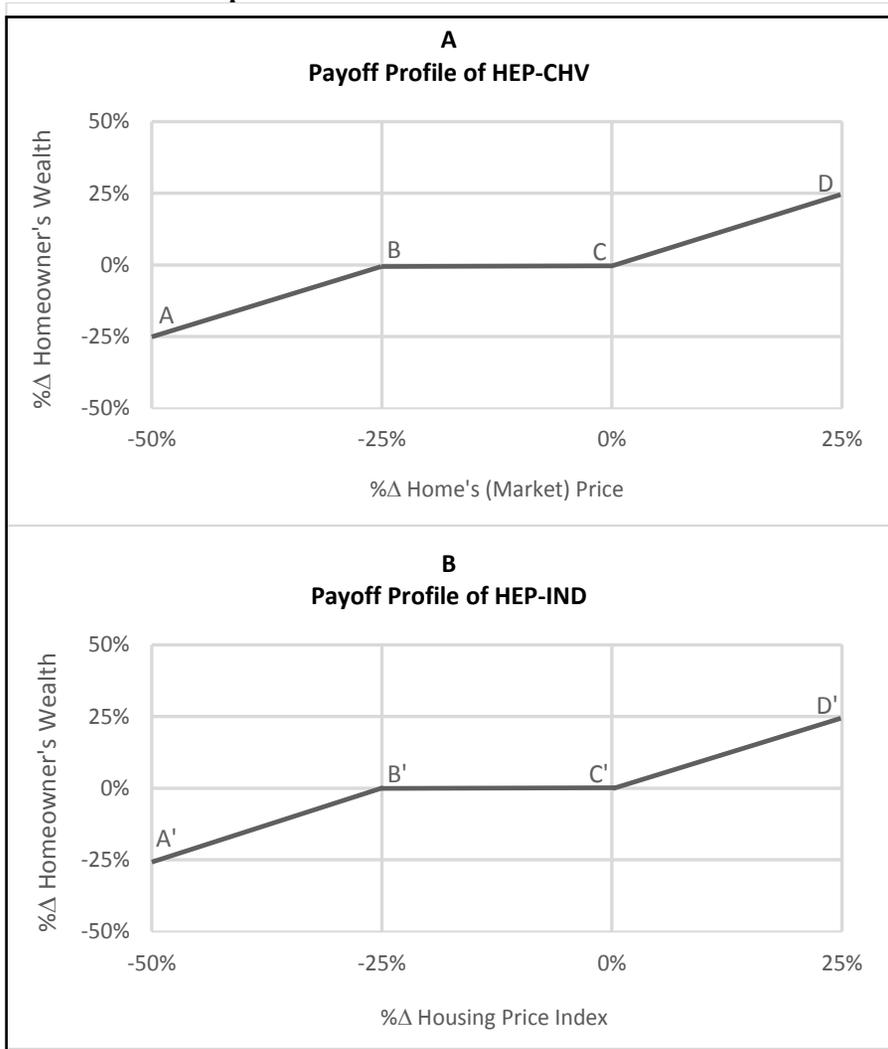
Exhibit 3A assumes the HEP payout is tied to the percentage change in a home's market value (HEP-CHV), and Exhibit 3B assumes the contract is tied to a percentage change in the housing price index (HEP-IND).²¹ The HEP-CHV payoff profile, which is shown in Exhibit 3A, is the discontinuous line labeled A–B–C–D, and the HEP-IND payoff profile is the discontinuous line labeled A'–B'–C'–D', which is shown in Exhibit 3B. Due to the

²⁰ This reasoning is consistent with NY DFS' written opinion, which changed its position on whether HEP contracts were NIFP or FGI. See N.Y. DEP'T FIN. SERV., *supra* note 14.

²¹ To simplify the graphs, these examples assume that the home is 100% financed.

maximum payout limit (e.g., 25%), neither contract provides complete indemnification relative to its underlier price (see segments A–B in Exhibit 3A and A'–B' in Exhibit 3B). At the same time, both contracts allow owners to enjoy capital gains when home prices rise (see segments C–D in Exhibit 3A and C'–D' in Exhibit 3B).

Exhibit 3
Relationship between HEP-CHV and HEP-IND Contracts



An important conclusion to draw from Exhibits 3A and 3B is that distinctions between FGI and NIFP, which seem to be based on

indemnification, are actually distinctions about whether the maximum payout on a HEP contract is sufficiently large to be called *indemnification* because, once the maximum payout percent is reached, indemnification stops.

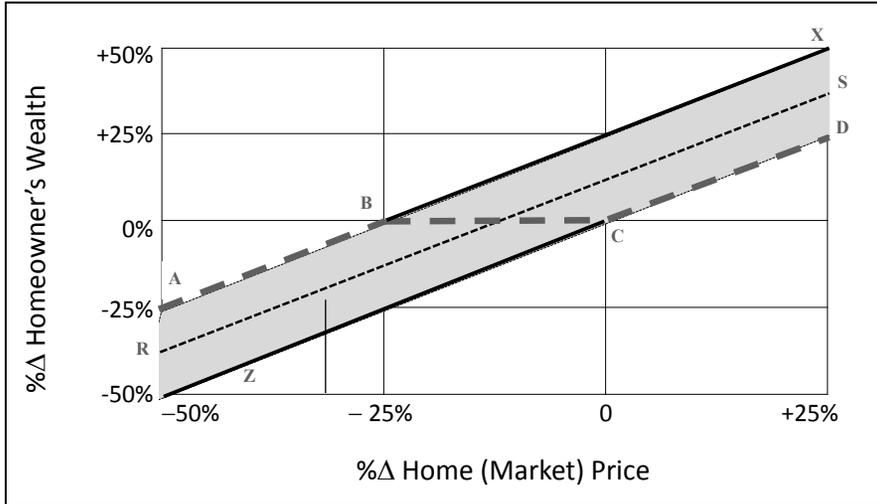
VII. ADVANTAGES OF USING HOME-PRICE-INDEXED HEP CONTRACTS

Linking HEP contracts to home price indices has both social and individual advantages, such as: (1) encouraging home maintenance, improvements, and repairs, (2) enabling existing homeowners to purchase these contracts, (3) permitting individuals to make claims without selling their homes, and (4) reducing illicit customer claims.

A. PRICE-INDEXED HEP CONTRACTS ENCOURAGE HOME MAINTENANCE, IMPROVEMENTS, AND REPAIRS

In Exhibit 4, the payoff profiles for the HEP-CHV and HEP-IND contracts provide illuminating insights when both of them are evaluated relative to changes in a home's current market price. The HEP-CHV contract has the same asymmetric payoff profile (A–B–C–D) shown in Exhibit 3A. By contrast, the HEP-IND contract now has a symmetric payoff profile (like a long forward contract), which shifts to the left as the price index falls and shifts to the right as it rises. Therefore, if the price index falls, the HEP-IND payoff profile changes, for example, from Z–D to an interior line, such as R–S (see Exhibit 4).

Exhibit 4
Payoffs When Changes in a Home's Price and the Price Index Are Not Perfectly Correlated



If there was a perfect, one-for-one inverse relationship between changes in home prices and changes in housing price indices, the payoff profile for HEP-IND would be identical to the payoff profile of HEP-CHV, namely, A–B–C–D in Exhibit 4. By contrast, if these prices were not perfectly correlated, the payoff profile labeled A–X would be the left-side limit to which the HEP-IND contract could move, and it would be reached once the price index fell by 25% or more. The payoff profile labeled Z–D would be the right-side limit of the HEP-IND contract, which would be reached when price index remained the same or rose.

In the range of prices between B and C, changes in the price index vary between –25% (i.e., the maximum payout) and positive infinity. If price index falls by a greater percentage than the market value of a home, the wealth of the HEP-IND contract owner rises (see the gray area above B–C in Exhibit 4). Similarly, in the range B–C, if a home's market value falls by a greater percentage than the price index, the wealth of a HEP-IND contract owner falls (see the gray area below B–C in Exhibit 4).

An important conclusion to draw from Exhibit 4 is HEP-IND contracts promote behavior that enhances social welfare because owners are over-indemnified only when the market values of their homes fall by less than the price index. Therefore, added compensation comes only by *beating the average*, which encourages overall home care and maintenance.

B. PRICE-INDEXED HEP CONTRACTS CAN BE PURCHASED BY EXISTING HOME OWNERS

Individuals who already own homes and those purchasing them both have material interests, but potential problems can arise when HEP contracts are sold to the former group because reliable market values for the protected assets may be lacking in the absence of actual home sales. If this problem were insurmountable, then HEP contracts might be restricted to only individuals who are purchasing homes.

One way to offer these contracts to existing homeowners is by using mutually agreeable, independent appraisers to determine home values;²² another is to use housing price indices to inflate or deflate property values from their original purchase prices to the current index-adjusted values and, then, use the differences as the basis for claims. Therefore, the HEP payout per home would equal the percentage change in the price index times the protected value.

C. PRICE-INDEXED HEP INSURANCE CONTRACTS ALLOW CLAIMS AT CONTRACT MATURITY, WITHOUT HOME SALES

HEP insurance contracts could be written to allow claims (1) only when a home is sold, (2) at contract maturity, or (3) any time before the contract matures. The differences are important.

1. Allowing claims only upon the sale of a home

Restricting HEP insurance claims solely to contract owners who sell their homes at a loss has two major advantages. First, it clearly establishes the contract as a risk-transfer vehicle that protects against unfortunate, fortuitous life events. Second, the requirement significantly reduces the liquidity risks facing HEP insurance companies because it moderates claims by broadly distributing them over time (i.e., temporal diversification).

2. Paying claims at contract maturity

Allowing individuals to make claims when their contracts mature raises questions regarding how a home's market price can be determined in the absence of a free market sale. As previously mentioned, one solution is

²² Shiller and Weiss, *supra* note 2, at 25.

to use independent external appraisers, and another is to tie claims to changes in price indices.

A major advantage of allowing individuals to make claims on HEP contracts at maturity, without the need to sell their homes, is it improves the long-term hedging effectiveness of these contracts.²³ Consider an individual who simultaneously purchases a \$100,000 home and 10-year HEP contract. To finance the transaction, suppose he/she borrows \$90,000 and makes a \$10,000 down payment. At maturity, if the home's market value falls to \$95,000 and the price index falls to 95, the homeowner is unlikely to sell his/her home and relocate in order to collect just \$5,000 in claims. Transaction costs are too high. As a result, if the contract is renewed at the home's current market value (i.e., \$95,000), the individual's wealth would fall by \$5,000. By contrast, if this HEP owner could make a claim without selling his/her home at maturity, s/he would receive \$5,000 in claims and then be able to re-protect the home for \$95,000, thereby retaining his/her equity at the original level of \$10,000.

Because selling a home and moving to a new location can be costly, the sales price must fall considerably to offer attractive opportunities. At a minimum, the home price reduction needs to exceed the monetary costs (e.g., realtor's fees, moving expenses, and refurbishments) and the emotional costs that come from leaving familiar friends, schools, and social networks. Evidence in the market for mortgage insurance indicates that a home's market value needs to fall at least 10% to 25%²⁴ below the outstanding

²³ This practice is common for non-delivery derivative contracts, such as those purchased and sold on the Intercontinental Exchange (ICE).

²⁴ Luigi Guiso, Paola Sapienza, & Luigi Zingales, *Moral and Social Constraints to Strategic Default on Mortgages* 5 (Nat'l Bureau of Econ. Research, Working Paper No. 15145, 2009), <http://www.nber.org/papers/w15145.pdf> (accessed Jan. 1, 2016). Neil Bhutta, Jane Dokko, & Hui Shan, *The Depth of Negative Equity and Mortgage Default Decisions* 43 (FINANCE AND ECONOMICS DISCUSSION SERIES 2010-35, 2010), <http://www.federalreserve.gov/pubs/feds/2010/201035/201035pap.pdf>, (accessed Jan. 1, 2016); Christopher L. Foote, Kristopher Gerardi, & Paul S. Willen, *Negative Equity and Foreclosure: Theory and Evidence*, 64 J. URB. ECON. 234 (2008); EXPERIAN-OLIVER WYMAN, *Understanding Strategic Default in Mortgages Part I* (Experian-Oliver Wyman Market Intelligence Report 2009 Topical Report Series, 2009); EXPERIAN-OLIVER WYMAN, *Strategic Defaults in Mortgages: Q2 2011 Update, Market Intelligence Reports* (2011 Topical Report Series, 2011), <https://www.experian.com/assets/decision-analytics/reports/oliver-wyman-strategic-default-2011.pdf> (accessed Jan. 1, 2016); EXPERIAN-OLIVER WYMAN,

mortgage value to trigger a strategic default, which occurs when individuals, who can afford to pay their mortgages, walk away from them because the market values of their homes are less than the outstanding mortgage balances (i.e., they have negative equity).²⁵

3. Allowing claims any time before contract maturity

Allowing policyholders to make claims any time before contracts mature changes a HEP policy from a risk transfer agent to a risk transformer. Such flexibility also complicates the efforts of these companies to predict future claim liabilities and, thereby, results in higher premiums, which reduce the amount of protection purchased.²⁶ Furthermore, permitting such flexibility distances these HEP policies from the fortuitous, unfortunate life-events they are supposed to address.

D. PRICE-INDEXED HEP CONTRACTS CAN REDUCE ILLEGITIMATE CUSTOMER CLAIMS

HEP insurance companies can be the victims of asymmetric information problems, as well as collusion and deceit.²⁷ Asymmetric information occurs when one party to a transaction has more or better information than his/her counterpart. Collusion and deceit can occur when individuals sell their homes to collaborators at unjustifiably low prices, make illicit HEP claims, and then split the ill-gotten gains.

Strategic Defaults in Mortgages: Q2 2010 update (Market Intelligence Reports, 2010 Topical Report Series, 2010), <https://www.experian.com/assets/decision-analytics/reports/strategic-default-report-2-2010.pdf> (accessed Jan. 1, 2016).

²⁵ Strategic defaults can also be caused by *double-trigger* events, such as negative equity in combination with pessimistic expectations about housing prices. Therefore, even if negative equity is the primary cause of a strategic default, it may not be the only cause.

²⁶ It is virtually impossible for a HEP company to hedge the risk of contract cancellations. While the average duration of a contract might be estimated, its variance is tied closely to whether home prices rise or fall, thereby leaving these companies vulnerable to significant over-estimations or under-estimations of revenues.

²⁷ See Karl E. Case, Robert J. Shiller & Allen N. Weiss, *Mortgage Default Risk and Real Estate Prices: The Use of Index-Based Futures and Options in Real Estate* (Cowles Foundation Discussion Paper No. 1098, 1995), <http://cowles.yale.edu/sites/default/files/files/pub/d10/d1098.pdf>; Shiller & Weiss, *supra* note 2.

1. Asymmetric information

Two major types of asymmetric information are adverse selection, which occurs before a contract has been signed, and moral hazard, which occurs afterwards. Both cause potential problems for HEP insurance companies.

a. *Adverse selection*

Home sellers are likely to have better information than FGI companies about the fair market values of their particular houses and also about specific community risks. For instance, individuals who feel they overpaid for their homes or live in areas with substantial downside price risks (e.g., due to increasing crime rates) are likely to be HEP buyers. Conversely, those who feel they paid bargains prices for their homes or live in areas with substantial upward price potential are unlikely buyers of these contracts. Therefore, asymmetric information introduces selection biases into the pool of potential HEP insurance customers, weighting the population toward those most in need, which increases claim risk and renders statistical analyses problematic – especially when predictive validity and reliability depend on customer pools having normal distributions. These added risks increase customer premiums, which reduce the amount of protection purchased.

b. *Moral hazard*

Moral hazard occurs when individuals behave differently after they are insured because they no longer bear the full consequences of their actions and also when they can influence both the odds and size of their potential claims. On the demand side, HEP contracts encourage individuals to pay above-market prices for their homes, knowing that their downside market risks are hedged. In fact, losses on properties that have been owned for long periods of time have been traced to their owners paying too much for them.²⁸ On the supply side, HEP contracts reduce sellers' incentives to negotiate the best prices in down markets because they know that losses, up to the maximum limits, will be covered by insurance. HEP contracts also

²⁸ Between 1990 and 2006, about 50% to 60% of the homes sold in the Melbourne, Australia area were estimated to have incurred losses due to initial overpayments. See Dag Einar Sommervoll & Gavin Wood, *Home Equity Insurance*, 3 J. FIN. ECON. POL'Y 66, 75 (2011).

discourage homeowners from performing routine maintenance on protected properties, and they encourage fanciful decorating, which could reduce a home's sales price. One way companies could try to protect themselves from this moral hazard problem is by requiring evidence of minimum maintenance, but such arrangements are difficult to enforce because objective verification of needed repairs may not be possible and the timing of such work is open to discretion.²⁹ Another alternative is for HEP insurance companies to retain the right of first refusal, which would allow them to purchase and then resell homes whose sales prices seem unjustifiably low.

c. *Using a price index to solve collusion, deceit, and asymmetric information problems*

The major benefit of using transaction prices to determine HEP claims is the clear line of sight they provide between changes in the equity an owner has at risk and changes in the value of the protection contract. The major disadvantage is these contracts encourage collusion, deceit, and asymmetric information problems. One solution to this problem is to base claims on home price indices because companies that supply these contracts do not need to appraise or monitor the protected homes. Price indices can reduce these problems by disconnecting HEP claims from property sales prices. Therefore, regardless of how far below the market price a home is sold, claims can be made only if the housing price index (over which the individual has no power) falls from beginning to end.

Consider the problems of collusion and deceit. Suppose a home with an initial market value of \$100,000 is purchased simultaneously with a HEP contract having a maximum payout of 25%. Suppose further that, when the home is sold (after the vesting period), its market value remains the same, but the owner tries to deceive the HEP company by selling the house to an accomplice for a below-market price equal to \$85,000. Exhibit 5 assumes that all the proceeds from this collusive act (\$15,000) revert, in the form of a kickback, to the original homeowner. It compares the results if claims are based on the property's transaction prices versus a home price index, which rises by 10%, stays the same, or falls by 10%, 15%, and 40%.

²⁹ Shiller and Weiss, *supra* note 2, at 25,27.

Exhibit 5

Payoffs to Collusion and Deceit: Transaction-Price versus Price-Indexed Contracts*

Contract Initiation					
Purchase price	\$100,000	\$100,000	\$100,000	\$100,000	\$100,000
Price Index	100	100	100	100	100
Contract Termination					
%Δ Home Price Index	+10%	0%	-10%	-15%	-40%
Return to the collusive seller when transaction prices are used					
Purchase price	-\$100,000	-\$100,000	-\$100,000	-\$100,000	-\$100,000
Unfair sales price	\$85,000	\$85,000	\$85,000	\$85,000	\$85,000
Claim <i>Purchase price – sales price</i>	\$15,000	\$15,000	\$15,000	\$15,000	\$15,000
Kickback	\$15,000	\$15,000	\$15,000	\$15,000	\$15,000
Net gain for the seller	+\$15,000	+\$15,000	+\$15,000	+\$15,000	+\$15,000
Return to the collusive seller when a price index is used					
Purchase price	-\$100,000	-\$100,000	-\$100,000	-\$100,000	-\$100,000
Unfair sales price	\$85,000	\$85,000	\$85,000	\$85,000	\$85,000
HEP Claim	0	0	\$10,000	\$15,000	\$25,000**
<i>If %ΔPI < 0, then claims = %Δ price index × protected value; otherwise, claims = 0.</i>					
Kickback	\$15,000	\$15,000	\$15,000	\$15,000	\$15,000
Net gain for the seller	\$0	\$0	\$10,000	\$15,000	+\$25,000
<p>* Assets and claims are positive values. Liabilities are negative values. This example ignores mortgage amortization.</p> <p>** The maximum payout is 25%. Therefore, the price index can fall no lower than 75 when prices decline by 25% or more.</p>					

Notice that the transaction-price alternative locks in a \$15,000 gain, but the price-index-alternative gains nothing if the price index rises or stays the same. It progressively earns positive returns as the price index falls, reaching a maximum gain of \$25,000 when the percentage change in the price index reaches the payoff limit of 25%. Exhibit 5 shows that it is possible for the seller to gain more under the price-index alternative than the

transaction-price alternative only if the price index declines by a greater percent than the home's market price.

HEP companies could eliminate this profit loophole by basing claims on the higher of a home's market price *or* housing price index. Exhibit 6 shows the results from this hybrid method. Notice how losses to the colluding seller are the same as Exhibit 5 until the price index falls by a greater percent than the sales price, at which point the hybrid method reduces the sellers' gains from what would have occurred using the price-index method.

Exhibit 6
Payoffs to Collusion and Deceit if Claims are Based the Higher of the Sales Price or Price-Indexed Price*

Contract Initiation					
Purchase price of home	\$100,000	\$100,000	\$100,000	\$100,000	\$100,000
Contract Termination					
%Δ Home Price Index	+10%	0%	-10%	-15%	-40%
Price index-value	\$110,000	\$100,000	\$90,000	\$85,000	\$75,000**
Unfair sales price	\$85,000	\$85,000	\$85,000	\$85,000	\$85,000
HEP Claim	\$0	\$0	\$10,000	\$15,000	\$15,000
<i>Claims = higher of (1) (sales price - purchase price) or (2) if %ΔPI < 0, (%Δ price index × protected value), otherwise, claims = 0</i>					
Kickback	\$15,000	\$15,000	\$15,000	\$15,000	\$15,000
Net gain to collusive seller	\$0	\$0	\$10,000	\$15,000	\$15,000
* Assets and claims are positive values. Liabilities are negative values. This example ignores mortgage amortization.					
** Maximum payout is 25%					

Customer perceptions about the fairness of the hybrid method might be improved if the HEP contract required the insurer and customer to share the burden when a home's sales price fell by a greater percent than the price index. Employing deductibles into these contracts would also reduce or eliminate collusion, deceit, and moral hazard problems because it would force homeowners to have *skin-in-the-game*, thereby preventing them from extracting the full benefits of their unethical acts.

VIII. DISADVANTAGES OF USING HOME-PRICE-INDEXED HEP CONTRACTS

Using home price indices is one of the keys to successfully offering and developing HEP contracts and markets. For this reason, serious attention has been paid to improving price index methodology³⁰ and narrowing index coverage to increasingly tapered geographic areas, but until these indices can pinpoint each particular home, the chances for full (100%) indemnification will remain small.

The indemnification problem is not unique to the housing market and relates to *basis risk*, which exists when changes in the value of a protected asset or liability are not equal and opposite to changes the value of the protection contract. As basis risk rises, the likelihood that a hedge will fully indemnify the contract owner falls. For example, a U.S. company with a €20 million accounts receivable maturing in November might use a September or December futures contract to hedge because November futures contracts do not exist. Similarly, oil producers may try to hedge the value of their committed sales with futures contracts offered on the Chicago Mercantile Exchange, where the Brent oil benchmark is used, even though the blend of oils in this benchmark does not fully match the producers' specific oil output.

Basis risk can cause homeowners to be either under-compensated or over-compensated whenever the housing price indices used do not have one-to-one, inverse relationships with the protected homes' sales prices. Under U.S. Financial Accounting Standards (FAS), a transaction qualifies as a *hedge* if it is identified, as such, at inception and achieves its goal within a predefined range.³¹ FAS rules do not differentiate hedge transaction from

³⁰ See Shiller, *Derivative Markets for Home Prices* 4, 9-10 (Yale Univ. Econ. Dep't, Working Paper No. 46; Cowles Foundation Discussion Paper No. 1648, 2008); Karl E. Case, Robert J. Shiller, & Allan N. Weiss, *Mortgage Default Risk and Real Estate Prices: The Use of Index-Based Futures and Options in Real Estate* (Nat'l Bureau of Econ. Research, Working Paper No. 5078, 1995).

³¹ Under U.S. Financial Accounting Standard 133, a hedge must be declared when it is purchased (i.e., at inception), and the correlation coefficient between the asset and hedge must range between -0.80 and +1.25, which means any gains above 25% or losses below 20% are treated, for financial statement purposes, as non-hedge transactions. See FIN. ACCT. STANDARDS BOARD, *Financial Standards No. 133: Accounting for Derivative Instruments and Hedging Activities*, http://www.fasb.org/jsp/FASB/Document_C/DocumentPage?cid=1218220124631&acceptedDisclaimer=true (accessed Jan. 1, 2016).

investment and speculation transactions based on not whether they guarantee 100% indemnification. In terms of payoff profiles, hedge contracts are identical to insurance contracts.

If FAS logic were applied to HEP contracts, a company would be classified as offering FGI if: (1) each buyer's intention, at inception and until maturity, was to *hedge* the value of his/her home equity position, and (2) indemnification was permitted to vary within reasonable, predetermined limits. Ensuring that HEP customers are hedging (i.e., transferring risks) and not speculating (i.e., transforming risks) can be accomplished by requiring material interest from contract initiation to termination or maturity.

Whether the HEP contract is effective can be evaluated by its *payout efficiency*, which is the: (1) portion of paid claims that go to individuals who incur losses on the sale of their homes³² and/or (2) the extent to which homeowners who incur losses are compensated. Therefore, a 0.0 measure implies that individuals who incurred losses on their home sales were not compensated at all by HEP policies, and a 1.0 measure implies full indemnification.

A study in Melbourne, Australia,³³ using metropolitan and neighborhood housing price indices to determine HEP payout efficiency, found that between half and slightly less than two-thirds of the people who experienced home equity losses would have been compensated by these contracts.³⁴ Payout efficiency improved when contract maturity was lengthened.

To implement price-indexed FGI contracts, U.S. states could establish allowable limits for payout efficiency, perhaps beginning with U.S. FAS standards and then adjusting them with experience. New FGI companies might be required by state insurance commissions to show evidence that threshold payout efficiencies could be reached before they sell their contracts. Such requirements would promote the creation of better home price indices and also encourage the development of private market solutions that protect home equity. Because the level of basis risk depends heavily on the index chosen, results could be back-checked, periodically, to

³² Remember that, in a declining market, HEP contracts would also pay claims to individuals whose homes rose in price or remained constant.

³³ Australia's housing market is similar to the United States in that approximately 70% of families own homes and home equity constitutes about 40% of the average family's wealth.

³⁴ Sommervoll & Wood, *supra* note 28. This study did not allow for moral hazard and adverse selection, which could significantly affect the study's conclusions.

make sure the best-in-class housing price indices were being used. Earnings or losses that fell outside the predetermined bounds could be taxed as ordinary income.

A. REGULATORY ARBITRAGE AND PRICE-INDEXED HEP CONTRACTS

The attributes of HEP contracts are endogenous, in the sense that companies can configure them to gain or circumvent state regulation. Problems arise when these attributes meet the letter of the law but not its intent. One way these companies can engage in regulatory arbitrage is by establishing themselves as NIFP companies in states that permit it and then transforming their financial liabilities into insurance liabilities via special purpose vehicles (i.e., transformer companies). Companies may gain NIFP status by linking their contracts to home price indices, which do not guarantee full indemnification and, therefore, do not meet the pure definition of *insurance*. Once established as NIFP companies, they try to conduct business in other states, either by offering NIFP contracts directly or by using surplus lines brokers.

B. TRANSFORMER COMPANIES

Transformer companies can convert financial risks into insurance risks or vice versa. They may be independent from the HEP firms with which they deal or created and capitalized by the HEP companies, themselves. Therefore, a company can (1) sell its contracts as financial products in one state, (2) create an FGI company in a different state, country, or offshore center that has lower standards, and (3) then use this FGI company as evidence to potential and existing customers that its contracts are safe. Problems can arise when this type of regulatory arbitrage creates only the illusion of safety. The likelihood of this happening is relatively high when the standards regulating the relationships between in-state NIFP companies and out-of-state FGI companies, which are business-to-business (B2B) transactions, are weaker than the standards regulating in-state business-to-customer (B2C) transactions.

Resident victimization could result if the buyers of these FGI contracts are unlikely to understand or take the time to discover that an out-of-state FGI company is owned or controlled by the in-state NIFP firm and, therefore, offers little additional protection. Similarly, problems could arise when the out-of-state FGI company's policies, procedures, and financial structure would not pass in-state insurance standards. One way states can

defend residents against potential abuses of transformer companies is to allow them only for licensed insurers in state-authorized locations.

C. SURPLUS LINES INSURANCE AND BROKERS

Surplus lines insurance permits a state's residents to purchase insurance from out-of-state property and casualty insurance companies via licensed in-state surplus lines brokers. The out-of-state insurers bear the real estate price risks and collect premiums for these services. Surplus lines brokers are used when a type of property or casualty insurance is not offered by any insurance company in a particular state. Therefore, an insurance company in State A can sell its policies in States B, C, and D by offering a unique insurance product and then finding surplus lines brokers in other states that are willing and able to sell it. The use of surplus lines brokers eliminates the time, effort, and expense of gaining licenses in these other states.³⁵ If surplus lines brokers are used for purposes of regulatory arbitrage, states can try to control this practice by restricting transactions to licensed FGI companies that are located in pre-approved states, countries, and offshore centers.

IX. CONCLUSION

HEP contracts can transfer home price risks from those who are least able to evaluate them to those who are best able. These contracts can more fully develop capital markets by providing a low-cost and efficient means of shorting the housing market, thereby making real estate prices more efficient and reducing the likelihood of speculative distortions, such as price bubbles. Less distorted prices, lower transactions costs, and greater liquidity act to encourage capital flows toward real estate markets, thereby increasing aggregate investments. Even in cases where the correlation between the homes being insured and the real estate price index used for hedging is not exact, HEP products can bring substantial value to many homeowners who are seeking ways to protect the home equity they have accumulated.

Linking FGI contracts to home price indices is a practical and effective way to develop the HEP market while protecting both HEP insurance customers and companies. Price indexed FGI contracts: (1) encourage home maintenance, improvements, and repairs, (2) more fully open the HEP market to existing homeowners, (3) offer protection to

³⁵ If a state insurance regulator determines that the contract offered is impermissible FGI, then it cannot be sold in that state via surplus lines brokers.

individuals who do not wish to sell their homes, and (4) help defend FGI contract suppliers from customer collusion, deceit, and asymmetric information problems. At the same time, states can retain more rights than they relinquish, which enables them to protect resident homeowners, who are the likely victims of illicit HEP companies and contracts.

For all the years that HEP insurance contracts have been offered, states have wrestled with regulating them appropriately, taxing them fairly, and allowing these markets to function effectively. Solving regulatory issues related to HEP contracts is not a singular cause because these debates will continue to surface, as they have in the past, when financial instruments (e.g., weather derivatives, credit default swaps, and catastrophe options) were invented and offered for sale.

REMOVING THE LEGAL IMPEDIMENTS TO OFFERING LIFETIME ANNUITIES IN PENSION PLANS*

JONATHAN BARRY FORMAN†

Longevity risk—the risk of outliving one’s retirement savings—is probably the greatest risk facing current and future retirees in the United States. At present, for example, a 65-year-old man has a 50 percent chance of living to age 82 and a 20 percent chance of living to age 89, and a 65-year-old woman has a 50 percent chance of living to age 85 and a 20 percent chance of living to age 92. The joint life expectancy of a 65-year-old couple is even more remarkable: there is a 50 percent chance that at least one 65-year-old spouse will live to age 88 and a 30 percent chance that at least one will live to 92. In short, many individuals and couples will need to plan for the possibility of retirements that can last for 30 years or more. There were 48.6 million retirees in the United States in 2014, but there are expected to be 66.4 million retirees in 2025 and 82.1 million in 2040.

* Copyright © 2017, Jonathan Barry Forman. The research reported herein was performed pursuant to a grant from the TIAA Institute through the Pension Research Council/Boettner Center of the Wharton School of the University of Pennsylvania (PRC). The findings and conclusions expressed are solely those of the author and do not represent the views of the PRC or TIAA. A similar version of the Work has been posted (published) as Pension Research Council Working Paper No. WP2016-6 (The Wharton School, University of Pennsylvania) at <http://www.pensionresearchcouncil.org/publications/document.php?file=1347>. Also, the TIAA Institute will post (publish) various versions of the Work on its website, <https://www.tiaainstitute.org/public/institute>. Thanks to Benjamin Goodman, Christopher R. Hoyt, Gordon D. Mackenzie, and Olivia S. Mitchell; to the participants in the Fifth Annual National Benefits & Social Insurance Conference held at the University of Connecticut School of Law, Hartford, Connecticut, Apr. 15, 2016; to the participants in a panel on retirement at the Law and Society Annual Meeting, New Orleans, Louisiana, June 3, 2016; to the participants in the International Scientific Conference on Security, Responsibility and Property of Pensions held at the University of Gdansk in cooperation with The European Network for Research on Supplementary Pensions, Sopot, Poland, Sept. 8, 2016; and to the participants in the TIAA Fellows/Pensions Research Council Researcher Symposium, New York, New York, Oct. 21, 2016.

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One of the best ways to protect against longevity risk is by securing a stream of lifetime income with a traditional defined benefit pension plan or a lifetime annuity. Over the years, however, there has been a decided shift away from traditional pensions and towards 401(k) plans and other defined contribution plans that typically distribute benefits in the form of lump sum distributions rather than as lifetime annuities. When given the choice, people rarely choose to receive annuity distributions, nor is it common for people to buy annuities in the retail annuity market. All in all, Americans will have longer and longer retirements, yet fewer and fewer retirees will have secure, lifetime income streams.

This Article considers how changes in the laws and regulations governing pensions and annuities could help promote secure, lifetime income streams. More specifically, this Article explores how the laws governing annuities could be changed to make voluntary annuitization more attractive and how pension laws could be changed to incentivize plan sponsors to offer more lifetime income options and to encourage plan participants to select those options.

After a brief introduction, Part II of this Article provides an overview of Social Security, pensions, annuities, and other lifetime income mechanisms in the United States. Next, Part III focuses on the legal rules that govern annuities and pension distributions, and Part IV discusses the role for pensions, annuities, and other lifetime income mechanisms in providing secure, lifetime income streams. Finally, Part V considers some options for statutory and regulatory changes that would promote greater annuitization of retirement savings.

I. INTRODUCTION

Longevity risk—the risk of outliving one’s retirement savings—is probably the greatest risk facing current and future retirees in the United States.¹ At present, for example, a 65-year-old man has a 50 percent chance

¹ See, e.g., Youngkyun Park, *Retirement Income Adequacy with Immediate and Longevity Annuities*, EMP. BENEFIT RES. INST. (Issue Brief No. 357, 2011), http://www.ebri.org/pdf/briefspdf/EBRI_IB_05-2011_No357_Annuities.pdf; Peter Nakada, Chris Breux, Mehrdad Honarkhah, Chris Hornsby, Dean Tolla & Rebecca Vessenes, *The Fundamentals of Longevity Risk*, 17 J. ALT. INV. 55 (2014); Diane Oakley, *Retirement Security Risks: What Role can Annuities Play in Easing Risks in Public Pension Plans?*, NAT’L INST. ON RET. SEC. 6 (Issue Brief, Aug. 2015), http://www.nirsonline.org/storage/nirs/documents/Annuities/annuities_aug_2015.p

of living to age 82 and a 20 percent chance of living to age 89, and a 65-year-old woman has a 50 percent chance of living to age 85 and a 20 percent chance of living to age 92.² The joint life expectancy of a 65-year-old couple is even more remarkable: there is a 50 percent chance that at least one 65-year-old spouse will live to age 88 and a 30 percent chance that at least one will live to 92.³ In short, many individuals and couples will need to plan for the possibility of retirements that can last for 30 years or more. There were 48.6 million retirees in the United States in 2014, but there are expected to be 66.4 million retirees in 2025 and 82.1 million in 2040.⁴

One of the best ways to protect against longevity risk is by securing a stream of lifetime income with a traditional defined benefit pension plan⁵ or a lifetime annuity.⁶ Over the years however, there has been a decided shift

df; *The Challenge of Longevity Risk: Making Retirement Income Last a Lifetime*, AUSTL. ACTUARIES INST., INST. AND FACULTY OF ACTUARIES [U.K.], & AM. ACAD. OF ACTUARIES (Oct. 2015), <http://www.actuary.org/files/The-Challenge-of-Longevity-Risk.pdf>.

² Calculations from the Soc’y of Actuaries, *Life Expectancy Calculator* (last visited Aug. 2, 2016), <https://www.soa.org/Files/Xls/research-life-expect-calc.xls> (based on the Social Security Administration’s 2010 mortality tables for the general U.S. population; an individual’s life expectancy is the average number of years until death). See also AM. ACAD. OF ACTUARIES, *Risky Business: Living Longer Without Income for Life* 4–8 (Discussion Paper, June 2013), https://www.actuary.org/files/Risky-Business_Discussion-Paper_June_2013.pdf (showing the probability of living from age 65 to various ages and discussing various factors that can affect that probability); SOC. SEC. ADMIN., *Retirement & Survivors Benefits: Life Expectancy Calculator* (last visited Mar. 22, 2016), <https://www.socialsecurity.gov/oact/population/longevity.html> (a calculator that can be used to estimate individual and joint life expectancies).

³ Soc’y of Actuaries, *Life Expectancy Calculator*, *supra* note 2.

⁴ Robert A. Kerzner (President and CEO, LIMRA, LOMA, LL Global), *Presentation to Federal Advisory Committee on Insurance* 4 (Aug. 2015), <https://www.treasury.gov/initiatives/fio/Documents/LIMRA8.6.15.pdf>.

⁵ As more fully discussed in Part II.C.1.a, *infra*, in a defined benefit plan, an employer promises employees a specific “benefit” at retirement. For example, a traditional defined benefit plan might promise to pay a long-time employee a pension equal to 60 percent of her final pay for the rest of her life.

⁶ As more fully discussed in Part II.D.2, *infra*, an annuity is a financial instrument (i.e., an insurance contract) that converts a lump sum of money into a stream of income payable over a period of years, typically for life. See, e.g., U.S. SEC. AND EXCH. COMM’N, *Annuities*, <http://www.sec.gov/answers/annuity.htm> (last updated Apr. 6, 2011); *Annuities*, INVESTOR.GOV, U.S. SEC. AND EXCH. COMM’N, <http://m.investor.gov/investing-basics/investment-products/annuities> (last visited

away from traditional pensions and towards 401(k) plans⁷ and other defined contribution plans⁸ that typically distribute benefits in the form of lump sum distributions rather than as lifetime annuities.⁹ When given the choice, people rarely choose to receive annuity distributions,¹⁰ nor is it common for people to buy annuities in the retail annuity market.¹¹ All in all, Americans will have longer and longer retirements, yet fewer and fewer retirees will have secure, lifetime income streams.

This Article considers how changes in the laws and regulations governing pensions and annuities could help promote secure, lifetime income streams. More specifically, this Article explores how the laws governing annuities could be changed to make voluntary annuitization more attractive and how pension laws could be changed to incentivize plan sponsors to offer more lifetime income options and to encourage plan participants to select those options.

Part II of this Article provides an overview of Social Security, pensions, annuities, and other lifetime income mechanisms in the United States. Next, Part III focuses on the legal rules that govern annuities and pension distributions, and Part IV discusses the role for pension, annuities, and other lifetime income mechanisms in providing secure, lifetime income streams. Finally, Part V considers some options for statutory and regulatory changes that would promote greater annuitization of retirement savings.

July 19, 2016); American Council of Life Insurers, *Glossary* (“Annuity”), <https://www.acli.com/Tools/Pages/Glossary.aspx> (last visited Mar. 20, 2016); *Life Annuity*, INVESTOPEDIA, <http://www.investopedia.com/terms/l/lifeannuity.asp> (last visited July 19, 2016). The person holding an annuity is called an annuitant. *See, e.g., Annuitant*, INVESTOPEDIA, <http://www.investopedia.com/terms/a/annuitant.asp> <http://www.investopedia.com/terms/a/annuitant.asp> (last visited July 19, 2016).

⁷ As more fully discussed in Part II.C.1.b, *infra*, 401(k) plans are retirement savings plans that are authorized by I.R.C. § 401(k) (2014).

⁸ As more fully discussed in Part II.C.1.b, *infra*, in a defined contribution plan, the plan sponsor promises to make a specific “contribution” into an individual investment account for each employee. For example, an employer might contribute 10 percent of annual compensation each year to each employee’s account, and, at retirement, each employee would be entitled to a benefit based on all those contributions plus investment earnings.

⁹ *Id.*

¹⁰ *Id.*

¹¹ *See infra* Parts II.D.2 & IV.A.

II. AN OVERVIEW OF SOCIAL SECURITY, PENSIONS, AND OTHER LIFETIME INCOME MECHANISMS IN THE UNITED STATES

Elderly Americans can generally count on Social Security benefits to cover at least a portion of their retirement income needs. In addition, retirees use pensions, annuities, and a variety of other mechanisms to ensure that they have adequate incomes throughout their retirement years. These are discussed in turn.

A. SOCIAL SECURITY

Social Security provides monthly cash benefits to retirees and their families.¹² A worker builds Social Security protection by working in employment that is covered by Social Security and paying the applicable payroll taxes. At retirement, disability, or death, monthly benefits are paid to insured workers and to their eligible dependents and survivors. While “full retirement age” was once age 65, it is currently age 66, and it is gradually increasing to age 67 for workers born after 1959 (who reach age 67 in or after 2027).¹³ In January of 2016, Social Security paid retirement benefits to more than 40.2 million retired workers, and the average monthly benefit paid to a retired worker was \$1343.68.¹⁴

Social Security retirement benefits are financed primarily through payroll taxes imposed on individuals working in employment or self-employment that is covered by the Social Security system.¹⁵ Workers over the age of 62 generally are entitled to Social Security retirement benefits if

¹² See, e.g., HOUSE WAYS AND MEANS COMMITTEE, GREEN BOOK: BACKGROUND MATERIAL AND DATA ON PROGRAMS WITHIN THE JURISDICTION OF THE COMMITTEE ON WAYS AND MEANS, Chapter 1: Social Security Introduction and Overview (2014), <http://greenbook.waysandmeans.house.gov/2014-green-book>.

¹³ SOC. SEC. ADMIN., *Retirement Planner: Full Retirement Age*, <http://www.socialsecurity.gov/retire2/retirechart.htm> (last visited July 19, 2016).

¹⁴ SOC. SEC. ADMIN., *Monthly Statistical Snapshot, January 2016* 2 tbl.2, https://www.ssa.gov/policy/docs/quickfacts/stat_snapshot/2016-01.pdf (last visited July 19, 2016).

¹⁵ For 2017, employees and employers each pay a Social Security payroll tax of 6.2 percent on up to \$127,200 of wages, for a combined Old-Age and Survivors and Disability Insurance (OASDI) rate of 12.4 percent. SOC. SEC. ADMIN., *2017 Social Security Changes*, <https://www.ssa.gov/news/press/factsheets/colafacts2017.pdf> (last visited Nov. 19, 2016). Self-employed workers pay an equivalent OASDI tax of 12.4 percent on up to \$127,200 of net earnings. *Id.*

they have worked in covered employment for at least 10 years.¹⁶ Benefits are based on a measure of the worker's earnings history in covered employment.¹⁷ The benefit formula is highly progressive,¹⁸ and, as a result, the Social Security retirement system favors workers with low lifetime earnings relative to workers with higher lifetime earnings.¹⁹ These redistributive Social Security retirement benefits play an important role in reducing poverty among the elderly.²⁰ Roughly two-thirds of aged Social Security beneficiaries receive at least half of their income from Social Security.²¹

¹⁶ 42 U.S.C. § 402(a) (2015); 42 U.S.C. § 414(a)(2) (2004).

¹⁷ SOC. SEC. ADMIN., *Social Security Benefit Amounts*, <http://www.ssa.gov/oact/cola/Benefits.html> (last visited July 19, 2016).

¹⁸ Benefits for retired workers are based on a measure of the worker's earnings history in covered employment known as the "average indexed monthly earnings" (AIME). *Id.* The starting point for determining the worker's AIME is to determine how much the worker earned each year through age 60. Once those "benefit computation years" and "covered earnings" for those years have been identified, the worker's earnings are indexed for wage inflation, using the year the worker turns 60 to index the earnings of prior years. The highest 35 years of earnings are then selected, and the other years are dropped out. The AIME is then computed as the average earnings for the remaining 35 years (420 months). The AIME is then linked by a progressive formula to the monthly retirement benefit payable to the worker at full retirement age, a benefit known as the "primary insurance amount" (PIA). For a worker turning 62 in 2016, the PIA equals 90 percent of the first \$856 of the worker's AIME, plus 32 percent of the AIME over \$856 and through \$5157 (if any), plus 15 percent of the AIME over \$5157 (if any). *Id.*; SOC. SEC. ADMIN., *Primary Insurance Amount*, <http://www.ssa.gov/oact/cola/piaformula.html> (last visited July 19, 2016).

¹⁹ *See, e.g.*, Michael Clingman, Kyle Burkhalter & Chris Chaplain, *Money's Worth Ratios Under The OASDI Program For Hypothetical Workers*, SOC. SEC. ADMIN., OFF. OF THE CHIEF ACTUARY (Actuarial Note No. 2015.7, Mar. 2016), <http://www.ssa.gov/OACT/NOTES/ran7/index.html>.

²⁰ *See, e.g.*, Kathleen Romig, *Social Security Lifts 21 Million Americans Out of Poverty*, *CTR. ON BUDGET AND POL'Y PRIORITIES* (Nov. 9, 2015), <http://www.cbpp.org/blog/social-security-lifts-21-million-americans-out-of-poverty-0>. *See also* Kathleen Short, *The Supplemental Poverty Measure: 2014 9 tbl.4a*, U.S. BUREAU OF THE CENSUS (Report No. P60-254, Sept. 2015), <https://www.census.gov/content/dam/Census/library/publications/2015/demo/p60-254.pdf> (showing that with Social Security, just 14.4 percent of elderly Americans were poor in 2014, but without it 50.0 percent would have been); NAT'L ACAD. OF SOC. INS., *The Role of Benefits in Income and Poverty*, <https://www.nasi.org/learn/socialsecurity/benefits-role> (last visited July 19, 2016).

²¹ SOC. SEC. ADMIN., *Fast Facts & Figures About Social Security, 2015 ii* (Publication No. 13-11785, Sept. 2015), <https://www.ssa.gov/policy/docs/>

Benefits may be increased or decreased for several reasons. Most importantly, benefits are indexed each year for inflation as measured by the consumer price index.²² Also, the “retirement earnings test” can reduce the monthly benefits of individuals who have not yet reached full retirement age but who continue to work after starting to draw Social Security retirement benefits.²³

In addition, workers who retire before their full retirement age have their benefits actuarially reduced.²⁴ On the other hand, benefits payable to workers who choose to retire after their full retirement age are actuarially increased (but only up to age 70).²⁵ In effect, beneficiaries can buy additional annuity protection by delaying retirement.²⁶ For example, consider a worker who reached age 62 in January 2016 and earned the maximum taxable amount under Social Security for every year of her working life. If she claimed her Social Security benefits at 62, she would get a starting benefit of \$2102 per month, but if she instead waited until she is 65 to start drawing her benefits, she would get \$2491 per month, and if she waited until age 70, she would get \$3576 per month—and she could get even more when cost-of-living increases and extra earnings are factored in.²⁷

In addition to Social Security benefits, a means-tested Supplemental Security Income (SSI) program provides monthly cash benefits to certain low-income elderly, disabled, or blind Americans.²⁸ In 2016, the maximum federal benefit for a single individual is \$733 per month, and the maximum

chartbooks/fast_facts/2015/fast_facts15.pdf (64 percent of aged beneficiaries received at least half of their income from Social Security in 2013).

²² See, e.g., SOC. SEC. ADMIN., *2017 Social Security Changes*, *supra* note 15.

²³ 42 U.S.C. § 403(f) (2000).

²⁴ 42 U.S.C. § 402(q) (2015).

²⁵ 42 U.S.C. § 402(w) (2015).

²⁶ See, e.g., Kenn Beam Tacchino, David A. Littell & Bruce D. Schobel, *A Decision Framework for Optimizing the Social Security Claiming Age*, 28 BENEFITS Q. 40 (2012), <https://www.iscebs.org/Documents/PDF/bqpublic/bq212f.pdf>; Melissa A. Z. Knoll & Anya Olsen, *Incentivizing Delayed Claiming of Social Security Retirement Benefits Before Reaching the Full Retirement Age*, 74 SOC. SEC. BULL. 21 (2014), <https://www.ssa.gov/policy/docs/ssb/v74n4/v74n4p21.pdf>.

²⁷ SOC. SEC. ADMIN., *Workers with Maximum-Taxable Earnings*, <http://www.ssa.gov/oact/COLA/examplemax.html> (last visited July 19, 2016).

²⁸ See, e.g., HOUSE WAYS AND MEANS COMMITTEE, GREEN BOOK: BACKGROUND MATERIAL AND DATA ON PROGRAMS WITHIN THE JURISDICTION OF THE COMMITTEE ON WAYS AND MEANS, *supra* note 12, at Chapter 3: Supplemental Security Income.

for a couple is \$1,100 per month.²⁹ In January of 2016, almost 2.2 million elderly Americans received SSI benefits from the federal government, and the average monthly benefit was \$434.68.³⁰

B. A BRIEF OVERVIEW OF RETIREMENT SAVINGS

Before delving into the details of pensions, annuities, and other ways of providing lifetime retirement income, it is worth taking a brief look at the magnitude and nature of household retirement savings. According to the Federal Reserve Board, Americans had \$27.3 trillion in household retirement assets at the end of 2015, including \$11.3 trillion in defined benefit plans, \$6.3 trillion in defined contribution plans, \$7.4 trillion in individual retirement accounts (IRAs), and \$2.3 trillion in annuities.³¹ While Americans can also use their other financial assets, and even their houses,³² to help provide them with retirement income, the primary focus of this Article is on the household retirement saving items identified by the Federal Reserve Board. Of the \$8.5 trillion in private-sector pension plans, \$3.1 trillion was held by defined benefit plans, and \$5.4 trillion was held by defined contribution plans.³³ On the other hand, of the \$5.6 trillion in state and local pension plans, \$5.2 trillion was held by defined benefit plans, and just \$478 billion was held by defined contribution plans.³⁴ Similarly, of the \$3.8 trillion

²⁹ SOC. SEC. ADMIN., *SSI Federal Payments for 2016*, <http://www.ssa.gov/oact/cola/SSI.html> (last visited July 19, 2016).

³⁰ SOC. SEC. ADMIN., *Monthly Statistical Snapshot, January 2016*, *supra* note 14, at 3 tbl.3.

³¹ BD. OF GOVERNORS OF THE FED. RESERVE SYS., FINANCIAL ACCOUNTS OF THE UNITED STATES: FLOW OF FUNDS, BALANCE SHEETS, AND INTEGRATED MACROECONOMIC ACCOUNTS: FOURTH QUARTER 2015 (Mar. 10, 2016), <http://www.federalreserve.gov/releases/z1/current/z1.pdf>, at tbl.L.117. *See also* INV. CO. INST., *Quarterly Retirement Market Data*, <https://www.ici.org/research/stats/retirement> (last visited July 19, 2016) (providing data on retirement savings assets in the United States for the most recent quarter). For a discussion of IRAs, *see* Part II.C.1.d, *infra*.

³² *See, e.g.*, U.S. DEP'T OF HOUS. & URBAN DEV., *Frequently Asked Questions About HUD's Reverse Mortgages*, http://portal.hud.gov/hudportal/HUD?src=/program_offices/housing/sfh/hecm/rmtopten (last visited July 19, 2016).

³³ BD. OF GOVERNORS OF THE FED. RESERVE SYS., FINANCIAL ACCOUNTS OF THE UNITED STATES: FLOW OF FUNDS, BALANCE SHEETS, AND INTEGRATED MACROECONOMIC ACCOUNTS: FOURTH QUARTER 2015, *supra* note 31, at tbls.L.118, L.118.b & L.118.c.

³⁴ *Id.* at tbls.L.120, L.120.b & L.120.c.

in federal government pension plans, \$3.3 trillion was held in defined benefit plans, and just \$430 billion was held in defined contribution plans.³⁵

C. PENSION PLANS

The United States has a “voluntary” private pension system, and employers can decide whether and how to provide pension benefits for their employees.³⁶ However, when employers do provide pensions, those pensions are typically subject to regulation under the Employee Retirement Income Security Act of 1974 (ERISA).³⁷ Overall, in March of 2016, 66 percent of private-sector workers had access to ERISA retirement plans, and 49 percent of them participated.³⁸

To encourage Americans to save for retirement in our voluntary pension system, the government relies on two major approaches. First, most pension plans qualify for favorable tax treatment. Basically, employer contributions to a pension are not taxable to the employee;³⁹ the pension fund’s earnings on those contributions are tax-exempt;⁴⁰ and employees pay

³⁵ *Id.* at tbls.L.119, L.119.b & L.119.c. A little bit of caution is warranted here, as the federal government includes both its funded and unfunded obligations to the plans as “assets” of the plans. For example, of the \$3.8 trillion “held” by federal pensions, \$1.7 trillion is identified as marketable and nonmarketable Treasury securities, and \$1.8 trillion represent claims of the pension funds on the sponsor. *Id.* at tbl.L.119.

³⁶ *See, e.g.*, Jonathan Barry Forman & George A. (Sandy) Mackenzie, *The Cost of “Choice” in a Voluntary Pension System*, N. Y. U. REV. OF EMP. BENEFITS & EXEC. COMP. 6-1, 6-4–6-5 (2013).

³⁷ Employee Retirement Income Security Act of 1974, Pub. L. No. 93-406, 88 Stat. 864. *See generally* STAFF OF THE J. COMM. ON TAXATION, 114TH CONG., PRESENT LAW AND BACKGROUND RELATING TO TAX-FAVORED RETIREMENT SAVING AND CERTAIN RELATED LEGISLATIVE PROPOSALS (Comm. Print 2016), https://www.jct.gov/publications.html?func=download&id=4865&chk=4865&no_html=1.

³⁸ U.S. DEP’T OF LABOR, BUREAU OF LABOR STATISTICS, *Employee Benefits in the United States—March 2016* 5 tbl.1 (New Release No. USDL-16-1493, July 22, 2016), <http://www.bls.gov/news.release/pdf/ebs2.pdf>.

³⁹ I.R.C. § 402 (2014).

⁴⁰ I.R.C. § 501(a) (2015). Most pensions hold assets in a trust. I.R.C. § 401(a) (2014); INTERNAL REVENUE SERV., *A Guide to Common Qualified Plan Requirements*, <https://www.irs.gov/Retirement-Plans/A-Guide-to-Common-Qualified-Plan-Requirements> (last updated June 6, 2016) (“A trust is a medium under which the retirement plan assets are accumulated. The employer or employees, or both, contribute to the trust, which forms part of the retirement plan. The assets

tax only when they receive distributions of their pension benefits.⁴¹ Nevertheless, the employer is allowed a current deduction for its contributions (within limits).⁴² Distributions from a pension plan may generally be rolled over tax-free to another pension plan or to an IRA.⁴³ Second, employers and workers are given great flexibility in designing their pension plans, in making contributions, and in making (or taking) distributions.⁴⁴

Despite these retirement savings incentives, pension coverage and participation rates are low. At any point in time, only about one out of two American workers have pension plans. For example, of the 157.3 million Americans workers in 2013, just 80.7 million (51.3 percent) worked for an employer (or union) that sponsored a retirement plan, and just 64.2 million (40.8 percent) participated in that plan.⁴⁵ The probability of pension coverage

are held in the trust until distributed to the employees or their beneficiaries according to the plan's provisions.”). In passing, however, it should be noted that so-called “qualified annuity plans” are invested in annuity contracts rather than held in a trust. I.R.C. §§ 403(a) (2008), 404(a)(2) (2014); STAFF OF THE J. COMM. ON TAXATION, 114TH CONG., PRESENT LAW AND BACKGROUND RELATING TO TAX-FAVORED RETIREMENT SAVING AND CERTAIN RELATED LEGISLATIVE PROPOSALS, *supra* note 37, at 18.

⁴¹ I.R.C. §§ 72 (2015), 402 (2014). *See generally* INTERNAL REVENUE SERV., *Pension and Annuity Income* (Publication No. 575, 2016), <http://www.irs.gov/pub/irs-pdf/p575.pdf>. As distributions are generally taxed at ordinary income tax rates of up to 39.6 percent, retirement accounts are, in effect, “smaller than they appear.” Richard L. Kaplan, *What Now? A Boomer's Baedeker for the Distribution Phase of Defined Contribution Retirement Plans*, N.Y.U. REV. OF EMP. BENEFITS & EXECUTIVE COMPENSATION 4-1, 4-4 (2013).

⁴² I.R.C. § 404 (2014).

⁴³ I.R.C. § 402(c) (2014); STAFF OF THE J. COMM. ON TAXATION, 114TH CONG., PRESENT LAW AND BACKGROUND RELATING TO TAX-FAVORED RETIREMENT SAVING AND CERTAIN RELATED LEGISLATIVE PROPOSALS, *supra* note 37, at 21; INTERNAL REVENUE SERV., *Rollovers of Retirement Plan and IRA Distributions*, <https://www.irs.gov/Retirement-Plans/Plan-Participant,-Employee/Rollovers-of-Retirement-Plan-and-IRA-Distributions> (last updated Feb. 19, 2016).

⁴⁴ Forman & Mackenzie, *The Cost of “Choice” in a Voluntary Pension System*, *supra* note 36, at 6–18.

⁴⁵ Craig Copeland, *Employment-Based Retirement Plan Participation: Geographic Differences and Trends, 2013* 9 fig.1, EMP. BENEFIT RES. INST. (Issue Brief No. 405, Oct. 2014), https://www.ebri.org/pdf/briefspdf/EBRI_IB_405_Oct14.RetPart.pdf.

is greater for older workers, for whites, for highly educated workers, for full-time workers, for higher-income workers, and for workers at larger firms.⁴⁶

Participation in IRAs is even lower than participation in pensions. For example, while 32 percent of U.S. households had an IRA in 2015, only around 14 percent of households made contributions to their IRAs (in 2014).⁴⁷

1. Types of Pension Plans

Pension plans generally fall into two broad categories based on the nature of the benefits provided: defined benefit plans and defined contribution plans.

a. *Defined Benefit Plans*

In a defined benefit plan, an employer promises employees a specific benefit at retirement.⁴⁸ For example, a plan might provide that a worker's annual retirement benefit (B) is equal to 2 percent times the number of years of service (yos) times final average compensation (fac) ($B = 2 \text{ percent} \times yos \times fac$). Under this traditional, final-average-pay formula, a worker who retires after 30 years of service with final average compensation of \$50,000 would receive a pension of \$30,000 a year for life ($\$30,000 = 2 \text{ percent} \times 30 yos \times \$50,000 fac$).⁴⁹

⁴⁶ *Id.* at 10 fig.2.

⁴⁷ Sarah Holden & Daniel Schrass, *The Role of IRAs in U.S. Households' Saving for Retirement, 2015*, 22(1) ICI RES. PERSP. 2, 19 (Feb. 2016), <https://www.ici.org/research/retirement>. See also Craig Copeland, *Individual Retirement Account Balances, Contributions, and Rollovers, 2013; With Longitudinal Results 2010–2013: The EBRI IRA Database*, EMP. BENEFIT RES. INST. (Issue Brief No. 414, May 2015), https://www.ebri.org/pdf/briefspdf/EBRI_IB_414.May15.IRAs.pdf.

⁴⁸ STAFF OF THE J. COMM. ON TAXATION, 114TH CONG., PRESENT LAW AND BACKGROUND RELATING TO TAX-FAVORED RETIREMENT SAVING AND CERTAIN RELATED LEGISLATIVE PROPOSALS, *supra* note 37, at 10–11. To provide that benefit, the employer typically makes payments into a trust fund, contributed funds grow with investment returns, and eventually the employer withdraws funds from the trust fund to pay the promised benefits. See *supra* note 40 and accompanying text. Employer contributions are based on actuarial valuations, and the employer bears all of the investment risks and responsibilities.

⁴⁹ Final average compensation is often computed by averaging the worker's salary over the last three or five years prior to retirement. Alternatively, some plans

The default benefit for defined benefit plans is a retirement income stream in the form of an annuity for life.⁵⁰ While many defined benefit plans allow for lump sum distributions, most retirees receive lifetime annuities. According to the U.S. Government Accountability Office, 67.8 percent of workers who left employment and retired with a defined benefit pension from 2000 through 2006 took the defined benefit plan annuity.⁵¹ For married participants, defined benefit plans (and some defined contribution plans) are required to provide a qualified joint-and-survivor annuity (QJSA) as the normal benefit payment, unless the spouse consents to another form of distribution.⁵² Defined benefit plans generally cannot make in-service distributions to a participant before age 62, but they may permit loans to participants.⁵³

b. *Defined Contribution Plans*

Under a typical defined contribution plan, the employer simply withholds a specified percentage of the worker's compensation, which it

use career-average compensation instead of final-average compensation. Under a career-average earnings formula, benefits are based on a percentage of an average of career earnings for every year of service by the employee. *See, e.g.*, William J. Wiatrowski, *The last private industry pension plans: a visual essay*, 135(12) MONTHLY LAB. REV. 3, 13 (2012), <http://www.bls.gov/opub/mlr/2012/12/art1full.pdf>; Olivia S. Mitchell, with Erica L. Dykes, *New Trends in Pension Benefit and Retirement Provisions*, in BENEFITS FOR THE WORKPLACE OF THE FUTURE 110 (Olivia S. Mitchell, David S. Blitzstein, Michael Gordon & Judith F. Mazo, eds.); EMP. BENEFIT RES. INST., *Fundamentals Chapter 4 - Pension Plans*, <https://www.ebri.org/publications/books/index.cfm?fa=fund04> (last visited July 19, 2016).

⁵⁰ In the United States, defined benefit plans are generally designed to provide annuities, i.e., “definitely determinable benefits . . . over a period of years, usually for life after retirement.” Treas. Reg. § 1.401-1(b)(1) (2016).

⁵¹ U.S. GOV'T ACCOUNTABILITY OFF., GAO-11-400, RETIREMENT INCOME: ENSURING INCOME THROUGHOUT RETIREMENT REQUIRES DIFFICULT CHOICES 26 (2011), <http://www.gao.gov/new.items/d11400.pdf>.

⁵² ERISA § 205, 29 U.S.C. § 1055 (2014); I.R.C. § 401(a)(11) (2014). A QJSA is an immediate annuity for the life of the pension plan participant and a survivor annuity for the life of the participant's spouse. ERISA § 205(d)(1), 29 U.S.C. § 1055(d)(1) (2014); I.R.C. § 417(b) (2014).

⁵³ INTERNAL REVENUE SERV., *Choosing a Retirement Plan: Defined Benefit Plan*, <https://www.irs.gov/Retirement-Plans/Choosing-a-Retirement-Plan:-Defined-Benefit-Plan> (last updated Oct. 20, 2015).

contributes to an individual investment account for the worker.⁵⁴ For example, contributions might be set at 10 percent of annual compensation. Under such a plan, a worker who earned \$50,000 in a given year would have \$5,000 contributed to an individual investment account for her (\$5,000 = 10 percent × \$50,000). Her benefit at retirement would be based on all such contributions plus investment earnings.⁵⁵ Many defined contribution plans also provide for loans to participants,⁵⁶ and some plans can also provide in-service “hardship” distributions.⁵⁷

Unlike defined benefit plans, defined contribution plans usually make distributions as lump sum or periodic distributions rather than as lifetime annuities.⁵⁸ Indeed, relatively few defined contribution plans even offer annuity options, and, in any event, relatively few participants elect

⁵⁴ STAFF OF THE J. COMM. ON TAXATION, 114TH CONG., PRESENT LAW AND BACKGROUND RELATING TO TAX-FAVORED RETIREMENT SAVING AND CERTAIN RELATED LEGISLATIVE PROPOSALS, *supra* note 37, at 10.

⁵⁵ Defined contribution plans are also known as “individual account” plans because each worker has her own account, as opposed to defined benefit plans, where the plan’s assets are pooled for the benefit of all of the employees. ERISA § 3(34), 29 U.S.C. § 1002(34) (2008).

⁵⁶ I.R.C. § 72(p) (2015); STAFF OF THE J. COMM. ON TAXATION, 114TH CONG., PRESENT LAW AND BACKGROUND RELATING TO TAX-FAVORED RETIREMENT SAVING AND CERTAIN RELATED LEGISLATIVE PROPOSALS, *supra* note 37, at 31–33; INTERNAL REVENUE SERV., *Retirement Topics - Plan Loans*, <https://www.irs.gov/Retirement-Plans/Plan-Participant,-Employee/Retirement-Topics-Loans> (last updated May 26, 2016); *Many Have Access to 401(k) Loans, Few Have Outstanding Balances*, EMP. BENEFIT RES. INST. (Fast Fact No. 264, Jan. 16, 2014), <https://www.ebri.org/pdf/FF.264.K-loans.16Jan142.pdf> (87 percent of participants in the 2012 EBRI/ICI 401(k) database were in plans offering loans at year-end 2012); *see also* Jack VanDerhei, Sarah Holden, Luis Alonso, Steven Bass & AnnMarie Pino, *401(k) Plan Asset Allocation, Account Balances, and Loan Activity in 2013*, EMP. BENEFIT RES. INST. (Issue Brief No. 408, 2014), [https://www.ebri.org/pdf/briefspdf/EBRI_IB_408_Dec14.401\(k\)-update.pdf](https://www.ebri.org/pdf/briefspdf/EBRI_IB_408_Dec14.401(k)-update.pdf).

⁵⁷ *See, e.g.*, STAFF OF THE J. COMM. ON TAXATION, 114TH CONG., PRESENT LAW AND BACKGROUND RELATING TO TAX-FAVORED RETIREMENT SAVING AND CERTAIN RELATED LEGISLATIVE PROPOSALS, *supra* note 37, at 31–33.

⁵⁸ *See, e.g.*, WILLIS TOWERS WATSON, INTERNATIONAL PENSION PLAN SURVEY: REPORT 2016, at 14 (2016), <https://www.willistowerswatson.com/en/insights/2016/02/international-pension-plan-survey-report-2015> (indicating that lump sums distributions are “by far the most prevalent” form of distribution for defined contribution plans).

those annuity options.⁵⁹ There are exceptions like TIAA—which reports that around 75 percent of its beneficiaries receive annuity payments.⁶⁰ Also, some

⁵⁹ In 2010, just 18 percent of private industry workers in defined contribution plans had annuities available to them. U.S. BUREAU OF LABOR STAT., *National Compensation Survey: Health and Retirement Plan Provisions in Private Industry in the United States, 2010* tbl.21 (Bulletin 2770, 2011), <http://www.bls.gov/nchs/ebs/detailedprovisions/2010/ebb10047.pdf>. See also John E. Foster & David C. Zook, *Selected characteristics of savings and thrift plans for private industry workers*, 4(11) BEYOND THE NUMBERS: PAY & BENEFITS cht.3 (July 2015), <http://www.bls.gov/opub/btn/volume-4/selected-characteristics-of-savings-and-thrift-plans-for-private-industry-workers.htm> (showing that just 17 percent of participants in private-sector thrift and savings plans had an annuity option available in 2012); *Annual Defined Contribution Benchmarking Survey Ease of Use Drives Engagement in Saving for Retirement, 2015 Edition*, DELOITTE 32 ex.5.1 (2015), <http://www2.deloitte.com/content/dam/Deloitte/us/Documents/human-capital/us-hc-annual-defined-benchmarking-survey-2015.pdf> (only 5 percent of 401(k) plan sponsors included an in-plan retirement income product in the menu of options presented to participants); Michael J. Brien & Constantijn W.A. Panis, *Annuities in the Context of Defined Contribution Plans* 12–14 (Nov. 2011), <http://www.dol.gov/ebsa/pdf/deloitte2011.pdf> (finding that just 6.1 percent of workers who retire with a defined contribution plan convert their account balance to an annuity, although additional annuitization probably takes place among those retirees who roll their defined contribution balances into IRAs); U.S. GOV'T ACCOUNTABILITY OFF., GAO-11-400, RETIREMENT INCOME: ENSURING INCOME THROUGHOUT RETIREMENT REQUIRES DIFFICULT CHOICES, *supra* note 51, at 28 (also a 6.1 percent election rate); Lawrence A. Frolik, *Rethinking ERISA's Promise on Income Security in a World of 401(k) Plans*, 20(2) CONN. INS. L.J. 371 (2013–2014); Carlos Figueiredo & Sandy Mackenzie, *Older Americans' Ambivalence Toward Annuities: Results of an AARP Survey of Pension Plan and IRA Distribution Choices*, TIAA INST. 6 n.9 (2012), <https://www.tiaainstitute.org/public/pdf/institute/events/pdfs/Older+Americans+Ambivalence+Toward+Annuities.pdf> (noting that the 54th Annual Survey of Profit Sharing and 401(k) Plans carried out by the Plan Sponsor Council of America found that just 16.6 percent offered annuities as an option, while 60.2 percent offered periodic withdrawals); JOHN J. TOPOLESKI, CONG. RESEARCH SERV., R40707, 401(K) PLAN AND RETIREMENT SAVINGS: ISSUES FOR CONGRESS 25 (2011), http://digitalcommons.ilr.cornell.edu/cgi/viewcontent.cgi?article=1785&context=key_workplace (only 21 percent of 401(k) plans offered lifetime annuity options in 2007, and fewer than 10 percent of participants in those plans chose that annuity option); Paul Yakoboski, *Retirees, Annuitization and Defined Contribution Plans*, TIAA-CREF INST. 3, 5 (Apr. 2010), https://www.tiaa-crefinstitute.org/public/pdf/institute/research/trends_issues/ti_definedcontribution0410.pdf (finding that only around 19 percent of retirees with significant defined contribution plan assets but little defined benefit pension income

public sector plans allow their retirees to convert the balances in their defined contribution plans to annuities.⁶¹

In the United States, there are a variety of different types of defined contribution plans, including money purchase pension plans, target benefit plans, profit-sharing plans, stock bonus plans, and employee stock

annuitized a portion of their retirement savings); Beverly I. Orth, *Approaches for Promoting Voluntary Annuityization*, in 2008 Retirement 20/20 Conference (Society of Actuaries Monograph No. M-RS08-1, 2009), <http://www.soa.org/library/monographs/retirement-systems/retirement2020/2008/november/mono-2008-m-rs08-01-orth.pdf>; Michael Hurd & Constantijn Panis, *The Choice to Cash Out, Maintain, or Annuitize Pension Rights upon Job Change or Retirement*, 90(12) J. OF PUB. ECON. 2213 (2006) (finding that just 7 percent of workers who retired from a job with a defined contribution plan converted their retirement savings into an annuity).

⁶⁰ Josh B. McGee, *Defined-Contribution Pensions Are Cost Effective*, CTR. FOR ST. AND LOC. LEADERSHIP AT THE MANHATTAN INST. 13, (Aug. 2015), <https://www.manhattan-institute.org/download/6361/article.pdf>; Josh B. McGee & Paul J. Yakoboski, *Equivalent Cost for Equivalent Benefits: Primary DC Plans in the Public Sector*, TIAA-CREF INST. 3 (Oct. 2013), <http://welcomentsa.org/wp-content/uploads/2014/02/equivalent-cost-for-equivalent-benefits.pdf>. See also Paul J. Yakoboski, *How Retirees Manage Retirement Savings for Retirement Income?: A Survey of TIAA-CREF Participants*, TIAA-CREF INST. (Oct. 2015), https://www.tiaainstitute.org/public/pdf/How_Retirees_Manage_Savings_for_Income_Data_Summary_FINAL.pdf (attitude survey); Yakoboski, *Retirees, Annuityization and Defined Contribution Plans*, *supra* note 59; Paul J. Yakoboski, *Converting Assets to Income in Retirement: What Near-Retirees Are Thinking*, TIAA-CREF INST. (Oct. 2009), https://www.tiaainstitute.org/public/pdf/institute/research/trends_issues/ti_convertingassets1009.pdf (attitude survey); Teresa Hassara, *The 403(b) lifetime income lesson for 401(k) plans*, PENSIONS & INVESTMENTS (Nov. 30, 2015), <http://www.pionline.com/article/20151130/PRINT/311309998/the-403b-lifetime-income-lesson-for-401k-plans>; David P. Richardson, *How do TIAA-CREF Participants Annuitize?*, INT'L CTR. FOR PENSION MGMT. DISCUSSION F. (Oct. 8, 2014), http://www.icpmnetwork.com/wp-content/uploads/2016/04/David_P_Richardson_TIAA-CREF_ICPM_October_2013.pdf.

⁶¹ See, e.g., Diane Oakley & Jennifer Erin Brown, *Preserving Retirement Income Security for Public Sector Employees* 14, NAT'L INST. ON RET. SEC. (July 2016), http://www.nirsonline.org/storage/nirs/documents/Portability%20Report/preserving_security_public_sector_web.pdf (noting that the Colorado Public Employees' Retirement Association allows retirees to convert their defined contribution account balances into annuities "at the PERA assumed rate of return, which is less costly than purchasing an annuity from an insurance company").

ownership plans (“ESOPs”).⁶² Of particular importance, profit-sharing and stock bonus plans often include a feature that allows workers to choose between receiving cash currently or deferring taxation by placing the money in a retirement account according to Internal Revenue Code Section 401(k). Consequently, these plans are usually called “401(k) plans,” and they are the most popular type of retirement plan in the United States.⁶³ The maximum annual amount of such elective deferrals that can be made by an individual in 2017 is \$18,000, although workers over the age of 50 can contribute another \$6,000 (for a total of up to \$24,000).⁶⁴ Also, since 2006, employers have been permitted to set up Roth 401(k) plans.⁶⁵ Section 401(k) plans may be designed so that the employee automatically makes elective deferrals at a specified rate unless the employee elects otherwise.⁶⁶ Such automatic enrollment features can lead to higher participation rates, and automatically escalating the participants’ levels of contributions can lead to even greater retirement savings.⁶⁷ In passing, it should be noted that 401(k)-type rules also

⁶² See, e.g., U.S. DEP’T OF LABOR, BUREAU OF LABOR STAT., *Six Ways to Save for Retirement*, 3(3) PROGRAM PERSPECTIVES 1, 2 (2011), http://www.bls.gov/opub/perspectives/program_perspectives_vol3_issue3.pdf. A money purchase pension plan is a defined contribution plan that requires fixed annual contributions from the employer to the employee’s individual account. See, e.g., U.S. DEP’T OF LABOR, EMP. BENEFITS SEC. ADMIN., *What You Should Know About Your Retirement Plan* 18, 36 (2013), <http://www.dol.gov/ebsa/pdf/wyskgreenbook.pdf>.

⁶³ See, e.g., U.S. DEP’T OF LABOR, BUREAU OF LABOR STAT., *BLS examines popular 401(k) retirement plans*, 2(6) PROGRAM PERSPECTIVES 1 (Nov. 2010), http://www.bls.gov/opub/perspectives/program_perspectives_vol2_issue6.pdf; see *infra* notes 114-116 and accompanying text.

⁶⁴ INTERNAL REVENUE SERV., *IRS Announces 2017 Pension Plan Limitations: 401(k) Contribution Limit Remains Unchanged at \$18,000 for 2017* (IR-2016-141, Oct. 27, 2016), <https://www.irs.gov/uac/newsroom/irs-announces-2017-pension-plan-limitations-401k-contribution-limit-remains-unchanged-at-18000-for-2017>.

⁶⁵ I.R.C. § 402A (2014). Contributions to these plans are not excludable, but neither the plan’s investment returns nor distributions are taxable.

⁶⁶ See, e.g., STAFF OF THE J. COMM. ON TAXATION, 114TH CONG., PRESENT LAW AND BACKGROUND RELATING TO TAX-FAVORED RETIREMENT SAVING AND CERTAIN RELATED LEGISLATIVE PROPOSALS, *supra* note 37, at 25–26.

⁶⁷ See, e.g., OECD, *OECD Pensions Outlook 2012* 45–76 (2012), http://www.oecd-ilibrary.org/finance-and-investment/oecd-pensions-outlook-2012_9789264169401-en; Jack VanDerhei, *Increasing Default Deferral Rates in Automatic Enrollment 401(k) Plans: The Impact on Retirement Savings Success in Plans with Automatic Escalation*, 33(9) EMP. BENEFIT RES. INST. NOTES 12 (2012); Richard H. Thaler & Schlomo Bernartzi, *The Behavioral Economics of Retirement*

apply to so-called “403(b) plans” that are used by many tax-exempt organizations and public schools (including colleges and universities).⁶⁸

c. *Hybrid Retirement Plans*

So-called “hybrid” retirement plans mix the features of defined benefit and defined contribution plans. For example, a cash balance plan is a defined benefit plan that looks like a defined contribution plan.⁶⁹

d. *Individual Retirement Accounts*

Favorable tax rules are also available for individual retirement accounts (IRAs).⁷⁰ Almost any worker can set up an IRA with a bank or other financial institution. In 2017, individuals without pension plans can contribute and deduct up to \$5,500 to an IRA, although individuals over age 50 can contribute and deduct another \$1,000 (for a total of up to \$6,500); and

Savings Behavior, AARP PUB. POL’Y INST. (Research Report No. 2007-02, 2007), http://assets.aarp.org/rgcenter/econ/2007_02_savings.pdf. Of note, the Pension Protection Act of 2006 made it easier for employers to include automatic enrollment features in pension plans. Pension Protection Act of 2006 § 902, Public Law No. 109-280, 120 Stat. 780 (adding I.R.C. §§ 401(k)(13), 401(m)(12) & 414(w)).

⁶⁸ I.R.C. § 403(b) (2008); STAFF OF THE J. COMM. ON TAXATION, 114TH CONG., PRESENT LAW AND BACKGROUND RELATING TO TAX-FAVORED RETIREMENT SAVING AND CERTAIN RELATED LEGISLATIVE PROPOSALS, *supra* note 37, at 18–21 (also discussing so-called “457(b) plans” used by State and local government and tax-exempt employers).

⁶⁹ *See, e.g.*, Jonathan Barry Forman & Amy Nixon, *Cash Balance Pension Plan Conversions*, 25(1&2) OKLA. CITY U. L. REV. 379 (2000). Like other defined benefit plans, employer contributions are based on actuarial valuations, and the employer bears all of the investment risks and responsibilities. Like defined contribution plans, however, cash balance plans provide workers with individual accounts (albeit hypothetical). A simple cash balance plan might allocate 10 percent of salary to each worker’s account each year and credit the account with 5 percent interest on the balance in the account. Under such a plan, a worker who earned \$50,000 in a given year would get an annual cash balance credit of \$5,000 ($\$5,000 = 10 \text{ percent} \times \$50,000$), plus an interest credit equal to 5 percent of the balance in her hypothetical account as of the beginning of the year.

⁷⁰ I.R.C. § 219 (2014); STAFF OF THE J. COMM. ON TAXATION, 114TH CONG., PRESENT LAW AND BACKGROUND RELATING TO TAX-FAVORED RETIREMENT SAVING AND CERTAIN RELATED LEGISLATIVE PROPOSALS, *supra* note 37, at 36–39.

spouses can contribute and deduct similar amounts.⁷¹ If a worker is covered by another retirement plan, however, the deduction may be reduced or eliminated in 2017 if the worker's income exceeds \$62,000 for a single individual or \$99,000 for a married couple.⁷² Like private pensions, IRA earnings are tax-exempt, and distributions are taxable.⁷³

Also, since 1998, individuals have been permitted to set up Roth IRAs.⁷⁴ Unlike regular IRAs, contributions to Roth IRAs are not deductible. Instead, withdrawals are tax-free.⁷⁵ Like regular IRAs, however, Roth IRA earnings are tax-exempt.⁷⁶

These days, rollovers from pension plans account for most of the balances in IRAs. For example, according to one recent study, 14.5 times as many dollars added to IRAs in 2013 came from rollovers than came from contributions.⁷⁷ Another recent study found that the majority (62 percent) of recent retirees with at least \$75,000 in a defined contribution plan at retirement moved their assets out of those plans, and the overwhelming majority of them rolled their money into an IRA.⁷⁸

⁷¹ INTERNAL REVENUE SERV., *IRS Announces 2017 Pension Plan Limitations; 401(k) Contribution Limit Remains Unchanged at \$18,000 for 2017*, *supra* note 64.

⁷² *Id.*

⁷³ I.R.C. § 408 (2015). Also, so-called "Keogh plans" give self-employed workers an ability to save for retirement that is similar to plans that employers sponsor, and Keogh plans allow self-employed workers to contribute more than they could otherwise contribute to a regular IRA. INTERNAL REVENUE SERV., *Retirement Plans for Small Business (SEP, Simple, and Qualified Plans)* 2, 12 (Publication No. 560, Jan. 14, 2016), <http://www.irs.gov/pub/irs-pdf/p560.pdf>.

⁷⁴ I.R.C. § 408A (2010).

⁷⁵ STAFF OF THE J. COMM. ON TAXATION, 114TH CONG., PRESENT LAW AND BACKGROUND RELATING TO TAX-FAVORED RETIREMENT SAVING AND CERTAIN RELATED LEGISLATIVE PROPOSALS, *supra* note 37, at 38–39.

⁷⁶ *Id.*

⁷⁷ Copeland, *Individual Retirement Account Balances, Contributions, and Rollovers, 2013; With Longitudinal Results 2010–2013: The EBRI IRA Database*, *supra* note 47, at 11.

⁷⁸ American College of Financial Services, *The American College Defined Contribution Rollover Survey 7*, 24 (Jan. 2016), http://retirement.theamericancollege.edu/sites/amcol-nylcri/files/IRA_Rollover_Research.pdf (online survey conducted by Greenwald & Associates on behalf of The American College's New York Life Center for Retirement Income).

As more fully discussed in Part III.D below, individuals can use their IRAs to buy annuities, although data limitations make it hard to get an accurate estimate of how often that happens.⁷⁹

e. *Other Tax Benefits for Retirement Savings*

Also, since 2002, certain low- and moderate-income individuals have been able to claim a saver's tax credit of up to \$1000 for certain qualified retirement savings contributions.⁸⁰ Finally, qualified small firms may claim a nonrefundable tax credit of up to \$500 for certain costs incurred in setting up a new retirement plan for employees ("start-up credit").⁸¹

2. The Regulation of Employment-based Plans

Since it was enacted more than 40 years ago, the Employee Retirement Income Security Act (ERISA) has been amended numerous times, and a whole regulatory system has grown up to enforce its provisions. The key agencies charged with the administration of ERISA are the U.S. Department of Labor, the Internal Revenue Service (IRS), and the Pension Benefit Guaranty Corporation (PBGC).⁸²

⁷⁹ Brien & Panis, *Annuities in the Context of Defined Contribution Plans*, *supra* note 59, at 14.

⁸⁰ I.R.C. § 25B (2013); INTERNAL REVENUE SERV., *Retirement Savings Contributions Credit (Saver's Credit)*, <https://www.irs.gov/Retirement-Plans/Plan-Participant,-Employee/Retirement-Savings-Contributions-Savers-Credit> (last updated Feb. 22, 2016). The credit equals a percentage (50 percent, 20 percent, or 10 percent) of up to \$2,000 of contributions. In effect, the credit acts like an employer match: the government matches a portion of the employee's contributions. Employer matches encourage workers to contribute, at least up to the match level, and the saver's tax credit seems to have similar pro-savings effects. *See, e.g.*, Lisa Southwirth & John Gist, *The Saver's Credit: What Does It Do For Saving?*, AARP PUB. POL'Y INST. (Insight on the Issues Paper, 2008), http://assets.aarp.org/rgcenter/econ/i1_credit.pdf.

⁸¹ I.R.C. § 45E (2002); INTERNAL REVENUE SERV., *Retirement Plans Startup Costs Tax Credit*, <https://www.irs.gov/Retirement-Plans/Retirement-Plans-Startup-Costs-Tax-Credit> (last updated Aug. 18, 2015). The credit is equal to 50 percent of up to \$1,000 in eligible costs incurred in each of the first three years of the plan's existence.

⁸² U.S. DEP'T OF LABOR, EMP. BENEFITS SEC. ADMIN., *About the Employee Benefits Security Administration*, <http://www.dol.gov/ebsa/aboutebsa/main.html> (last visited July 19, 2016); INTERNAL REVENUE SERV., *Tax Information for*

Pension plans must be operated for the exclusive benefit of employees (and beneficiaries).⁸³ To protect the interests of plan participants, ERISA requires significant reporting and disclosure in the administration and operation of employee benefit plans.⁸⁴ ERISA also imposes extensive fiduciary responsibilities on plan sponsors and the administrators of employee benefit plans.⁸⁵

In general, a fiduciary includes any person who: (1) exercises any authority or control respecting management or disposition of the plan's assets; (2) renders investment advice for a fee or other compensation with respect to any plan moneys or property, or has the authority or responsibility to do so; or (3) has any discretionary authority or responsibility in the administration of the plan.⁸⁶ When acting as a fiduciary, the plan sponsor must:

- (1) operate solely in the best interest of the participants and beneficiaries and with the exclusive purpose of providing benefits to them;
- (2) carry out its duties prudently;
- (3) follow the plan documents (unless inconsistent with ERISA); and
- (4) diversify the plan's investments; and pay only reasonable plan expenses.⁸⁷

Retirement Plans, <http://www.irs.gov/Retirement-Plans> (last visited July 19, 2016); Pension Benefit Guaranty Corporation, *About PBGC*, <http://www.pbgc.gov/about> (last visited July 19, 2016).

⁸³ ERISA § 404(a)(1)(A), 29 U.S.C. § 1104(a)(1)(A) (2008); I.R.C. § 401(a) (2014).

⁸⁴ ERISA §§ 101(a) et seq., 29 U.S.C. §1021 et seq. (2015). See also U.S. DEP'T OF LABOR, EMP. BENEFITS SEC. ADMIN., *Reporting and Disclosure Guide for Employee Benefit Plans* (Sept. 2014), <https://www.dol.gov/ebsa/pdf/rdguide.pdf>.

⁸⁵ ERISA § 404, 29 U.S.C. § 1104 (2008); I.R.C. § 401(a) (2014).

⁸⁶ ERISA § 3(21), 29 U.S.C. § 1002(21) (2008).

⁸⁷ See, e.g., U.S. DEP'T OF LABOR, EMP. BENEFITS SEC. ADMIN., *Meeting Your Fiduciary Responsibilities 2* (2012), <http://www.dol.gov/ebsa/pdf/meetingyourfiduciaryresponsibilities.pdf> (explaining to employers how to administer their retirement plans).

The fiduciary duty under ERISA is the “highest duty known to the law,”⁸⁸ and fiduciary “decisions must be made with an eye single to the interests of the participants and beneficiaries.”⁸⁹

Of note, the U.S. Department of Labor recently extended the definition of a fiduciary to virtually all retirement advisers who receive compensation for providing investment advice to plan sponsors, plan participants, or IRA owners.⁹⁰ The new fiduciary conflict-of-interest rule will apply to those who sell annuities to pension plans and IRAs.⁹¹

In addition to the fiduciary responsibility rules, so-called “prohibited transaction” rules prevent parties in interest from engaging in certain transactions with the plan.⁹² ERISA and the Internal Revenue Code impose many other requirements on retirement plans, including rules governing participation,⁹³ coverage,⁹⁴ vesting,⁹⁵ benefit accrual,⁹⁶ contribution and

⁸⁸ *Donovan v. Bierwirth*, 680 F.2d 263, 272 n.8 (2d Cir.), *cert. denied*, 459 U.S. 1069 (1982).

⁸⁹ *Id.* at 680 F.2d at 271.

⁹⁰ *See, e.g.*, U.S. DEP’T OF LABOR, EMP. BENEFITS SEC. ADMIN., *Conflict of Interest Final Rule*, <http://www.dol.gov/ebsa/regs/conflictsofinterest.html> (last visited July 19, 2016); U.S. DEP’T OF LABOR, EMP. BENEFITS SEC. ADMIN., *Definition of the Term “Fiduciary”; Conflict of Interest Rule-Retirement Investment Advice*, 81 Fed. Reg. 20,945 (Apr. 8, 2016), <http://webapps.dol.gov/FederalRegister/PdfDisplay.aspx?DocId=28806>.

⁹¹ U.S. DEP’T OF LABOR, EMP. BENEFITS SEC. ADMIN., *Amendment to and Partial Revocation of Prohibited Transaction Exemption (PTE) 84-24 for Certain Transactions Involving Insurance Agents and Brokers, Pension Consultants, Insurance Companies, and Investment Company Principal Underwriters*, 81 Fed. Reg. 21,147 (Apr. 8, 2016), <http://webapps.dol.gov/FederalRegister/PdfDisplay.aspx?DocId=28810>. *See also* David C. Kaleda, *Department of Labor’s Final “Investment Advice” Regulation and Its Impact on the Retail Investor Marketplace*, 23(7) THE INV. LAW. 1 (July 2016), http://www.groom.com/media/publication/1719_DOL_Final_Investment_Advice_Regulation_and_Its_Impact_on_the_Retail_Investor_Marketplace.pdf; Scott Stolz, *How Annuities Will Be Transformed by DOL Fiduciary Rule*, THINKADVISOR (Feb. 1, 2016), <http://www.thinkadvisor.com/2016/02/01/how-annuities-will-be-transformed-by-dol-fiduciary>.

⁹² ERISA § 406, 29 U.S.C. § 1106 (1974); I.R.C. § 4975 (2008). For example, an employer usually cannot sell, exchange, or lease any property to the plan.

⁹³ I.R.C. § 410(a) (2006); ERISA § 202, 29 U.S.C. § 1052 (1989).

⁹⁴ I.R.C. § 410(b) (2006).

⁹⁵ I.R.C. § 411(a) (2011); ERISA § 203, 29 U.S.C. § 1053 (2010).

⁹⁶ I.R.C. § 411(b) (2011); ERISA § 204, 29 U.S.C. § 1054 (2014).

benefits,⁹⁷ nondiscrimination,⁹⁸ and funding.⁹⁹ Also, distributions made before age 59½ are subject to an additional 10-percent early distribution penalty unless an exception applies;¹⁰⁰ and required minimum distribution (RMD) rules generally require plan participants to begin taking distributions soon after they reach age 70½.¹⁰¹

In addition to meeting their funding obligations, defined benefit plans in the private sector must also pay premiums to the PBGC for plan termination insurance.¹⁰² In the event that an underfunded, private-sector

⁹⁷ I.R.C. § 415 (2012).

⁹⁸ I.R.C. § 401(a)(4) (2011).

⁹⁹ I.R.C. § 412 (2016); ERISA § 302, 29 U.S.C. § 1082 (2011). While plan sponsors are supposed to fully fund their defined benefit plans, for a variety of reasons, plans can become underfunded. When a private sector defined benefit plans becomes underfunded, the funding rules generally require them to make up that shortfall by making level installment payments amortized over seven years. As ERISA does not apply to governmental plans, however, many such plans are underfunded. ERISA § 4, 29 U.S.C. § 1003 (2012); Alicia H. Munnell, Jean-Pierre Aubry & Mark Cafarelli, *How Did State/Local Plans Become Underfunded?*, B.C. CTR. FOR RET. RES. (State and Local Pension Plans Issue in Brief No. 42, Jan. 2015), http://crr.bc.edu/wp-content/uploads/2015/01/slp_42.pdf.

¹⁰⁰ I.R.C. § 72(t) (2012); STAFF OF THE J. COMM. ON TAXATION, 114TH CONG., PRESENT LAW AND BACKGROUND RELATING TO TAX-FAVORED RETIREMENT SAVING AND CERTAIN RELATED LEGISLATIVE PROPOSALS, *supra* note 37, at 43.

¹⁰¹ I.R.C. § 401(a)(9) (2011); STAFF OF THE J. COMM. ON TAXATION, 114TH CONG., PRESENT LAW AND BACKGROUND RELATING TO TAX-FAVORED RETIREMENT SAVING AND CERTAIN RELATED LEGISLATIVE PROPOSALS, *supra* note 37, at 43–47. More specifically, distributions typically must begin no later than April 1 of the calendar year following the calendar year in which the employee attains age 70½. Distributions after the death of a plan participant must also meet certain minimum distribution requirements. An exception allows older workers with a pension plan from their current employer to delay distributions until they retire, but workers with pensions from prior employers and IRA holders must begin taking distributions from those plans soon after they reach age 70½. I.R.C. § 401(a)(9) (2011). Failure to take the required minimum distribution can result in a 50 percent excise tax penalty on the excess of the amount required to have been distributed over the amount that actually was distributed. I.R.C. § 4974 (2007). In addition, a plan that fails to make the required minimum distributions can be disqualified. INTERNAL REVENUE SERV., *Fixing Common Plan Mistakes - Failure to Timely Start Minimum Distributions*, <https://www.irs.gov/retirement-plans/plan-sponsor/fixing-common-plan-mistakes-failure-to-timely-start-minimum-distributions> (last updated Jan. 22, 2016).

¹⁰² ERISA § 4006, 29 U.S.C. § 1306 (2012); PENSION BENEFIT GUAR. CORP., *Premium Rates*,

defined benefit plan terminates (for example, because the employer goes out of business), the PBGC will pay annual pension benefits of up to \$64,432 per participant in 2017 (\$5,369.32 per month).¹⁰³ The PBGC insures the benefits of more than 40 million workers and retirees, and it pays benefits to nearly 840,000 people each month.¹⁰⁴

Federal laws outside of ERISA and the Internal Revenue Code can also impose limits on pension plans. For example, even though women tend to live longer than men,¹⁰⁵ Title VII of the Civil Rights Act of 1964 bars pension plans from requiring higher contributions from women than men or paying women lower benefits than men.¹⁰⁶

3. The Shift from Defined Benefit Plans to Defined Contribution Plans

Over the past few decades, there has been a major shift from traditional defined benefit plans to defined contribution plans.¹⁰⁷ As already

<http://www.pbgc.gov/prac/prem/premium-rates.html> (last visited Nov. 19, 2016).

¹⁰³ PENSION BENEFIT GUAR. CORP., *PBGC Guarantee Limit for Single-Employer Plans Increases for 2017* (Oct. 28, 2016), <http://pbgc.gov/news/press/releases/pr16-16.html>; PENSION BENEFIT GUAR. CORP., *Maximum Monthly Guarantee Tables*, <http://www.pbgc.gov/wr/benefits/guaranteed-benefits/maximum-guarantee.html#2017> (last visited Nov. 19, 2016) (noting that the guarantee is lower for those who retire early or when there is a benefit for a survivor. The guarantee is increased for those who retire after age 65).

¹⁰⁴ 2016 ANNUAL REPORT: PRESERVING AND PROTECTING PENSIONS ii, iii (2016), <http://www.pbgc.gov/Documents/2016-annual-report.pdf>.

¹⁰⁵ See, e.g., *supra* note 2 and accompanying text.

¹⁰⁶ 42 U.S.C. § 2000e-2 (2012); *Ariz. Governing Comm. for Tax Deferred Annuity & Deferred Comp. Plans v. Norris*, 463 U.S. 1073, 1074-75 (1983) (per curiam) (finding that Title VII of the Civil Rights Act of 1964 prohibits an employer from paying lower monthly retirement benefits to a woman than to a man who has made the same contributions); *City of L.A. Dep't of Water & Power v. Manhart*, 435 U.S. 702, 711 (1978) (finding that Title VII of the Civil Rights Act of 1964 prohibits an employer from requiring female employees to make larger contributions to its pension plan than male employees because of mortality table differentials between the sexes).

¹⁰⁷ See, e.g., STAFF OF THE J. COMM. ON TAXATION, 114TH CONG., PRESENT LAW AND BACKGROUND RELATING TO TAX-FAVORED RETIREMENT SAVING AND CERTAIN RELATED LEGISLATIVE PROPOSALS, *supra* note 37, at 56, 57 fig.2. See also William J. Wiatrowski, *Changing Landscape of Employment-based Retirement Benefits*, COMP. AND WORKING CONDITIONS ONLINE (U.S. Dep't of Labor, Bureau of Labor Statistics, Sept. 29, 2011),

mentioned, 66 percent of private-sector workers had access to ERISA retirement plans in 2016, and 49 percent of them participated;¹⁰⁸ but defined contribution plans have come to dominate the pension landscape.¹⁰⁹ For example, just 20 percent of *Fortune 500* companies offered salaried employees a defined benefit plan in 2015, down from 59 percent in 1998.¹¹⁰

According to the most recent complete data from the U.S. Department of Labor, there were 681,000 ERISA-covered private pension plans in the United States in 2013.¹¹¹ Of these ERISA-covered plans, just 44,163 were defined benefit plans, and these defined benefit plans had a total of \$2.9 trillion in assets.¹¹² These defined benefit plans had 39.1 million participants but just 15.2 million of those were active participants (i.e., current employees as opposed to retirees and other separated participants).¹¹³

On the other hand, there were 636,991 defined contribution plans in 2013, and these had a total of \$5.0 trillion in assets.¹¹⁴ These defined contribution plans had 92.5 million participants, including 76.7 million active participants.¹¹⁵ Of these defined contribution plans, 527,000 were 401(k)-type plans.¹¹⁶

As more fully explained in Part III.E below, the current movement away from defined benefit plans in the private sector is known as “de-risking.” All in all, the era of the traditional defined benefit plan in the private sector is largely behind us.¹¹⁷

landscape-of-employment-based-retirement-benefits.pdf; Wiatrowski, *The last private industry pension plans: a visual essay*, *supra* note 49, at 3.

¹⁰⁸ See *supra* note 38 and accompanying text.

¹⁰⁹ See, e.g., STAFF OF THE J. COMM. ON TAXATION, 114TH CONG., PRESENT LAW AND BACKGROUND RELATING TO TAX-FAVORED RETIREMENT SAVING AND CERTAIN RELATED LEGISLATIVE PROPOSALS, *supra* note 37, at 54–57.

¹¹⁰ Brendan McFarland, *A Continuing Shift in Retirement Offerings in the Fortune 500*, 26(2) WILLIS TOWERS WATSON INSIDER 1 (Feb. 2016), <https://www.towerswatson.com/DownloadMedia.aspx?media={E60DA978-55D4-4332-AEAC-C2CBC8A0BD9B}>.

¹¹¹ U.S. DEP’T of LABOR, EMP. BENEFITS SEC. ADMIN., DOL-OPS-14-D-0017, PRIVATE PENSION PLAN BULLETIN (2015), <http://www.dol.gov/ebsa/pdf/2013pensionplanbulletin.pdf>.

¹¹² *Id.* at 3 tbl.A1.

¹¹³ *Id.*

¹¹⁴ *Id.*

¹¹⁵ *Id.*

¹¹⁶ *Id.* at 1, 2.

¹¹⁷ See, e.g., GEORGE A. MACKENZIE, THE DECLINE OF THE TRADITIONAL PENSION: A COMPARATIVE STUDY OF THREATS TO RETIREMENT SECURITY (2010); Barbara A. Butrica, Howard M. Iams, Karen E. Smith & Eric J. Toder, *The*

There has also been a shift from defined benefit plans to defined contribution plans in the public sector. For example, in 1986, the federal government replaced much of its traditional defined benefit plan for civilian employees with the “Thrift Savings” defined contribution plan.¹¹⁸ The shift from defined benefit to defined contribution plans among state and local governments has been more modest.¹¹⁹

D. OTHER SOURCES OF LIFETIME INCOME

In addition to voluntary saving through 401(k) elections and IRAs, individuals can also save money outside of the retirement system. Investment income is generally subject to federal income tax rates of up to 39.6 percent in 2017;¹²⁰ however, capital gains and dividends are generally taxed at a preferential tax rate of 0, 15, or 20 percent, depending on the income tax rate that would be assessed on the same amount of ordinary income.¹²¹ Also, there

Disappearing Defined Benefit Pension and Its Potential Impact on the Retirement Incomes of Baby Boomers, 69(3) SOC. SEC. BULL. 2 (2009); Janice Kay McClendon, *The Death Knell of Traditional Defined Benefit Plans: Avoiding a Race to the 401(k) Bottom*, 80(3) TEMP. L. REV. 809 (2007); EDWARD A. ZELINSKY, *THE ORIGINS OF THE OWNERSHIP SOCIETY: HOW THE DEFINED CONTRIBUTION PARADIGM CHANGED AMERICA* (2004); Edward A. Zelinsky, *The Defined Contribution Paradigm*, 114(3) YALE L.J. 451 (2004).

¹¹⁸ See, e.g., Wilmer L. Kerns, *Federal Employees’ Retirement System Act of 1986*, 49(11) SOC. SEC. BULL. 5 (Nov. 1986), <https://www.ssa.gov/policy/docs/ssb/v49n11/v49n11p5.pdf>; OFF. OF PERSONNEL MGMT., *FERS Information*, <https://www.opm.gov/retirement-services/fers-information/> (explaining that the Federal Employees Retirement System [FERS] provides benefits from a basic defined benefit plan, Social Security, and the Thrift Savings defined contribution plan). See also KATELIN P. ISAACS, CONG. RESEARCH SERV., RL30387, *FEDERAL EMPLOYEES’ RETIREMENT SYSTEM: THE ROLE OF THE THRIFT SAVINGS PLAN* (2015), <https://www.fas.org/sgp/crs/misc/RL30387.pdf>.

¹¹⁹ See, e.g., Alicia H. Munnell, Jean-Pierre Aubry & Mark Cafarelli, *Defined Contribution Plans in the Public Sector: An Update*, CTR. FOR STATE & LOCAL GOV’T EXCELLENCE (Issue Brief, Apr. 2014), http://www.nasra.org/files/Topical%20Reports/Plan%20Design/Defined_Contribution_Plans_An_Update.pdf.

¹²⁰ I.R.C. § 1 (1985); Rev. Proc. 2016-55, 2016-45 I.R.B. 707.

¹²¹ I.R.C. § 1(h) (1985); STAFF OF THE J. COMM. ON TAXATION, 114TH CONG., *OVERVIEW OF THE FEDERAL TAX SYSTEM AS IN EFFECT FOR 2016 6* (Comm. Print 2016) (“For 2016, the maximum rate of tax on the adjusted net capital gain of an individual is 20 percent on any amount of gain that otherwise would be taxed at a 39.6-percent rate. In addition, any adjusted net capital gain otherwise taxed at a 10- or 15-percent rate is taxed at a zero-percent rate. Adjusted net capital gain otherwise

are various tax advantages associated with investments in homes,¹²² state and local bonds,¹²³ annuities,¹²⁴ and life insurance.¹²⁵ This subpart focuses on two ways that individuals commonly generate lifetime income: 1) systematic withdrawals from an investment portfolio; and 2) annuities.

1. Phased Withdrawals

One of the simplest and most common strategies for managing retirement savings is to invest all of the retirement savings in a diversified portfolio and then use a conservative withdrawal rate and a systematic withdrawal plan (SWP) designed to have a high probability that the retirement savings will last for 20 or 30 years.¹²⁶ This phased withdrawal strategy can be used with free-standing retirement savings or with retirement savings in defined contribution plans, IRAs, and those defined benefit plans that permit periodic withdrawals.

In that regard, financial planners often suggest following the so-called “4 percent rule.”¹²⁷ The basic idea is to set spending at 4 percent of

taxed at rates greater than 15 percent but less than 39.6 percent is taxed at a 15-percent rate. These rates apply for purposes of both the regular tax and the alternative minimum tax. Dividends are generally taxed at the same rate as capital gains.”). In addition, there is also a 3.8 percent surcharge on the net investment income of certain individuals with incomes over \$200,000, which includes capital gains, dividends, and other investment income such as rents). I.R.C. § 1411 (2012). Gains on investments are typically taxed only when they are realized at a sale or exchange. I.R.C. §§ 61, 1001 (2012).

¹²² I.R.C. §§ 163(a), 121 (2012) (for example, home mortgage interest is generally deductible, and gains from the sale of a personal residence are often excludable).

¹²³ I.R.C. § 103 (2012) (interest exclusion).

¹²⁴ See I.R.C. § 72 (2012). The individual can exclude a fraction of each annuity payment from income. That fraction (the “exclusion ratio”) is based on the amount of premiums or other after-tax contributions made by the individual. The exclusion ratio enables the individual to recover her own after-tax contributions tax free and to pay tax only on the remaining portion of benefits which represents income. The net effect is a deferral of taxation.

¹²⁵ I.R.C. § 101(a) (2012) (exclusion for insurance proceeds paid by reason of the death of the insured).

¹²⁶ See, e.g., Jonathan Barry Forman & Michael J. Sabin, *Tontine Pensions*, 163(3) U. PA. L. REV. 757, 770–771 (2015).

¹²⁷ See William P. Bengen, *Determining Withdrawal Rates Using Historical Data*, J. OF FIN. PLAN., Oct. 1994, 171, 174–175 (explaining, using historical data, why retirees should withdraw no more than 4 percent of their retirement savings

retirement savings and invest those savings in a 50-percent-stock-50-percent-bond portfolio.¹²⁸ Each year thereafter, spending is increased to keep up with inflation. For example, assuming that an individual has a \$1,000,000 nest egg, in the first year of retirement, she would withdraw 4 percent (\$40,000), and each year thereafter that dollar amount would increase to keep up with inflation.¹²⁹ Assuming a 3 percent annual inflation rate, annual withdrawals would increase to \$41,200 in the second year, \$42,436 in the third year, and so on. While there is a possibility of running out of money before death, many financial planners believe this strategy can usually work for 30 years. To minimize the prospect of outliving one's nest egg in the recent economic recession, however, some financial advisers advised retirees to skip their scheduled inflation adjustments or to withdraw less than 4 percent of their new balances.¹³⁰

each year); *see also* JANEMARIE MULVEY & PATRICK PURCELL, CONG. RESEARCH SERV., RL40008, CONVERTING RETIREMENT SAVINGS INTO INCOME: ANNUITIES AND PERIODIC WITHDRAWALS 17 (2008), http://digitalcommons.ilr.cornell.edu/cgi/viewcontent.cgi?article=1571&context=key_workplace (“[A] large body of research on safe withdrawal rates for individuals has determined that a real withdrawal rate in the neighborhood of 4 percent of the initial portfolio has a low chance of running out of money.” [internal quotation marks omitted]); Benjamin Bridges, Robert Gesumaria & Michael V. Leonesio, *Assessing the Performance of Life-Cycle Portfolio Allocation Strategies for Retirement Saving: A Simulation Study*, 70(1) SOC. SEC. BULL., 23 (2010) (examining the performance of life-cycle portfolio allocation strategies with varying exposure to stock and bond market risk based on observed historical U.S. asset returns); Joseph A. Tomlinson, *Managed-Payout Funds vs. Annuities: Who Wins?*, RET. INCOME J. (Sept. 10, 2015), <http://retirementincomejournal.com/issue/march-3-2016/article/managed-payout-funds-vs-annuities-who-wins>.

¹²⁸ Bengen, *Determining Withdrawal Rates Using Historical Data*, *supra* note 127, at 175.

¹²⁹ *See* Eleanor Laise, *A Strategy for a Lifetime of Income*, KIPLINGER (Aug. 17, 2011), <http://www.kiplinger.com/features/archives/krr-a-strategy-for-a-lifetime-of-income.html>.

¹³⁰ *Id.*; *see also* R. Evan Inglis, *The “Feel Free” Retirement Spending Strategy*, in Soc’y of Actuaries, *Diverse Risks: 2016 Call for Essays* 4 (Apr. 2016), <https://www.soa.org/Library/Essays/2016/diverse-risk/2016-diverse-risks-essay.pdf> (suggesting that a safe percentage of savings to spend should be determined by dividing your age by 20; for example, someone who is 70 years-old could safely spend 3.5 percent of their savings [3.5 = 70/20]); Michael Finke, Wade D. Pfau & David M. Blanchett, *The 4 Percent Rule is Not Safe in a Low-Yield World* (2013), <http://ssrn.com/abstract=2201323>; Dirk Cotton, *Retirement Savings and*

Another simple withdrawal strategy is for a retiree to base withdrawals on the retiree's life expectancy (e). Under the simplest approach, each year the retiree would withdraw one over her life expectancy (i.e., $1/e$), but then about half of retirees would run out of money.¹³¹ A better approach would be to recalculate the retiree's life expectancy each year. For example, a 65-year-old man with a \$1-million nest egg and a 17.75 year life expectancy would withdraw around \$56,300 in his first year of retirement ($\$56,300 = \$1,000,000 \times 1/17.75$ [5.63 percent]).¹³² If he lives ten years to age 75, his life expectancy would then be around 11.03 (not $7.75 = 17.75 - 10.00$),¹³³ and, accordingly, he would then withdraw just 9.07 percent ($9.07 = 1/11.03$) of the balance in his retirement savings account. There is still a sizable chance of outliving his nest egg, but recalculating his life expectancy makes that risk less likely.

In passing, it should be noted that many pensions and IRAs already make distributions based on life expectancy. In that regard, the required minimum distribution rules require that most retirement plan participants start receiving minimum distributions soon after they reach age 70½, and these distributions are based on life expectancy.¹³⁴ In effect, the required minimum distribution rule is the default distribution rule for many pension

Annual Spending, THE RET. CAFE (Mar. 7, 2016), <http://www.theretirementcafe.com/2016/03/retirement-savings-and-annual-spending.html>.

¹³¹ See, e.g., AM. ACAD. OF ACTUARIES, *Risky Business: Living Longer Without Income for Life: Information for Current and Future Retirees* 1 (Oct. 2015), http://actuary.org/files/Retiree_PreRetirees_IB_102215.pdf.

¹³² See SOC. SEC. ADMIN., *Period Life Table, 2013*, <http://www.ssa.gov/oact/STATS/table4c6.html> (last visited July 19, 2016) (According to the Social Security Administration, a 65-year-old male in the Social Security area population had a life expectancy of 17.75 years in 2013.). $0.056338 = 1/17.75$.

¹³³ *Id.* ($0.090661 = 1/11.03$.)

¹³⁴ See *supra* note 101 and accompanying text.

plans and IRAs.¹³⁵ For example, TIAA has been offering a so-called “Minimum Distribution Option” since 1991.¹³⁶

2. Lifetime Annuities and Deferred Income Annuities

Annuities are another common way to provide lifetime income,¹³⁷ and, in general, most analysts believe that lifetime annuities offer better lifetime income security than systematic withdrawals.¹³⁸ While the market for annuities is well-developed in the United States, the penetration rate is fairly low—just 8 percent of retirement assets in 2015—and declining in recent years.¹³⁹

¹³⁵ See, e.g., Wei Sun & Anthony Webb, *Can Retirees Base Wealth Withdrawals on the IRS’ Required Minimum Distributions?*, B.C. CTR. FOR RET. RES. (Issue in Brief No. 12-19, Oct. 2012), http://crr.bc.edu/wp-content/uploads/2012/10/IB_12-19-508.pdf; John Ameriks, *How do Retirees Go from Stock to Flow?*, in PENSION DESIGN AND STRUCTURE: NEW LESSONS FROM BEHAVIORAL FINANCE Chapter 13 (Olivia S. Mitchell & Stephen P. Utkus eds., 2004); Steve Vernon, *Retirement Income in DC Plans: The Next Evolution in Plan Design*, BENEFITS MAG. 14, 18 (Nov. 2014), <http://longevity3.stanford.edu/wp-content/uploads/2015/12/Benefits-Mag-Vernon-November-2014-copy.pdf>.

¹³⁶ Ameriks, *How do Retirees Go from Stock to Flow?*, *supra* note 135; TIAA-CREF Financial Services, *Minimum Distribution*, http://www1.tiaa-cref.org/public/support/forms/topics/Minimum_Distribution.html (last visited July 19, 2016).

¹³⁷ See, e.g., Farrell Dolan, *Applying the 4-Box Strategy to Retirement Income Planning: Generating a Lifetime of Income*, LIMRA’S MARKET-FACTS Q. 84, 88 (Fall 2009), <http://pjwalkercommunications.com/wp-content/uploads/2010/02/Market-Facts.pdf>; Darla Mercado, *Making the case for annuities*, INVESTMENTNEWS (Mar. 25, 2012), <http://www.investmentnews.com/article/20120325/REG/303259969&issuedate=20120323&sid=RI0326>.

¹³⁸ See, e.g., Mark Warshawsky, *Distribution Methods for Assets in Individual Accounts for Retirees: Life Income Annuities and Withdrawal Rates*, 3(2) J. OF RET. 105 (Fall 2015); *but see* Michael E. Kitces & Wade D. Pfau, *The True Impact of Immediate Annuities on Retirement Sustainability: A Total Wealth Perspective* (July 15, 2013), <http://ssrn.com/abstract=2296867> (suggesting that immediate annuities should only be used to hedge significant longevity risk beyond life expectancy).

¹³⁹ See, e.g., Citi GPS: Global Perspectives & Solutions, *The Coming Pensions Crisis* 69–70, 80 (Mar. 2016), <https://www.citivelocity.com/citigps/>. The penetration rate can be estimated by dividing the Federal Reserve Board’s estimate of annuity reserves by its estimate of total retirement savings. For example, the Federal Reserve Board reported that at the end of 2015, there were \$2.3 trillion in annuities out of a total of \$27.3 trillion in household retirement assets, or approximately 8 percent ($0.084249 = \$2.3 \text{ trillion} / \27.3 trillion). See *supra* note 31 and accompanying text.

a. *Types of Annuities*

There are various types of annuities. One distinction has to do with the way the annuity is designed. With a “fixed annuity,” the insurance company typically promises to make specific dollar payments to the annuitant for the term of the annuity contract, often for life.¹⁴⁰ On the other hand, variable annuities allow the annuitant to select from a range of investment options, and she can do better if the underlying investments do well, or worse if those investments perform poorly.¹⁴¹ It should be noted, however, that many investors buy variable annuities primarily for their tax advantages and rarely elect to turn them into lifetime income streams.¹⁴²

Another distinction has to do with how long the insurance company makes the annuity payments. For example, term certain annuities pay a given amount per year for a certain number of years, regardless of what happens to

¹⁴⁰ See, e.g., *Fixed Annuity*, INVESTOPEDIA, <http://www.investopedia.com/terms/f/fixedannuity.asp> (last visited July 19, 2016).

¹⁴¹ See, e.g., *Variable Annuity*, INVESTOPEDIA, <http://www.investopedia.com/terms/v/variableannuity.asp> (last visited July 19, 2016); U.S. SEC. AND EXCH. COMM’N, *Variable Annuities: What You Should Know* (Apr. 18, 2011), <http://www.sec.gov/investor/pubs/varannty.htm>.

¹⁴² See, e.g., Oakley, *Retirement Security Risks: What Role can Annuities Play in Easing Risks in Public Pension Plans?*, *supra* note 1, at 15; Anthony Webb, *The United States Longevity Insurance Market*, in *SECURING LIFELONG RETIREMENT INCOME: GLOBAL ANNUITY MARKETS AND POLICY 63, 68* (Olivia S. Mitchell, John Piggott & Noriyuki Takayama, eds., 2011); Jose Ruiz & Olivia S. Mitchell, *Pension Payouts in Chile: Past, Present, and Future Prospects*, in *SECURING LIFELONG RETIREMENT INCOME: GLOBAL ANNUITY MARKETS AND POLICY 106* (Olivia S. Mitchell, John Piggott & Noriyuki Takayama, eds., 2011); Monika Bütler & Stefan Staubli, *Payouts in Switzerland: Explaining Developments in Annuitization*, in *SECURING LIFELONG RETIREMENT INCOME: GLOBAL ANNUITY MARKETS AND POLICY 195* (Olivia S. Mitchell, John Piggott & Noriyuki Takayama, eds., 2011); Hazel Bateman & John Piggott, *Too Much Risk to Insure? The Australian (non-) Market for Annuities*, in *SECURING LIFELONG RETIREMENT INCOME: GLOBAL ANNUITY MARKETS AND POLICY 50* (Olivia S. Mitchell, John Piggott & Noriyuki Takayama, eds., 2011); Edmund Cannon & Ian Tonks, *Compulsory and Voluntary Annuity Markets in the United Kingdom*, in *SECURING LIFELONG RETIREMENT INCOME: GLOBAL ANNUITY MARKETS AND POLICY 171* (Olivia S. Mitchell, John Piggott & Noriyuki Takayama, eds., 2011).

the annuitant over the course of that term.¹⁴³ This Article is instead primarily concerned with various types of lifetime annuities, and in this section, we explain the distinction between level-payment fixed lifetime annuities, inflation-adjusted annuities, and deferred income annuities.

i. Fixed Annuities

Annuities are often used to provide lifetime retirement income. For example, for a 65-year-old man who purchased a \$100,000 immediate fixed (lifetime) annuity without inflation protection on December 1, 2015, the annual payment would be around \$6540 (6.54 percent of the annuity's purchase price).¹⁴⁴ Because women tend to live longer than men, the annual payments for a 65-year-old woman who elected an immediate fixed annuity on December 1, 2015 would be only \$6132 (6.13 percent of the annuity's purchase price).¹⁴⁵ Unlike ERISA-covered pension plans,¹⁴⁶ insurance companies can price the annuities that they offer to men and women differently.¹⁴⁷

In addition to lifetime annuities based on a single life, it is also possible to buy lifetime annuities that are based on the joint lives of a couple. For example, for a couple consisting of a 65-year-old man and a 60-year-old woman who purchased a \$100,000 immediate fixed annuity without inflation protection on December 1, 2015, the annual payment would be around \$5112 (5.11 percent of the annuity's purchase price).¹⁴⁸

Many analysts believe that most individuals will get the best value for their investment if they defer their decision to annuitize until age 75 or 80.¹⁴⁹ In that regard, a 75-year-old man who purchased a \$100,000

¹⁴³ See, e.g., *Term Certain Annuity*, INVESTOPEDIA, <http://www.investopedia.com/terms/t/termcertainannuity.asp> (last visited July 19, 2016).

¹⁴⁴ See ANNUITY SHOPPER, BUYER'S GUIDE 17 tbl.5 (2016), <https://www.immediateannuities.com/pdfs/as/annuity-shopper-2016-01.pdf> (\$6540 per year = 12 × an average payment of \$545 per month).

¹⁴⁵ *Id.* (\$6132 = 12 × an average payment of \$511 per month).

¹⁴⁶ See *supra* notes 105–106 and accompanying text.

¹⁴⁷ *But see* Mary L. Heen, *Nondiscrimination in Insurance: The Next Chapter*, 49 GA. L. REV. 1 (2014) (arguing that gender discrimination laws should be expanded to prevent insurance companies from selling gender-based annuities).

¹⁴⁸ ANNUITY SHOPPER, BUYER'S GUIDE, *supra* note 144, at 25 tbl.11 (\$5112 = 12 × an average payment of \$426 per month).

¹⁴⁹ See, e.g., Moshe A. Milevsky, *Optimal Annuitization Policies: Analysis and Options*, 5 N. AM. ACTUARIAL J. 57 (2001); Anthony Webb, *Providing Income for*

immediate fixed annuity without inflation protection in December of 2015 could get an annuity with an annual payout of \$8892; an 80-year-old could get an annual payout of \$10,920 and an 85-year-old could get an annual payout of \$13,812.¹⁵⁰ According to the Life Insurance Marketing and Research Association (LIMRA), 73 is the average age of purchasers of single premium immediate annuities (SPIAs).¹⁵¹

ii. Inflation-adjusted Annuities

Inflation-adjusted annuities offer an even better way to hedge against living too long. With inflation-adjusted annuities, annual payments would start out lower than level-payment fixed annuities but could end up higher. For example, if our hypothetical 65-year-old man instead chose an annuity stream with a 3-percent annual escalator, the initial annual payment would be just \$4728, but, eventually, the annual payments would exceed the \$6540 per year under the level-payment fixed lifetime annuity.¹⁵²

iii. Deferred Income Annuities

Alternatively, retirees can protect against longevity risk by purchasing deferred income annuities (a/k/a longevity insurance).¹⁵³ The

a Lifetime: Bridging The Gap Between Academic Research And Practical Advice, AARP PUB. POL'Y INST. (Research Report No. 2009-11, 2009), <http://assets.aarp.org/rgcenter/ppi/econ-sec/2009-11.pdf>.

¹⁵⁰ ANNUITY SHOPPER, BUYER'S GUIDE, *supra* note 144 at 21 tbl.7 (age 75: \$8892 = 12 × an average payment of \$741 per month), at 22 tbl.8 (age 80: \$10,920 = 12 × an average payment of \$910 per month), and at 23 tbl.9 (age 85: \$13,812 = 12 × an average payment of \$1151 per month).

¹⁵¹ Kerzner, *Presentation to Federal Advisory Committee on Insurance*, *supra* note 4, at 22.

¹⁵² ANNUITY SHOPPER, BUYER'S GUIDE, *supra* note 144 at 17 tbl.5 (showing average monthly payments to 65-year-old men with a 3-percent-cost-of-living adjustment of \$394 per month in the first year of his retirement [\$4728 in the first year = 12 × an average payment of \$394 per month]).

¹⁵³ See, e.g., Katherine G. Abraham & Benjamin H. Harris, *The Market for Longevity Annuities*, 3 J. OF RET. 12 (2016); Wade Pfau, *Why Retirees Should Choose DIAs over SPIAs*, ADVISOR PERSPECTIVES (Sept. 24, 2013), <http://www.advisorperspectives.com/articles/2013/09/24/why-retirees-should-choose-dias-over-spias.pdf>; Kimberly Lankford, *Deferred Income Annuities Offer Predictability*, KIPLINGER (Aug. 2013), <http://www.kiplinger.com/article/retirement/T003-C000-S004-deferred-income-annuities-offer-predictability.html>;

typical approach is to buy a deferred income annuity at age 65 that starts making annual payments only if the annuitant lives past age 80 or 85. For example, in February of 2012, a 65-year-old man could invest \$100,000 in a MetLife deferred income annuity; and beginning at age 85, he would receive a level lifetime income of \$25,451.04 per year.¹⁵⁴ Companies do not offer inflation-adjusted deferred income annuities, but some companies do offer fixed step-ups.¹⁵⁵

With a relatively small upfront investment, a retiree can secure an income stream that starts sometime in the future, and the retiree can then use the rest of her savings to cover the fixed number of years until the year that the deferred income annuity payments start.¹⁵⁶ There is some risk of running

Anthony Webb, Guan Gong & Wei Sun, *An Annuity That People Might Actually Buy*, B.C. CTR. FOR RET. RES. (Issue in Brief No. 7-10, July 2007), http://crr.bc.edu/wp-content/uploads/2007/07/ib_7-10-508.pdf; Moshe A. Milevsky, *Real Longevity Insurance with a Deductible: Introduction to Advanced-Life Delayed Annuities (ALDA)*, 9 N. AM. ACTUARIAL J. 109 (2005).

¹⁵⁴ Memorandum from Hersh L. Stern to author (Feb. 7, 2012) (on file with the author). Alternatively, he could purchase a deferred income annuity that instead starts at age 80 that pays \$17,069.40 per year; at age 75 that pays \$11,649.84 per year; or at age 70 and pays \$8,133.60 per year. *Id.* See also Abraham & Harris, *The Market for Longevity Annuities*, *supra* note 153, at 16 ex.4, 18 (showing various 2014 quotes for immediate and deferred income annuities and noting that “approximately two-thirds of the [deferred income] annuities sold had deferral periods of five years or less, with only 1% having deferral periods in excess of 15 years”).

¹⁵⁵ Joseph A. Tomlinson, *Income Choices*, FIN. PLAN. (May 1, 2011), http://www.financial-planning.com/fp_issues/2011_5/income-choices-2672801-1.html (comparing various investment strategies including systematic withdrawals, immediate annuities, deferred income annuities, and guaranteed lifetime withdrawal benefits).

¹⁵⁶ See, e.g., Michael Kitces, *A Fix for Retirement Plan Guessing*, FIN. PLAN. (Feb. 24, 2016), <http://www.financial-planning.com/news/portfolio/kitces-planning-for-the-long-haul-without-a-crystal-ball-2695826-1.html> (discussing various ways to use deferred income annuities to plan for secure lifetime income and showing that deferred income annuities offer better returns than bonds); Stephen Sexauer, Michael W. Peskin & Daniel Cassidy, *Making Retirement Income Last a Lifetime*, 68 FIN. ANALYSTS J. 74 (2012) (proposing a “decumulation benchmark” that would use about 88 percent of retiree savings to purchase a laddered portfolio of Treasury Inflation-Protected Securities [TIPS] for the first 20 years and would purchase a deferred income annuity with the remaining 12 percent); Rick Wurster, *DC 20/20: Pathways to a Secure Retirement*, 4 ROTMAN INT’L J. OF PENSION MGMT. 54, 58 (2011) (suggesting that an annuity providing 35 percent real income replacement at age 85 would cost about 7.5 percent of a participant’s average

out of money before the year that the deferred income annuity starts, but that is certainly a more manageable risk than trying to manage one's retirement savings over the indefinite future.¹⁵⁷

Deferred income annuities have gotten a lot more attention since 2014 when the IRS promulgated final regulations authorizing so-called "qualifying longevity annuity contracts" (QLACs).¹⁵⁸ Under the regulations, pension plan participants and IRA holders can spend up to \$125,000 on QLACs without running afoul of the required minimum distribution rules that normally require individuals to start taking taxable distributions by age 70½.¹⁵⁹ All in all, deferred income annuities could help improve retirement income security for elderly Americans.¹⁶⁰

account balance at retirement).

¹⁵⁷ Finally, it is worth noting that workers might be able to buy deferred income annuities in installments, starting at a young age. For example, a worker could use a portion of her retirement savings each year to purchase a deferred income annuity that starts at age 65, or at the advanced ages of 70, 75, 80, 85, or even 90. Accordingly, this type of deferred income annuity product could be used to provide retirement benefits that mimic the lifetime pensions provided by traditional defined benefit plans. Milevsky, *Real Longevity Insurance with a Deductible: Introduction to Advanced-Life Delayed Annuities*, *supra* note 153.

¹⁵⁸ Longevity Annuity Contracts, 79 Fed. Reg. 37,633 (July 2, 2014) (to be codified at 26 C.F.R. pts. 1, 602); Treas. Reg. §§ 1.401(a)(9)-5, A-3 & 1.401(a)(9)-6, A-12.

¹⁵⁹ See also Vorris J. Blankenship, *Retiree Tax Planning With Qualified Longevity Annuity Contracts*, THE TAX ADVISER (Nov. 1, 2014), <http://www.thetaxadviser.com/issues/2014/nov/blankenship-nov14.html>. The \$125,000 will be indexed for inflation in increments of \$10,000. Treas. Reg. § 1.401(a)(9)-6 (A-17)(d)(2)(i) (as amended in 2014). Recall that the required minimum distribution (RMD) rules generally requires plan participants to begin taking distributions soon after they reach age 70½. See *supra* note 101 and accompanying text.

¹⁶⁰ See, e.g., Jack VanDerhei, *How Much Can Qualifying Longevity Annuity Contracts Improve Retirement Security?*, 36(8) EMP. BENEFIT RES. INST. NOTES 10, 14 (2015), https://www.ebri.org/pdf/notespdf/EBRI_Notes_08_Aug15_HSAs-QLACs.pdf; David Blanchett, *Allocating to a Deferred Income Annuity in a Defined Contribution Plan*, 2 J. OF RET. 54 (2015); Katharine G. Abraham & Benjamin H. Harris, *Better Financial Security in Retirement? Realizing The Promise of Longevity Annuities*, BROOKINGS 18-19 (2015), http://www.brookings.edu/~media/images/abraham_harris_paper_rev4.pdf; Blankenship, *Retiree Tax Planning With Qualified Longevity Annuity Contracts*, *supra* note 159; John A. Turner & David D. McCarthy, *Longevity Insurance Annuities in 401(k) Plans and IRAs*, 29 BENEFITS Q. 58 (2013), <http://www.ifebp.org/inforequest/0163295.pdf>.

b. *The Market for Annuities*

The market for annuities is fairly complex because there are so many types of annuities and so many different purchasers. For example, many companies sell a range of variable annuities, and some of those annuities also provide a guaranteed payment period or a guaranteed minimum payment level.¹⁶¹ In any event, Table 1 shows that \$236.7 billion in annuities were sold in the United States in 2015: \$133 billion in variable annuities and \$103.7 billion in fixed annuities.¹⁶² Most of those annuity policies were purchased by businesses or plan sponsors. Indeed, individual annuity sales are a very small portion of the market. In 2015, for example, Table 1 shows that individuals bought just \$11.8 billion worth of fixed annuities (\$9.1 billion single premium immediate annuities and \$2.7 billion deferred income

¹⁶¹ Benjamin Goodman & David P. Richardson, *Achieving Retirement Income Security: A Comparison of Guaranteed Lifetime Withdrawal Benefit, Systematic Withdrawal and Partial Variable Annuity Strategies*, TIAA INST. (May 2016), https://www.tiaainstitute.org/public/pdf/rd_achieving_retirement_income_security.pdf. For example, many companies sell variable annuities with guaranteed lifetime withdrawal benefits (GLWB). A GLWB is based on a variable annuity, but it allows investors to lock in a minimum guarantee for life. Mechanically, the investor or retiree deposits or rolls over a sum of money into a variable annuity with subaccounts that are invested in a portfolio of stocks, bonds, and other generic investments. Depending on market performance, that investment portfolio grows (or shrinks). In any event, at retirement, the annuitant starts taking guaranteed withdrawals from the account. Payouts come from the invested funds, but if those funds are ever depleted due to long life and/or poor investment returns, the guaranteed minimum kicks in. On the other hand, if the investment portfolio performs well, payouts can be increased. See, e.g., Jonathan Barry Forman, *Supporting the Oldest Old: The Role of Social Insurance, Pensions, and Financial Products*, 21 ELDER L. J. 375, 402–03 (2014) and sources cited therein; U.S. GOV'T ACCOUNTABILITY OFF., GAO-13-75, RETIREMENT SECURITY: ANNUITIES WITH GUARANTEED LIFETIME WITHDRAWALS HAVE BOTH BENEFITS AND RISKS, BUT REGULATION VARIES ACROSS STATES (2012), <http://www.gao.gov/assets/660/650739.pdf>.

¹⁶² Life Insurance Marketing and Research Association (LIMRA) Secure Retirement Institute, *Annuity Industry Estimates*, http://www.limra.com/Posts/PR/Data_Bank/_PDF/2015-4Q-Annuity-Estimates.aspx (last visited July 20, 2016). See also Life Insurance Marketing and Research Association (LIMRA), *LIMRA Secure Retirement Institute: Indexed Annuities Break Quarterly and Annual Sales Records* (Feb. 23, 2016), http://www.limra.com/Posts/PR/News_Releases/LIMRA_Secure_Retirement_Institute__Indexed_Annuities_Break_Quarterly_and__Annual_Sales_Records.aspx.

annuities), but these individual annuity sales are expected to grow to \$21.6 billion in 2019.¹⁶³

Table 1. Annuity Industry Estimate

<i>Type of Annuities</i>	<i>2015</i>
Variable Annuities	
Separate accounts	105.0
Fixed accounts	28.0
Total Variable	133.0
Fixed Annuities	
Fixed-rate deferred	31.9
Book value	21.3
Market value adjusted	10.6
Indexed	54.5
Fixed deferred	86.4
Deferred income	2.7
Fixed immediate	9.1
Structured settlements	5.5
Total Fixed	103.7
Total	236.7

c. The Tax Treatment of Annuities

The federal income tax system generally provides favorable tax treatment of investments in annuities.¹⁶⁴ Although the value of an annuity investment grows over time, no tax is imposed until annuity distributions begin. In short, there is no tax on the so-called “inside buildup” until the “annuity starting date.”¹⁶⁵ Even then, the annuitant can exclude a fraction of each benefit

¹⁶³ Kerzner, *Presentation to Federal Advisory Committee on Insurance*, *supra* note 4, at 19.

¹⁶⁴ See I.R.C. § 72 (2016); INTERNAL REVENUE SERV., *Pension and Annuity Income*, *supra* note 41.

¹⁶⁵ I.R.C. § 72(c)(4) (2015) (“The annuity starting date in the case of any contract is the first day of the first period for which an amount is received as an annuity under the contract.”). See also DAVID L. BRUMBAUGH, CONG. RESEARCH SERV., RS20923, TAXES AND THE “INSIDE BUILD-UP” OF LIFE INSURANCE: RECENT ISSUES (2006), <https://archive.org/details/RS20923-crs>; ANDREW D. PIKE, CONG.

payment from income.¹⁶⁶ That fraction (the “exclusion ratio”) is based on the amount of premiums or other contributions made by the annuitant.¹⁶⁷ More specifically, the exclusion ratio is determined at the annuity starting date by dividing the “investment in the contract” by the “expected return under the contract.” The investment in the contract is the annuitant’s premium costs for the annuity,¹⁶⁸ and the expected return is simply the total amount expected to be received under the annuity.¹⁶⁹ This method of taxation allows the annuitant to recover her own contributions tax-free.

For example, assume that a 65-year old pays a \$100,000 to an insurance company for an immediate fixed annuity that pays \$7500 a year for life. Her investment in the contract is \$100,000. According to the applicable IRS unisex life expectancy tables, 65-year-olds can expect to live for another 20 years,¹⁷⁰ and that means that our 65-year-old will have an expected return of \$150,000 ($\$150,000 = 20 \times \7500). Accordingly, in each of the first 20 years that our hypothetical annuitant receives \$7500, she will exclude \$5000 ($\$5000 = \$7500 \times \$100,000/\$150,000$). Accordingly, she will report \$2500 in income in each of the first 20 years ($\$2500 = \$7500 - \$5000$). If she lives more than 20 years, all \$7500 she receives in year 21 and later years will be taxable, as she will have already recovered all \$100,000 of her investment in the contract tax-free.¹⁷¹

On the other hand, if an annuitant dies before she recovers her investment in the contract, she can usually deduct her unrecovered investment in the year of her death.¹⁷² For example, if our hypothetical annuitant died after receiving seven annual annuity payments, she would have recovered \$35,000 of her original \$100,000 investment tax-free ($\$35,000 = 7 \times \5000) (and she would have included \$17,500 in income [$\$17,500 = 7 \times \2500]). As she had not yet recovered her remaining \$65,000 investment in the contract, that \$65,000 unrecovered investment can be deducted on the tax return filed for the year that she died.¹⁷³

RESEARCH SERV., RL32000, TAXATION OF LIFE INSURANCE PRODUCTS: BACKGROUND AND ISSUES (2003), <http://crs.wikileaks-press.org/RL32000.pdf>.

¹⁶⁶ I.R.C. § 72(b) (2015).

¹⁶⁷ *Id.*

¹⁶⁸ I.R.C. § 72(c)(1) (2015).

¹⁶⁹ I.R.C. § 72(c)(3) (2015).

¹⁷⁰ Treas. Reg. § 1.72-9 tbl.V (1995).

¹⁷¹ I.R.C. § 72(b)(2) (2015).

¹⁷² I.R.C. §§ 72(b)(3)-(4) (2015).

¹⁷³ I.R.C. § 72(b)(3)(A) (2015). Literally, if an annuitant dies after the annuity starting date, she can deduct her unrecovered investment on her final income tax return. *Id.*

The current tax treatment of annuities results in some odd consequences. First, if an annuitant outlives her life expectancy, she will have to pay tax on the full amount of annuity payments that she receives each year for the rest of her life.¹⁷⁴ That greater tax liability in later years may discourage some people from buying annuities, and that greater tax liability in later years is not necessarily balanced out by the deduction for those who die before they have recovered their full investment in the contract.

Second, the rule allowing a deduction for unrecovered investments in the contract also has a quirk that can make deferred income annuities relatively unattractive as retirement income investments. The quirk is that the deduction for unrecovered investments is only available if the annuity payments “cease by reason of the death of an annuitant” . . . “*after the annuity starting date* (emphasis added).”¹⁷⁵ For example, consider a 65-year-old man who buys a deferred income annuity for \$100,000 that will pay him \$40,000 a year for life starting at age 85, and further assume that his expected return is \$400,000, giving him an exclusion ratio of 25 percent ($0.25 = \$100,000$ investment in the contract/ $\$400,000$ expected return). Under the usual annuity-taxation rules, if he lives to 85, he would exclude \$10,000 of the first \$40,000 annuity payment from income and include the remaining \$30,000 in income, and he would continue to do so until—after ten years—he would have recovered his \$100,000 investment in the contract (at which point all future \$40,000-a-year payments until he died would be fully taxable). Also, if he died at 87, having recovered \$30,000 tax-free ($\$30,000 = 3 \times \$10,000$), he would be allowed to deduct his remaining \$70,000 unrecovered investment. Unfortunately, if he dies *before* reaching age 85, he would not be allowed to deduct *any* portion of his \$100,000 investment in the contract as his death would have occurred *before* the annuity starting date. In short, individuals who buy deferred income annuities are unable to deduct their losses if they die before the annuity starting date, and that makes deferred income annuities less attractive as retirement income investments. Pertinent here, just 37 percent of 65-year-old men can expect to live to age 85.¹⁷⁶

¹⁷⁴ I.R.C. § 72(b)(2) (2015).

¹⁷⁵ *Id.*

¹⁷⁶ Calculations from the Soc’y of Actuaries, *Life Expectancy Calculator*, *supra* note 2, show that a 65-year-old man has a 37 percent chance of living 20 years to age 85. In passing, it should be acknowledged that those who buy annuities and especially deferred income annuities are probably healthier than the general population, and it may be more appropriate to use a “healthier” life expectancy table. In that regard, the Society of Actuaries calculator allows us to select such an alternative mortality table (the 2012 Individual Annuitant Mortality tables that were developed from a population of people buying individual immediate annuities), and

d. *The Tax Treatment of Life Insurance Proceeds Paid after the Insured's Death*

In passing, it is worth noting that a slightly different set of rules applies when the beneficiary of a life insurance policy elects to take payments for life rather than taking a lump sum payment. In general, life insurance proceeds paid to a beneficiary at the death of the insured are excluded from gross income.¹⁷⁷ If the beneficiary instead elects to take annuity-like payments for the rest of her life, then a pro rata portion of each payment is excluded,¹⁷⁸ and the rest is taxable.¹⁷⁹ That pro rata exclusion continues for as long as the beneficiary lives, but if she dies before recovering the full amount that she could have received tax-free, no deduction (or other tax benefit) is allowed for the unrecovered portion.

For example, if a husband dies with a \$100,000 life insurance policy naming his wife as the beneficiary, she could exclude all \$100,000 from her income. If she instead elected to take \$7500 per year payments for the rest of her life—and her life expectancy is 20 years, then she could exclude \$5000 each year ($\$5000 = \$100,000/20$), and she would report \$2500 each year in her gross income. If she lives more than 20 years, she could continue to exclude \$5000 each year until she dies. On the other hand, if she died before receiving 20 annual payments, she would not be allowed to take a deduction or other tax benefit for any of her unrecovered excludable amount. For example, if she died after seven years, she would have excluded just \$35,000 ($\$35,000 = 7 \times \5000), but she would not be allowed to claim a deduction or other tax benefit for the remaining \$65,000.

when we do, the results suggest that 60 percent of 65-year-old men who voluntarily buy annuities can expect to live 20 years to age 85. *See also* NAT'L ASS'N. OF INS. COMMISSIONERS [NAIC], *NAIC Model Rule for Recognizing a New Annuity Mortality Table for Use in Determining Reserve Liabilities for Annuities* (Jan. 2013), <http://www.naic.org/store/free/MDL-821.pdf>, at Appendix II. The 2012 Individual Annuity Reserving (IAR) Mortality Tables are designed for use in determining the minimum standard of valuation for individual annuity or pure endowment contracts issued after the effective date of the rule. *Id.* at § 4.D.

¹⁷⁷ I.R.C. § 101(a) (2013).

¹⁷⁸ I.R.C. § 101(a) (2013); Treas. Reg. § 1.101-4 (as amended in 1961).

¹⁷⁹ I.R.C. § 61(a)(10) (1984).

E. CURRENT ESTIMATES OF THE TAX EXPENDITURES
ASSOCIATED WITH SOCIAL SECURITY, PENSIONS, IRAS, AND
ANNUITIES

The special tax rules for Social Security, pensions, IRAs, and annuities are routinely identified as “tax expenditures” in the tax expenditure budgets prepared annually by the Office of Management and Budget.¹⁸⁰ Policymakers often use these tax expenditure estimates as a rough guide to the cost of these special income tax provisions.¹⁸¹ For example, Table 2 reproduces the Office of Management and Budget’s *2017 Federal Budget* estimates of the revenue losses attributable to the special income tax benefits for Social Security, pensions, IRAs, and annuities (and life insurance savings).¹⁸² All in all, these tax

¹⁸⁰ See, e.g., OFF. OF MGMT. & BUDGET, EXEC. OFF. OF THE PRESIDENT, ANALYTICAL PERSPECTIVES: BUDGET OF THE UNITED STATES GOVERNMENT, FISCAL YEAR 2017 228 tbl.14-1 (2016), https://www.whitehouse.gov/sites/default/files/omb/budget/fy2017/assets/ap_14_expenditures.pdf.

¹⁸¹ Admittedly, however, tax expenditure estimates do not necessarily equal the increase in Federal revenues that would result from repealing the special provisions. See, e.g., Jonathan Barry Forman, *Comparing Apples and Oranges: Some Thoughts on the Pension and Social Security Tax Expenditures*, 5 EMP. RTS. & EMP. POL’Y J. 297, 308 n.50 (2001).

¹⁸² OFF. OF MGMT. & BUDGET, EXEC. OFF. OF THE PRESIDENT, ANALYTICAL PERSPECTIVES: BUDGET OF THE UNITED STATES GOVERNMENT, FISCAL YEAR 2017, *supra* note 180, at 228–229, 231. There are also tax expenditures associated with the exclusion of railroad retirement system benefits and veterans’ pensions, not reprinted here.

Most of the items in Table 2 are also identified as tax expenditures in the tax expenditure budgets prepared annually by the Joint Committee on Taxation; however, in its most recent iteration, the Joint Committee on Taxation removed the exclusion for interest on life insurance and annuities from its list. STAFF OF THE J. COMM. ON TAXATION, 114TH CONG., *Estimates of Federal Tax Expenditures for Fiscal Years 2015-2019* (Comm. Print 2015), https://www.jct.gov/publications.html?func=download&id=4857&chk=4857&no_html=1. While the Joint Committee on Taxation acknowledged that a broad interpretation tax expenditures would include the exclusion of investment income on life insurance and annuity contracts, it noted that the Congressional Budget and Impoundment Control Act of 1974 defined tax expenditures as “revenue losses attributable to provisions of the Federal tax laws [emphasis added] which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of tax liability.” The Joint Committee on Taxation then decided that it would no longer include in its tax expenditure budget items for which no provision of the federal tax law specifically allows an exclusion, such as (in its opinion) the exclusion of investment income on life insurance and

expenditures are quite large.¹⁸³ In fact, two of these items are among the top ten largest tax expenditures each year, and five are in the top 20.¹⁸⁴

annuity contracts. *Id.* at 20. *See also* Aaron E. Lorenzo, *JCT Change on Insurance, Annuity Inside Buildup Won't Hurt*, 15 BNA DAILY TAX REP. G-1 (Jan. 25, 2016), http://taxandaccounting.bna.com/btac/T11100/split_display.adp?fedfid=82088380&vname=dtrnot&wsn=502760000&searchid=27029402&doctypeid=13&type=date&mode=doc&split=0&scm=T11100&pg=0; Warren S. Hersch, *AALU to Congress: Life insurance is not a tax expenditure*, LIFEHEALTHPRO (Apr. 30, 2013), <http://www.lifehealthpro.com/2013/04/30/aalu-to-congress-life-insurance-is-not-a-tax-expen>; Letter from Kenneth Kies to Mark J. Mazur, Assistant Secretary for Tax Policy, (Dec. 29, 2015) (on file at Bloomberg BNA), http://taxandaccounting.bna.com/btac/T11100/split_display.adp?fedfid=81337913&vname=dtrnot&jd=a0h7h6y1j5&split=0; U.S. DEP'T OF THE TREASURY, OFF. OF TAX ANALYSIS, *THE TAX EXPENDITURE FOR LIFE INSURANCE INSIDE BUILDUP* (Sept. 28, 2016), <https://www.treasury.gov/resource-center/tax-policy/tax-analysis/Documents/Life-Insurance-Inside-Buildup.pdf> (explaining why the Treasury continues to view the exclusion of inside buildup as a tax expenditure).

¹⁸³ Admittedly, the government's tax expenditure estimates are inflated as they do not take into account the present value of taxes that will be paid on retirement plan distributions outside of the government's 10-year budget window. *See, e.g.*, Peter J. Brady, *How America Supports Retirement: Challenging the Conventional Wisdom on Who Benefits* 39-45, INV. CO. INST. (Jan. 20, 2016), <https://www.ici.org/research/retirement/retirement>; Peter Brady, *Who Benefits from the U.S. Retirement System*, 21(7) ICI RES. PERSP. 1 (Nov. 2015), <https://www.ici.org/research/retirement/retirement> (also noting that "[w]hen evaluating the U.S. retirement system, it is important to assess both the Social Security system and tax deferral"); Judy Xanthopoulos & Mary M. Schmitt, *Retirement Savings and Tax Expenditure Estimates*, AM. SOC'Y OF PENSION PROFESSIONALS & ACTUARIES (May 2011), <https://www.asppa.org/Portals/2/APerspectiveOnTaxPolicyToPromoteRetirementSavingsMay2011.pdf.pdf>.

¹⁸⁴ OFF. OF MGMT. & BUDGET, EXEC. OFF. OF THE PRESIDENT, *ANALYTICAL PERSPECTIVES: BUDGET OF THE UNITED STATES GOVERNMENT, FISCAL YEAR 2017*, *supra* note 180, at 243.

Table 2. Estimates of Total Income Tax Expenditures for Fiscal Years 2016, 2017, 2016–2025 (In millions of dollars)

	2016	2017	2016–25
Exclusion of social security benefits:			
Social Security benefits for retired workers	26,900	28,280	315,420
Social Security benefits for disabled workers	8,490	8,580	94,920
Social Security benefits for spouses, dependents & survivors	4,160	4,310	48,010
Net exclusion of pension contributions & earnings:			
Defined benefit plans	66,600	66,760	622,530
Defined contribution plans	64,710	65,620	921,480
IRAs	16,850	16,970	197,420
Self-Employed plans	28,030	30,800	155,530
Low and moderate income savers credit	1,280	1,270	13,120
Exclusion of interest on annuities (and life insurance savings)	18,870	23,380	370,840

Source: EXECUTIVE OFFICE OF THE PRESIDENT AND OFFICE OF MANAGEMENT AND BUDGET, ANALYTICAL PERSPECTIVES, BUDGET OF THE UNITED STATES GOVERNMENT, FISCAL YEAR 2017 228 tbl.14-1 (2016).

F. RETIREMENT INCOME ADEQUACY

Social Security is the most common source of income for households aged 65 or older. For example, in 2014, 84.2 percent of households aged 65 or older received Social Security benefits.¹⁸⁵ Moreover, Social Security provided more than half of total income for 47.8 percent of aged beneficiary couples that year and 70.7 percent of total income for aged single beneficiaries.¹⁸⁶ Only 43.8 percent of households received retirement benefits from sources other than Social Security, and only 61.8 percent received income from other assets.¹⁸⁷

¹⁸⁵ SOC. SEC. ADMIN., INCOME OF THE POPULATION 55 AND OLDER, 2014, 34 (SSA Publication No. 13-11871, 2016), https://www.ssa.gov/policy/docs/statcomps/income_pop55/2014/incpop14.pdf. See also SOC. SEC. ADMIN., INCOME OF THE AGED CHARTBOOK, 2012, (SSA Publication No. 13-11727, 2014), https://www.ssa.gov/policy/docs/chartbooks/income_aged/2012/iac12.pdf; U.S. DEP'T OF HEALTH AND HUM. SERVICES, A PROFILE OF OLDER AMERICANS: 2015, http://www.aoa.acl.gov/aging_statistics/profile/2015/docs/2015-Profile.pdf (last visited July 22, 2016).

¹⁸⁶ SOC. SEC. ADMIN., INCOME OF THE AGED CHARTBOOK, *supra* note 185, at 9. See also SOC. SEC. ADMIN., *Fast Facts & Figures About Social Security, 2015*, *supra* note 21 (64 percent of aged beneficiaries received at least half of their income from Social Security in 2013).

¹⁸⁷ SOC. SEC. ADMIN., INCOME OF THE AGED CHARTBOOK, *supra* note 185, at 34.

All in all, Social Security provided 33.2 percent of personal income of households aged 65 or older in 2014.¹⁸⁸ Earnings accounted for another 32.2 percent of their income, pensions 20.9 percent, and asset income 9.7 percent.¹⁸⁹ Of course, as people age, earnings decline, and their inflation-adjusted Social Security benefits become an even larger portion of their incomes.¹⁹⁰ Still, Social Security alone cannot ensure that Americans will have adequate incomes throughout their retirement years.

Unfortunately, retirement savings may be inadequate for many retirees.¹⁹¹ As already mentioned, at any point in time, only about one out of two American workers has a pension plan.¹⁹² Over their lifetimes, most households will accumulate some retirement savings through current or past work.¹⁹³ Moreover, as households get closer to retirement age, they are even more likely to have accumulated some retirement assets, and recent cohorts of retirees tend to have more retirement assets than previous cohorts.¹⁹⁴ Still,

¹⁸⁸ *Id.* at 16.

¹⁸⁹ *Id.*

¹⁹⁰ See, e.g., Forman, *Supporting the Oldest Old: The Role of Social Insurance, Pensions, and Financial Products*, *supra* note 161, at 382–384 and sources cited therein; Sudipto Banerjee, *A Look at the End-of-Life Financial Situation in America*, 36(4) EMP. BENEFIT RES. INST. NOTES 2 (2015), https://www.ebri.org/pdf/notespdf/EBRI_Notes_04_Apr15_EoL-PolFor.pdf (showing the importance of Social Security to older households).

¹⁹¹ U.S. GOV'T ACCOUNTABILITY OFF., GAO-16-408, RETIREMENT SECURITY: LOW DEFINED CONTRIBUTION SAVINGS MAY POSE CHALLENGES (2016), <http://www.gao.gov/assets/680/676942.pdf>; U.S. GOV'T ACCOUNTABILITY OFF., GAO-15-419, RETIREMENT SECURITY: MOST HOUSEHOLDS APPROACHING RETIREMENT HAVE LOW SAVINGS (2015), <http://www.gao.gov/assets/680/670153.pdf>. See also Nari Rhee & Ilana Boivie, *The Continuing Retirement Savings Crisis*, NAT'L INST. ON RET. SEC. (2015), http://www.nirsonline.org/storage/nirs/documents/RSC%202015/final_rsc_2015.pdf.

¹⁹² See Copeland, *Employment-Based Retirement Plan Participation: Geographic Differences and Trends*, 2013, *supra* note 45 and accompanying text.

¹⁹³ See, e.g., Jesse Bricker, Arthur B. Kennickell, Kevin B. Moore & John Sabelhaus, *Changes in U.S. Family Finances from 2007 to 2010: Evidence from the Survey of Consumer Finances*, 98 FED. RES. BULL. 37 (2012), <http://www.federalreserve.gov/pubs/bulletin/2012/pdf/scf12.pdf> (finding that, in 2010, 55.1 percent of families had rights to some retirement plan other than Social Security through current or past work of the family head or that person's spouse or partner).

¹⁹⁴ Peter Brady, Kimberly Burham & Sarah Holden, *The Success of the U.S. Retirement System* 12, INV. CO. INST. (2012), <https://www.ici.org/>

low participation rates in pension plans, in general, and low contributions rates to 401(k) plans, in particular, have led many analysts to wonder whether current and future generations of retirees will have adequate retirement incomes.¹⁹⁵ Indeed, according to a recent study by the U.S. Government Accountability Office, about 29 percent of households age 55 and older had no retirement savings in 2013 (nor a defined benefit plan).¹⁹⁶ Even among those households that had some retirement savings, the median amount of those savings was just \$104,000 for households age 55–64 and \$148,000 for households age 65–74, which amounts could be used to purchase modest inflation-adjusted annuities of \$310 and \$649 per month, respectively.¹⁹⁷ Similarly, according to recent research by the Employee Benefit Research Institute, more than 40 percent of Baby-Boomer and Gen-Xer households are at risk of running short of money in retirement, and more than 15 percent are projected to have less than 80 percent of what they will need.¹⁹⁸ The

pdf/ppr_12_success_retirement.pdf (finding that households headed by a working individual aged 55 to 64 are doing especially well: while these near-retiree households are less likely to be covered by a defined benefit plan than previous cohorts, about 70 percent of them had defined contribution plans and/or IRAs, and the median amount of their total retirement accumulations was \$101,350 in 2010, up from just \$63,719 in 2001 [in 2010 dollars]).

¹⁹⁵ See, e.g., *Pension Savings: Are Workers Saving Enough for Retirement?: Hearing Before the Senate Committee on Health, Education, Labor & Pensions*, 113th Cong., SENATE, (Jan. 31, 2013), <http://www.help.senate.gov/hearings/hearing/?id=4cd69c00-5056-a032-52b4-2693a6672740>; Melissa M. Favreault, Richard W. Johnson, Karen E. Smith & Sheila R. Zedlewski, *BOOMERS' RET. INCOME PROSPECTS* (Urban Institute, Program on Retirement Policy, Brief No. 34, 2012), <http://www.urban.org/uploadedpdf/412490-boomers-retirement-income-prospects.pdf> (4 out of 10 late baby-boomers will lack sufficient income at age 79 to replace 75 percent of what they earned between ages 50 and 54); Jack VanDerhei, *Retirement Income Adequacy for Boomers and Gen Xers: Evidence from the 2012 EBRI Retirement Security Projection Model*[®], 33(5) EMP. BENEFIT RES. INST. NOTES 2 (2012), http://www.ebri.org/pdf/notespdf/EBRI_Notes_05_May-12.RSPM-ER.Cvg1.pdf.

¹⁹⁶ U.S. GOV'T ACCOUNTABILITY OFF., GAO-15-419, *RETIREMENT SECURITY: MOST HOUSEHOLDS APPROACHING RETIREMENT HAVE LOW SAVINGS*, *supra* note 191, at 8, 10.

¹⁹⁷ *Id.* at 11, 15.

¹⁹⁸ Jack VanDerhei, *What Causes EBRI Retirement Readiness RatingsTM to Vary: Results from the 2014 Retirement Security Projection Model*[®], EMP. BENEFIT RES. INST. (Issue Brief No. 396, 2014), https://www.ebri.org/pdf/briefspdf/EBRI_IB_396_Feb14.RRRs2.pdf; see also Jack VanDerhei, *Retirement Savings Shortfalls: Evidence from EBRI's Retirement Security Projection Model*[®],

bottom line is that many Americans are not saving enough in retirement plans or otherwise.¹⁹⁹

III. THE REGULATION OF ANNUITIES AND PENSION DISTRIBUTIONS

This Part focuses on the laws and regulations governing retail annuities and pension distributions. This Part also takes a more detailed look at the rules governing pension risk transfer transactions in defined benefit plans.

A. THE REGULATION OF RETAIL ANNUITIES

Individuals can use their freestanding and IRA savings to buy retail annuities in the marketplace. In general, companies offering annuities are subject to comprehensive regulation by state insurance departments.²⁰⁰ With

EMP. BENEFIT RES. INST. (Issue Brief No. 410, 2014), https://www.ebri.org/pdf/briefspdf/EBRI_IB_410_Feb15_RS-Shrtfls.pdf (finding that there is an aggregate national retirement savings deficit number of \$4.13 trillion for all U.S. households where the head of the household is between 35 and 64 years-old); Alicia H. Munnell, Wenliang Hou & Anthony Webb, *NRRI Update Shows Half Still Falling Short*, B.C. CTR. FOR RET. RES. (Issue in Brief No.14-20, Dec. 2014), http://crr.bc.edu/wp-content/uploads/2014/12/IB_14-20-508.pdf (estimating that, in 2013, some 52 percent of households were expected to have replacement rates that fall more than 10 percent below the target).

¹⁹⁹ See, e.g., CHRISTIAN E. WELLER, RETIREMENT ON THE ROCKS (2016); CHARLES D. ELLIS, ALICIA H. MUNNELL & ANDREW D. ESCHTRUTH, FALLING SHORT: THE COMING RETIREMENT CRISIS AND WHAT TO DO ABOUT IT (2014), http://crr.bc.edu/wp-content/uploads/2015/04/IB_15-7.pdf; Sudipto Banerjee, *Income Composition, Income Trends, and Income Shortfalls of Older Households*, EMP. BENEFIT RES. INST. (Issue Brief No. 383, 2013), http://www.ebri.org/pdf/briefspdf/EBRI_IB_02-13.No383.IncmEld.pdf; Barbara A. Butrica & Mikki D. Waid, *What Are the Retirement Prospects of Middle-Class Americans?*, AARP PUB. POL'Y INST. (Middle Class Security Project Paper No. 2013-01, 2013), http://www.aarp.org/content/dam/aarp/research/public_policy_institute/security/2013/retirement-prospects-middle-class-AARP-ppi-sec.pdf; Joelle Saad-Lessler, Teresa Ghilarducci & Kate Bahn, *Are U.S. Workers Ready for Retirement? Trends in Plan Sponsorship, Participation, and Preparedness*, SCHWARTZ CTR. FOR ECON. POLICY ANALYSIS (2015), http://www.economicpolicyresearch.org/images/docs/research/retirement_security/Are_US_Workers_Ready_for_Retirement.pdf.

²⁰⁰ See, e.g., *State Regulation of Annuities*, INSURED RET. INST., <http://www.irionline.org/government-affairs/annuities-regulation-industry->

a typical annuity, an insurance company bears the risk of making certain guaranteed payments, and because insurance companies bear such risks, they are heavily regulated and must maintain adequate reserves.²⁰¹ In addition, all states have state-based guaranty funds that provide protections for annuitants in case the insurance company that sold them the policy becomes insolvent.²⁰² While the guarantee limits vary from state to state, every state provides a minimum of \$100,000 in benefit protection for annuities, and most states provide at least \$250,000 in protection.²⁰³ These guarantees apply regardless of whether the annuities are in deferred or payout status at the time of the insurance company's insolvency.²⁰⁴

B. THE REGULATION OF ANNUITIES IN DEFINED BENEFIT PLANS

As mentioned, the default benefit for defined benefit plans is a lifetime pension in the form of an annuity.²⁰⁵ Defined benefit plans typically

information/state-regulation-of-annuities (last visited July 28, 2016). Both the U.S. Security and Exchange Commission (SEC) and state insurance departments regulate variable annuities; however, the SEC does not view fixed annuities as securities, and so it does not regulate them. *Annuities*, U.S. SEC. AND EXCH. COMM'N (Apr. 6, 2011), <http://www.sec.gov/answers/annuity.htm>.

²⁰¹ The National Association of Insurance Commissioners' Model Standard Valuation Law generally requires insurance companies to maintain annuity reserves according to the Commissioners' Annuity Reserve Method (CARVM). *See, e.g.*, AM. ACAD. OF ACTUARIES, *Special Issues for Variable Annuities 2* (1999), https://www.actuary.org/files/publications/Practice_Note_Special_Issues_for_Variable_Annuities_july1999.pdf; NAT'L ASS'N OF INS. COMMISSIONERS, *Standard Valuation Law 820*, §§ 5a, 6 (July 2010), <http://www.naic.org/store/free/MDL-820.pdf>. *See also* Kush Kotecha, Ben Yahr & James Collingwood, *Statutory Reserving for Fixed Indexed Annuities with Guaranteed Lifetime Withdrawal Benefits*, 90 FIN. REP. 4 (Sept. 2012), <https://www.soa.org/library/newsletters/financial-reporter/2012/september/frn-2012-iss90-kotecha.aspx>; Keith P. Sharp, *Commissioners Annuity Reserve Valuation Method*, 7 J. OF ACTUARIAL PRAC. 107 (1998), http://www.jofap.org/documents/vol7/v7_sharp.pdf.

²⁰² *See, e.g.*, NAT'L ORG. OF LIFE & HEALTH INS. GUAR. ASSOCIATIONS, *The Nation's Safety Net* (2014), <https://www.nolhga.com/resource/file/NOLHGA%20Safety%20Net%202014.pdf>; NAT'L ORG. OF LIFE & HEALTH INS. GUAR. ASSOC., *Policyholder Information: Frequently Asked Questions* (July 20, 2016), <https://www.nolhga.com/policyholderinfo/main.cfm/location/questions>.

²⁰³ NAT'L ORG. OF LIFE & HEALTH INS. GUAR. ASSOCIATIONS, *The Nation's Safety Net*, *supra* note 202, at 3.

²⁰⁴ *Id.*

²⁰⁵ *See supra* notes 50–52 and accompanying text.

manage a portfolio of investment assets in a trust and pay those lifetime pension benefits directly from the trust.²⁰⁶ Alternatively, defined benefit plans sometimes purchase retail annuities in order to meet their pension obligations. While defined benefit plans must offer pension benefit in the form of a lifetime annuity, the plans may also offer lump sum distributions and other payment options at retirement or job separation.²⁰⁷

1. Rules Governing Lump Sum Distributions

As mentioned, the default benefit for defined benefit plans is a lifetime pension in the form of an annuity, and for married participants, the default benefit is a qualified joint-and-survivor annuity (QJSA).²⁰⁸ These days, most defined benefit plans also offer participants some type of lump sum distribution option.²⁰⁹ Participants who can take a lump sum distribution can generally take that distribution when they terminate employment, or they can defer the distribution until a later date.²¹⁰

When a lump sum alternative is offered to a participant, the minimum lump sum amount must be determined in accordance with certain actuarial “relative valuation” rules.²¹¹ The minimum lump sum must have a value equal to the actuarially-determined present value of the participant’s expected stream of lifetime pension benefits.²¹² Those rules ensure that any lump sum distribution is the actuarial equivalent of the promised lifetime pension benefit. Basically, the Internal Revenue Code and related guidance specify the applicable interest rates and mortality tables that must be used to determine the minimum value of the lump sum.

²⁰⁶ See *supra* note 40 and accompanying text. Alternatively, a defined benefit pension plan can be designed to invest directly in annuity contracts. *Id.*

²⁰⁷ See *supra* notes 50–51 and accompanying text.

²⁰⁸ See *supra* notes 50–52 and accompanying text. In general, these pay-benefits-in-the-form-of-an-annuity rules also apply to defined contribution plans that are money purchase pension plans. See, e.g., U.S. DEP’T OF LABOR, EMP. BENEFITS SEC. ADMIN., *What You Should Know About Your Retirement Plan*, *supra* note 62, at 18, 36.

²⁰⁹ Sudipto Banerjee, *Annuity and Lump-Sum Decisions in Defined Benefit Plans: The Role of Plan Rules*, 381 EMP. BENEFIT RES. INST. 1, 4 (Issue Brief No. 381, Jan. 2013), https://www.ebri.org/pdf/briefspdf/EBRI_IB_01-13.No381.LSD2.pdf.

²¹⁰ *Id.*

²¹¹ I.R.C. § 411(c)(3) (2016); Treas. Reg. § 1.411(c)-1(e) (2016).

²¹² For an explanation of the mathematics of these present value determinations, see *infra* Part IV.B.

The plan sponsor must also provide an explanation of the “relative value” of the lump sum when compared to the participant’s lifetime pension benefit.²¹³ While plan sponsors have a good deal of flexibility about how to convey this information, the explanations “must be expressed to the participant in a manner that provides a meaningful comparison of the relative economic values of the two forms of benefit without the participant having to make [her own] calculations.”²¹⁴ For example, if a lump sum is offered, participants must be shown how that lump sum compares with the present value of the lifetime pension benefit.

The Pension Protection Act of 2006 raised the interest rates that defined benefit plans use to determine lump sum distribution amounts and so made lump sum distributions significantly less expensive for plan sponsors.²¹⁵ Basically, the Internal Revenue Code used to require plan sponsors to use low 30-year-Treasury-bill interest rates to determine the minimum value of the lump sum,²¹⁶ but now plan sponsors can use higher interest rates—calculated using three different corporate interest rates based on segments of the corporate bond yield curve.²¹⁷

Also, until updated mortality tables are required for 2017 or later,²¹⁸ plan sponsors can continue to use out-of-date mortality tables that reflect relatively shorter life expectancies than the new mortality tables will

²¹³ Treas. Reg. §§ 1.417(a)(3)-1, 1.417(e)-1.

²¹⁴ Treas. Reg. § 1.417(a)(3)-1.

²¹⁵ I.R.C. § 417(e)(3) (2016); Pension Protection Act of 2006, *supra* note 67, at §§ 301-303 (codified as amended in scattered sections of 26 U.S.C. and 29 U.S.C.); *as enhanced by* the Moving Ahead for Progress in the 21st Century Act (MAP-21), Pub.L. No. 112-141, 126 Stat. 405, 850-53, §§ 40221-22 (2012).

²¹⁶ *See, e.g.*, Notice 2002-26, 2002-1 C.B. 743 (requiring rates of interest based on 30-year Treasury securities during the four-year period ending on the last day before the beginning of the plan year).

²¹⁷ *See, e.g.*, INTERNAL REVENUE SERV., *Minimum Present Value Segment Rates*, <http://www.irs.gov/Retirement-Plans/Minimum-Present-Value-Segment-Rates> (last visited July 20, 2016).

²¹⁸ *See* Notice 2015-53, 2015-33 I.R.B. 1, 2–3 (suggesting new mortality tables would be required for 2017). *But see* David B. Brandolph, *De-Risking: IRS Window for 2016 Plan Mortality Table Rules Closing*, BLOOMBERG BNA DAILY TAX REPORTER (Mar. 17, 2016), http://benefits.bna.com/bprc/2226/split_display.adp?fedfid=84832144&vname=pbdnotallissues&jd=a0j0p0e2b3&split=0 (wondering if the IRS will issue mortality table guidance in time for 2017). As we were going to press, the IRS issued new mortality tables for 2017 that made no meaningful changes. Notice 2016-50, 2016-38 I.R.B. 371.

provide.²¹⁹ In that regard, as life expectancies increase, pensions will need to make monthly payments to participants over more years, and that means lump sum distributions will cost more. Accordingly, shifting to the new mortality tables is expected to result in a 5 to 7 percent increase in pension liabilities for the average plan.²²⁰

The Internal Revenue Code also generally restricts a defined benefit plan's ability to cash out a participant's benefit without the participant's consent.²²¹ The plan generally does not need the participant's consent if the present value of her benefit is \$5000 or less;²²² however, if the accrued benefit is over \$1000, the plan must also offer the employee the option of rolling such distributions into an IRA or a new employer's plan.²²³ If the participant's consent is needed and the participant is married, then spousal consent is also required.²²⁴ In any event, when a lump sum distribution is available, the participant is typically given the opportunity to roll it over to another pension plan or to an IRA.²²⁵

²¹⁹ To get an idea of the improved mortality experience that the IRS will incorporate in its future sets of required mortality tables, see *RP-2014 Rates*, Soc'y of Actuaries, *Total Dataset* (2014), <https://www.soa.org/Files/Research/Exp-Study/research-2014-rp-mort-tab-rates.xlsx>; *RP-2014 Mortality Tables*, Soc'y of Actuaries (2014), <https://www.soa.org/Research/Experience-Study/pension/research-2014-rp.aspx>; *RP-2014 Mortality Tables Report 5 n.2*, Soc'y of Actuaries (Nov. 2014), <https://www.soa.org/Files/Research/Exp-Study/research-2014-rp-report.pdf>. See also *Selecting and Documenting Mortality Assumptions for Pensions*, AM. ACAD. OF ACTUARIES (2015), http://actuary.org/files/Mortality_PN_060515_0.pdf; Joshua Gotbaum & William G. Gale, *Good news for retirement policy in spite of gridlock*, BROOKINGS (Dec. 2015), <http://www.brookings.edu/research/opinions/2015/12/18-good-news-retirement-policy-gale-gotbaum> ("IRS regulations specify the use of outmoded mortality tables . . .").

²²⁰ MetLife, NISA Investment Advisors, L.L.C. & Prudential, *Pension Risk Transfer Comes of Age*, PENSION SETTLEMENT STRATEGIES: THE DERISKING MARKET GROWS APACE 4, 5 (July 27, 2015), <https://www.metlife.com/assets/cao/institutional-retirement/plan-sponsor/defined-benefit/pension-settlement-strategies-conference-supplement.pdf>.

²²¹ I.R.C. § 411(a)(11) (2014); Treas. Reg. § 1.411(a)-11(c) (2006).

²²² Treas. Reg. § 1.411(a)-11(c)(3) (2006).

²²³ I.R.C. § 401(a)(31)(B) (2014); I.R.S. Notice 2005-5, 2005-1 C.B. 337.

²²⁴ Treas. Reg. §§ 1.417(a)(3)-1 (2006), 1.401(a)-20 (2006).

²²⁵ I.R.C. § 402(c) (2014); STAFF OF THE J. COMM. ON TAXATION, 114TH CONG., PRESENT LAW AND BACKGROUND RELATING TO TAX-FAVORED RETIREMENT SAVING AND CERTAIN RELATED LEGISLATIVE PROPOSALS, *supra* note 37, at 21; INTERNAL REVENUE SERV., *Rollovers of Retirement Plan and IRA Distributions*

While these lump sum distribution rules provide a variety of protections for plan participants, many analysts worry that employees who take lump sum distributions will dissipate them too quickly.²²⁶ The worry is even greater when it comes to younger workers who take and spend their lump sum distributions when they change jobs.²²⁷ Participants may take a lump sum distribution (or roll over their account balance into an IRA) and subsequently purchase an annuity in the individual market, but individuals rarely buy annuities voluntarily.²²⁸

2. Rules Governing the Purchase and Monitoring of Annuities

The selection of an annuity provider is a fiduciary decision, and under U.S. Department of Labor Interpretive Bulletin 95-1, the plan sponsor must choose the “safest available” provider.²²⁹ The plan sponsor must evaluate a potential annuity provider’s claims-paying ability and creditworthiness but cannot rely solely on ratings provided by insurance rating services. Factors that the plan sponsor should consider include:

(Feb. 19, 2016), <https://www.irs.gov/Retirement-Plans/Plan-Participant,-Employee/Rollovers-of-Retirement-Plan-and-IRA-Distributions>.

²²⁶ See, e.g., Lori Lucas, *Plug the Drain: 401(k) Leakage and the Impact on Retirement*, DEFINED CONTRIBUTION INST. INV. ASS’N (Aug. 1, 2011), http://www.dciia.org/assets/Publications2/WhitePaper/white%20paper_8.1.2011%20dciia%20plug%20the%20drain.pdf; Frolik, *Rethinking ERISA’s Promise on Income Security in a World of 401(k) Plans*, *supra* note 59, at 376–82; U.S. GOV’T ACCOUNTABILITY OFF., GAO-09-715, 401(K) PLANS: POLICY CHANGES COULD REDUCE THE LONG-TERM EFFECTS OF LEAKAGE ON WORKERS’ RETIREMENT SAVINGS (2009), <http://www.gao.gov/assets/300/294520.pdf>.

²²⁷ Craig Copeland, *Lump-Sum Distributions at Job Change*, 30(1) EMP. BENEFIT RES. INST. NOTES 2 (2009), https://www.ebri.org/pdf/notespdf/EBRI_Notes_Jan09_Rollovers.pdf; Hurd & Panis, *The Choice to Cash Out, Maintain, or Annuitize Pension Rights upon Job Change or Retirement*, *supra* note 59.

²²⁸ See *infra* notes 336–339 and accompanying text.

²²⁹ 29 C.F.R. § 2509.95-1 (2016) (a/k/a Interpretive Bulletin 95-1, Interpretive bulletin relating to the fiduciary standards under ERISA when selecting an annuity provider for a defined benefit pension plan); *Bussian v. RJR Nabisco, Inc.*, 223 F.3d 286, 298 (5th Cir. 2000) (discussing the “safest available” standard); *Riley v. Murdock*, 83 F.3d 415 (4th Cir. 1996) (declining to apply the “safest available” standard).

- (1) the quality and diversification of the annuity provider's investment portfolio;
- (2) the size of the insurer relative to the proposed contract;
- (3) the level of the insurer's capital and surplus;
- (4) the lines of business of the annuity provider and other indications of its exposure to liability;
- (5) the structure of the annuity contract and guarantees supporting the annuities, such as the use of separate accounts; and
- (6) the availability of additional protection through state guaranty associations and the extent of those guarantees.²³⁰

A plan sponsor also has a duty to monitor the appropriateness of the annuity providers that it selects, but that duty ends when the plan transfers the plan's liability with respect to the individual's benefits to that annuity provider.²³¹

The U.S. Department of Labor's new fiduciary conflict-of-interest rule will also apply to financial advisers who sell annuities to defined benefit plans and plan participants,²³² and it will have a transformative impact on the sales of annuities to defined benefit plans and plan participants.²³³ The new rule is almost certain to change the current commission structure of annuities offered to plans and plan participants, and probably for the better (i.e., lower and more transparent commissions and fees).²³⁴

²³⁰ 29 C.F.R. § 2509.95-1(c) (2008). *See also* ADVISORY COUNCIL ON EMP. WELFARE AND PENSION BENEFIT PLANS, *Report of the Working Group on Retirement Distributions & Options* (2005), http://www.dol.gov/ebsa/publications/AC_1105A_report.html (recommending that the U.S. Department of Labor revise Interpretive Bulletin 95-1 to clarify the prudent procedures for annuity selection and monitoring).

²³¹ 29 C.F.R. § 2509.95-1(b) (2008).

²³² *See supra* notes 90–91 and accompanying text.

²³³ *See, e.g.*, Sean Forbes, *Fixed Annuity Sales Surge Amid Fiduciary Rule Concerns*, BLOOMBERG BNA (July 7, 2016), <http://www.bna.com/fixed-indexed-annuity-n57982076676/>; Stolz, *How Annuities Will Be Transformed by DOL Fiduciary Rule*, *supra* note 91.

²³⁴ Stolz, *How Annuities Will Be Transformed by DOL Fiduciary Rule*, *supra* note 91. *See also* Greg Iacurci, *DOL fiduciary rule will transform the annuity industry*, INVESTMENTNEWS, (Feb. 21, 2016, 12:01 AM), <http://www.investmentnews.com/article/20160221/FREE/160219910/dol-fiduciary-rule-will-transform-the-annuity-industry?issuedate=20160221&sid=ANNUITY22016>; Michael Kitces, *Why The DoL Fiduciary Rule Won't Kill Annuities, It Will Make Them Stronger!*,

C. THE REGULATION OF ANNUITIES IN DEFINED CONTRIBUTION PLANS

Annuities can also play a role in defined contribution plans. First, defined contribution plans may offer deferred income annuities among their investment options. Second, a defined contribution plan may offer participants the option to annuitize their account balances at retirement or job separation. Third, almost all defined contribution plan participants may take a lump sum distribution (or roll over their account balance into an IRA) and subsequently purchase an annuity.²³⁵

1. Rules Governing Lump Sum Distributions

Defined contribution plans are not required to offer annuities, and as already mentioned, most defined contribution plans make distributions in lump sum or periodic distributions rather than lifetime annuities.²³⁶ In that regard, defined contribution plans typically allow lump sum distributions whenever an employee leaves employment—both at retirement or simply upon job separation.²³⁷ Plans are not required to offer departing employees a lump sum distribution (at least not until they are eligible to retire), but most plans do.²³⁸ If the accrued benefit of the departing employee is under \$5000, the plan is allowed to distribute the accrued amount in a lump sum distribution without the employee's consent,²³⁹ however, if the accrued benefit is over \$1000, the plan must also offer the employee the option of rolling such distributions into an IRA or a new employer's plan.²⁴⁰ All in all, departing employees can leave the money in the plan, roll it over into an IRA or other plan, or cash it out and spend it. Many analysts worry about

KITCES.COM (Apr. 21, 2016), <https://www.kitces.com/blog/why-dol-fiduciary-wont-kill-annuities-it-will-make-them-stronger/>.

²³⁵ Brien & Panis, *Annuities in the Context of Defined Contribution Plans*, *supra* note 59, at 12.

²³⁶ *See supra* Part II.C.1.b.

²³⁷ U.S. DEP'T OF LABOR, EMP. BENEFITS SEC. ADMIN., *What You Should Know About Your Retirement Plan*, *supra* note 62, at 21.

²³⁸ *Id.*

²³⁹ I.R.C. § 411(a)(11) (2014); Treas. Reg. § 1.411(a)-11(c)(3) (2006).

²⁴⁰ I.R.C. § 401(a)(31)(B); Notice 2005-5, 2005-1 C.B. 337.

employees dissipating their retirement savings when they receive lump sum distributions (or loans) and spend them before retirement.²⁴¹

2. Rules Governing the Purchase and Monitoring of Annuities

a. *Fiduciary Duties Generally*

When a defined contribution plan does offer an annuity, the selection of an annuity provider is, of course, a fiduciary function.²⁴² The current safe harbor provides that a defined contribution plan fiduciary satisfies its fiduciary responsibility if the fiduciary:

- (1) engages in an objective, thorough and analytical search for the purpose of identifying and selecting providers from which to purchase annuities;
- (2) appropriately considers information sufficient to assess the ability of the annuity provider to make all future payments under the annuity contract;
- (3) appropriately considers the cost (including fees and commissions) of the annuity contract in relation to the benefits and administrative services to be provided under such contract;
- (4) appropriately concludes that, at the time of the selection, the annuity provider is financially able to make all future payments under the annuity contract and the cost of the annuity contract is reasonable in relation to the

²⁴¹ See, e.g., Lucas, *Plug the Drain: 401(k) Leakage and the Impact on Retirement*, *supra* note 226, at 1; Copeland, *Lump-Sum Distributions at Job Change*, *supra* note 227, at 2; Hurd & Panis, *The Choice to Cash Out, Maintain, or Annuitize Pension Rights upon Job Change or Retirement*, *supra* note 59, at 7.

²⁴² 29 C.F.R. § 2550.404a-4 (2008) (relating to the safe harbor on defined contribution annuity distribution options). See also Robert N. Eccles, Gregory F. Jacob & Wayne Johnson, *Guaranteed Lifetime Withdrawal Benefits: Fiduciary Considerations for Plan Sponsors*, 27(2) *BENEFITS L. J.* 379 (Summer 2014), <http://www.ircouncil.org/docs/BenefitsLawJournalGLWBFiduciaryConsideration.s.pdf>; Bruce Ashton, *The Retirement Income Dilemma: An In-plan Solution*, *DRINKER BIDDLE* (Mar. 2016), <https://secure02.principal.com/publicsupply/GetFile?fm=HZ2364&ty=VOP&EXT=.VOP>.

- benefits and services to be provided under the contract;
and
(5) if necessary, consults with an appropriate expert or experts for purposes of compliance with these provisions.²⁴³

A defined contribution plan sponsor also has a duty to monitor the appropriateness of the annuity providers that it selects, but that duty ends when the plan transfers the plan's liability with respect to the participant's benefits to that annuity provider.²⁴⁴

A defined contribution plan is relatively free to impose restrictions on the amount of assets that may be annuitized, even "unpalatable" restrictions.²⁴⁵ For example, the plan may require the participant to annuitize either all or none of her account balance.²⁴⁶

The U.S. Department of Labor's new fiduciary conflict-of-interest rule also applies to financial advisers who sell annuities to defined contribution plans and plan participants.²⁴⁷

b. *Annuity Investments within Defined Contribution Plans*

While a defined contribution plan sponsor can select the investments for its plan, ERISA Section 404(c) generally allows plans to permit individual participants to direct their own investments (a/k/a, "self-directed" or "participant-directed" accounts).²⁴⁸ To be eligible for this safe harbor, the

²⁴³ 29 C.F.R. § 2550.404a-4 (2008). *See also* Field Assistance Bulletin 2015-2 (U.S. Dep't of Labor, Jul. 13, 2015), <http://www.dol.gov/ebsa/pdf/fab2015-2.pdf> (clarifying the meaning of "the time of selection").

²⁴⁴ Field Assistance Bulletin 2015-2, *supra* note 243; 29 C.F.R. § 2550.404a-4 (2008).

²⁴⁵ Brien & Panis, *The Choice to Cash Out, Maintain, or Annuitize Pension Rights upon Job Change or Retirement*, *supra* note 59, at 14.

²⁴⁶ *Id.* (noting plan limits may also make it difficult to wait to select an annuity).

²⁴⁷ *See supra* notes 90–91 and accompanying text.

²⁴⁸ ERISA § 404(c), 29 U.S.C. §1104(c) (2008) (providing plans with a "safe harbor" from liability for losses that a participant suffers in their 401(k) accounts to the extent that the participant exercises control over the assets in her 401(k) account). *See also* U.S. DEP'T OF LABOR, EMP. BENEFITS SEC. ADMIN., *Meeting Your Fiduciary Responsibilities*, *supra* note 87, at 6; INTERNAL REVENUE SERV., *Retirement Topics - Participant-Directed Accounts* (Oct. 7, 2015),

plan must provide the participant with the opportunity “to exercise control over assets in his individual account” and “to choose, from a broad range of investment alternatives.”²⁴⁹ The plan must also provide the participant with “the opportunity to obtain sufficient information to make informed decisions with regard to investment alternatives available under the plan,” including information about transaction fees and expenses.²⁵⁰ Also, “the act of designating investment alternatives in an ERISA Section 404(c) plan is a fiduciary function,” and “in deciding whether and to what extent to invest in a particular investment, or to make a particular fund available as a designated investment alternative, a fiduciary must ordinarily consider only factors relating to the interests of plan participants and beneficiaries in their retirement income.”²⁵¹ Defined contribution plans can include fixed and variable annuities among their investment alternatives.²⁵²

When a plan sponsor allows participants to direct their own investments, the plan sponsor must also choose a default investment for workers who do not otherwise direct their own investments.²⁵³ Historically, plan sponsors used low-yield, stable-value bond funds for that purpose, but the Pension Protection Act of 2006 amended ERISA Section 404(c) to improve the default investments for workers who do not otherwise direct their own investments.²⁵⁴ That law—and the U.S. Department of Labor’s regulation—encouraged employers to replace their low-yield, stable-value bond funds with balanced funds (funds with an unchanging mix of stocks

<https://www.irs.gov/retirement-plans/plan-participant-employee/retirement-topics-participant-directed-accounts>.

²⁴⁹ 29 C.F.R. § 2550.404c-1(b)(1) (2010).

²⁵⁰ 29 C.F.R. § 2550.404c-1(b)(2)(i)(B) (2010).

²⁵¹ U.S. DEP’T OF LABOR, PENSION AND WELFARE BENEFITS ADMIN., OFF. OF REG. AND INTERPRETATIONS, ADVISORY OPINION NO. 98-04(A) (May 28, 1998).

²⁵² See, e.g., TIAA-CREF FINANCIAL SERVICES, *Defined Benefit vs. Defined Contribution Plans*, <http://www1.tiaa-cref.org/public/support/help/ask-tiaa-cref/db-vs-dc/index.html> (last visited July 19, 2016) (noting TIAA defined contribution plans have both fixed and variable annuity options that the plan sponsor can include in its offerings). See also Raimond Maurer, Olivia Mitchell, Vanya Horneff & Ralph Rogalla, *Variable Annuities, Lifetime Income Guarantees, and Investment Downside Protection*, TIAA INST., 1 (Mar. 2016), https://www.tiaainstitute.org/public/pdf/ti_variable_annuities_lifetime_income_guarantees.pdf; TIAA-CREF FINANCIAL SERVICES, *The Case for Guaranteed Annuities in Defined Contribution Plans* (Oct. 2010), https://www.tiaa.org/public/pdf/case_guaranteed_annuities.pdf.

²⁵³ ERISA § 404(c)(5), 29 U.S.C. § 1104(c)(5) (2008).

²⁵⁴ Pension Protection Act of 2006, *supra* note 67 (amending ERISA § 404(c), 29 U.S.C. § 1104(c) (2008)).

and bonds) and life-cycle funds (funds that gradually shift their investments from stocks towards bonds as workers age).²⁵⁵ More specifically, the final regulation provides for four types of so-called “qualified default investment alternatives” (QDIAs) and also clarifies that a QDIA may be offered through variable annuity contracts or other pooled investment funds.²⁵⁶ In response to these rule changes, defined contribution plans have generally moved away from stable-value bond funds and towards target date funds,²⁵⁷ but plan sponsors can also offer annuities.²⁵⁸

Recently issued guidance makes it easier for defined contribution plan sponsors to offer annuities.²⁵⁹ More specifically, if certain conditions are satisfied, plan sponsors can offer, as investment options, a series of target date funds that include deferred income annuities among their assets, even if some of the target date funds within the series are available only to older participants.²⁶⁰ In related guidance the U.S. Department of Labor noted that target date funds that serve as qualified default investment alternatives may include annuities as part of their investment portfolios.²⁶¹

²⁵⁵ *Id.*; 29 C.F.R. § 2550.404c-5 (2008). *See, e.g.*, U.S. DEP’T OF LABOR, EMP. BENEFITS SEC. ADMIN, *Default Investment Alternatives Under Participant Directed Individual Account Plans*, 72 Fed. Reg. 60,452, 60,461 (Oct. 24, 2007), <http://www.dol.gov/ebsa/regs/fedreg/final/07-5147.pdf> (amending 29 C.F.R. Part 2550); Olivia S. Mitchell, Gary R. Mottola, Stephen P. Utkus & Takeshi Yamaguchi, *The Dynamics of Lifecycle Investing in 401(k) Plans*, PENSION RES. COUNCIL 12-13 (Population Aging Research Center Working Paper No. 19, 2008), http://repository.upenn.edu/cgi/viewcontent.cgi?article=1018&context=pare_working_papers.

²⁵⁶ U.S. DEP’T OF LABOR, EMP. BENEFITS SEC. ADMIN., *Fact Sheet: Regulation Relating to Qualified Default Investment Alternatives in Participant-Directed Individual Account Plans* (2008), <http://www.dol.gov/ebsa/pdf/fsQDIA.pdf>.

²⁵⁷ Andrew Bary, *Target-Date Funds Take Over*, BARRON’S (Jul. 5, 2014), <http://www.barrons.com/articles/SB50001424053111904544004579651134019266274>; Meaghan Kilroy, *Vanguard finds soaring use of auto enrollment, target-date funds 10 years after PPA*, PENSIONS & INVESTMENTS (Jun. 8, 2016), <http://www.pionline.com/article/20160608/ONLINE/160609873/vanguard-finds-soaring-use-of-auto-enrollment-target-date-funds-10-years-after-ppa>

²⁵⁸ *See, e.g.*, TIAA-CREF FINANCIAL SERVICES, *The Case for Guaranteed Annuities in Defined Contribution Plans*, *supra* note 252.

²⁵⁹ Notice 2014-66, 2014-46 I.R.B. 820.

²⁶⁰ *Id.*; U.S. DEP’T OF THE TREASURY, *Treasury Issues Guidance to Encourage Annuities in 401(k) Plans* (Oct. 24, 2014), <https://www.treasury.gov/press-center/press-releases/Pages/jl2673.aspx>.

²⁶¹ U.S. DEP’T OF LABOR, EMP. BENEFITS SEC. ADMIN., *Information letter from Phyllis Borzi, Assistant Secretary for EBSA, U.S. Department of Labor, to Mark*

Regardless of how participants invest over the course of their careers, at retirement or job separation, a defined contribution plan can offer an in-plan annuity distribution option.²⁶² To avoid the fiduciary risks that come from selecting and monitoring annuity providers, however, plan sponsors can instead offer annuities outside the plan as an IRA rollover option.²⁶³

D. THE REGULATION OF ANNUITIES IN INDIVIDUAL RETIREMENT ACCOUNTS

Individuals can also use their IRAs to buy annuities. For example, an individual might roll over a lump sum pension distribution into an IRA and then have the IRA purchase an annuity. For that matter, the individual could roll over the funds directly to an “IRA annuity” offered by an insurance company.²⁶⁴ Having an IRA purchase an immediate fixed (lifetime) annuity will usually satisfy the required minimum distribution rules.²⁶⁵ The U.S. Department of Labor’s new fiduciary conflict-of-interest rule will also apply to financial advisers who sell annuities to IRA holders.²⁶⁶

E. PENSION RISK TRANSFERS

Over the years, defined benefit plan sponsors have found it challenging to manage the risks associated with those plans. This has been

Iwry, Senior Advisor to the Secretary and Deputy Assistant Secretary for Retirement and Health Policy, U.S. Department of the Treasury (Oct. 23, 2014), <https://www.dol.gov/agencies/ebsa/employers-and-advisers/guidance/information-letters/10-23-2014>.

²⁶² See, e.g., Steve Utkus, *Annuity—or not?*, VANGUARD BLOG FOR INST. INVESTORS (Nov. 20, 2015), <http://vanguardinstitutionalblog.com/2015/11/20/annuity-or-not/>.

²⁶³ *Id.*

²⁶⁴ See, e.g., Hersh Stern, *Can I Buy An Annuity With My IRA or 401k?*, IMMEDIATEANNUITIES (Aug. 7, 2016), <https://www.immediateannuities.com/roll-over-ira-or-401k/>.

²⁶⁵ Treas. Reg. § 1.401(a)(9)-6 (2014). See, e.g., Hersh Stern, *Required Minimum Distribution (RMD)*, IMMEDIATEANNUITIES (Aug. 10, 2016), <https://www.immediateannuities.com/required-minimum-distribution/> (noting that the required minimum distribution (RMD) rules generally require plan participants to begin taking distributions soon after they reach age 70½). See *supra* note 101 and accompanying text.

²⁶⁶ See *supra* notes 90–91 and accompanying text.

particularly true since the Financial Accounting Standards Board (FASB) began requiring corporate employers to recognize the funding obligations associated with their defined benefit plans.²⁶⁷ Also, recent fluctuations in the national economy have resulted in changes in the value of plan assets and in market interest rates, which, in turn, have led to volatility in the funded status of defined benefit plans and in the pension contributions that plan sponsors are required to make.²⁶⁸ In general, corporate employers have responded by “freezing,” terminating, or replacing their traditional defined benefit plans.²⁶⁹ Many plan sponsors have also chosen to reduce their risks by managing their plan assets with so-called “liability driven investing” (LDI).²⁷⁰ Finally, many plan sponsors are now focused on de-risking their defined benefit plans—pension risk transfer strategies that transfer risk to insurance companies by purchasing annuities for participants (insurance annuity risk transfers) or that transfer risk to participants by making lump sum distributions to the participants (lump sum risk transfers).²⁷¹

²⁶⁷ See, e.g., *FASB Improves Employers’ Accounting for Defined Benefit Pension and Other Postretirement Plans*, FIN. ACCT. STANDARDS BD. (Sep. 29, 2016), http://www.fasb.org/jsp/FASB/FASBContent_C/NewsPage&cid=900000004155.

²⁶⁸ U.S. GOV’T ACCOUNTABILITY OFF., GAO-15-74, PRIVATE PENSIONS: PARTICIPANTS NEED BETTER INFORMATION WHEN OFFERED LUMP SUMS THAT REPLACE THEIR LIFETIME BENEFITS 3 (2015), <http://www.gao.gov/assets/670/668106.pdf>.

²⁶⁹ See, e.g., Wiatrowski, *Changing Landscape of Employment-based Retirement Benefits*, *supra* note 107; Wiatrowski, *The Last Private Industry Pension Plans: A Visual Essay*, *supra* note 49; Justin Owens & Joshua Barbash, *Defined Benefit Plans: A Brief History*, (2014), <http://www.russell.com/documents/institutional-investors/research/defined-benefit-plans-a-brief-history.pdf>; U.S. DEP’T OF LAB., BUREAU OF LAB. STAT., “Frozen” *Defined-benefit Plans*, 2 PROGRAM PERSPECTIVES ON DEFINED BENEFIT PLANS (2010), http://www.bls.gov/opub/perspectives/program_perspectives_vol2_issue3.pdf; *Pension Freezes*, PENSION RIGHTS CTR., <http://www.pensionrights.org/publications/fact-sheet/pension-freezes#sthash.04SP0a6P.dpuf> (last visited July 20, 2016).

²⁷⁰ See, e.g., U.S. DEP’T OF LABOR, ADVISORY COUNCIL ON EMP. WELFARE AND PENSION BENEFIT PLANS, *Private Sector Pension De-risking and Participant Protections*, 13–14 (Nov. 2013), <http://www.dol.gov/ebsa/pdf/2013ACreport2.pdf>.

²⁷¹ See, e.g., *id.* at 14–17; Joanne Sammer, *Companies Eye Pension De-Risking*, HR MAGAZINE (Feb. 1, 2016), <https://www.shrm.org/hr-today/news/hr-magazine/pages/0216-pension-de-risking.aspx>; AONHEWITT, PENSION SETTLEMENTS THROUGH TERMINATED VESTED LUMP SUM WINDOWS: INSIGHTS INTO PLAN SPONSOR EXPERIENCE 2 (Feb. 2013), <http://www.hekblog.com/wp->

1. An Overview of Risk Transfer Strategies for Defined Benefit Plans

Defined benefit plan sponsors can significantly reduce their financial risks by engaging in lump sum risk transfers and insurance annuity risk transfers.²⁷² In a lump sum risk transfer, the participant gets a lump sum distribution that has a value that is the actuarial equivalent of the remaining expected payments under her pension. In an insurance annuity risk transfer, the participant gets an insurance company annuity instead of her pension. In both types of risk transfers, the plan sponsor is able to reduce the size of its pension

content/uploads/2013/03/Pension-Settlements-through-TV-Windows-_3_18_13.pdf; CFO Research & Mercer, *Taking the Next Step in Pension Risk Management*, CFO.COM (July 2015), <http://www.cfo.com/research/index.cfm/download/14717490>; Marcia Wagner, *De-Risking Strategies*, PLAN SPONSOR (Feb. 2016) <http://www.plansponsor.com/MagazineArticle.aspx?id=6442517918>; Rebecca Moore, *Risk Capture*, PLAN ADVISER 50 (Jan.–Feb. 2016), http://www.planadviserdigital.com/planadviser/january_february_2016?sub_id=F07mtVh0axU7&folio=50&pg=54#pg54; Timothy J. Geddes, Bradley B. Howard, Anthony G. Conforti & Allison R. Steinmetz, *Pension Risk Transfer: Evaluating Impact and Barriers for De-Risking Strategies*, DELOITTE 6 (2014), <https://www.soa.org/Files/Research/Projects/2014-pension-risk-transfer-study.pdf> (noting that pension de-risking strategies fall under three main categories: plan design; funding and investment policy; and liability management); Paul M. Secunda & Brendan S. Maher, *Pension De-Risking*, 93(3) WASHINGTON U. L. REV. 733 (2016).

²⁷² See, e.g., *supra* note 271 and accompanying text. Note that defined contribution plans do not need to engage in risk transfer strategies. A defined contribution plan sponsor's principal financial obligation is to fully fund its plan by making the required (defined) contributions. Thereafter, the plan sponsor is required to manage the plan's assets as the individual account balances grow and to make distributions from those individual accounts when the participants retire or terminate their employment, but, unlike a defined benefit plan sponsor, a defined contribution plan sponsor has no further financial obligations (absent a breach of fiduciary duties). Defined contribution plan sponsors can, however, "outsource" many of their plan administration duties to third-party administrators, but that is not at all like the de-risking of financial risks by defined benefit plans). U.S. DEP'T OF LABOR, ADVISORY COUNCIL ON EMP. WELFARE AND PENSION BENEFIT PLANS, *Outsourcing Employee Benefit Plan Services* (Nov. 2014), <http://www.dol.gov/ebsa/pdf/2014ACreport3.pdf>.

plan and its pension costs, for example, by reducing its PBGC premiums.²⁷³ In short, pension risk transfers reduce risks for defined benefit plan sponsors.

At the same time, however, pension risk transfers generally increase risks for participants and often push them away from receiving streams of lifetime income. For example, participants who receive lump sum distributions must bear all of the longevity risk for making their money last for the rest of their lives; they must bear all the costs and risks of managing their investments; and their assets are no longer entitled to the creditor and other protections of ERISA.²⁷⁴ Participants who receive insurance company annuities have their PBGC guarantees replaced by the less generous guarantees of state guaranty funds.²⁷⁵

2. The Recent (and Coming) Increase in Pension Risk Transfers

²⁷³ See, e.g., PENSION BENEFIT GUAR. CORP., *Premium Rates*, *supra* note 102 (noting plan sponsors have to pay both per-participant PBGC premiums and a variable-rate premium that is based on the plan's level of funding); The Bipartisan Budget Act of 2015, Public Law No. 114-74, 129 Stat. 584 (providing for significant increases in PBGC premiums). *Id.* For example, for single-employer plans, the per-participant flat premium rate for plan years beginning in 2017 is \$69 for single-employer plans and the variable-rate premium (VRP) for single-employer plans is \$34 per \$1000 of unfunded vested benefits (UVBs). PENSION BENEFIT GUAR. CORP., *Premium Rates*, *supra* note 102.

²⁷⁴ See, e.g., *Model Notices and Disclosures for Pension Risk Transfers: Hearing Before the Advisory Council on Employee Welfare and Pension Benefit Plans* 5 (May 28, 2015) (statement of Roberta Rafaloff, MetLife), <http://www.dol.gov/ebsa/pdf/erisaadvisorycouncil2015risk8.pdf> (“The relative value statement does not even begin to evaluate the costs and risks assumed by the participant. In accepting the lump sum, the participant assumes the investment, mortality and longevity risks. The value of these risks, which the participant will pay if they attempt to turn the lump sum into lifetime income with a retail annuity, is not part of the relative value disclosure.”). See also Gotbaum & Gale, *Good news for retirement policy in spite of gridlock*, *supra* note 219 (“Many retirement experts view lump sum payments that substitute for pensions to be pernicious because they divert professionally-managed accounts and instead put large sums in the hands of individuals who have little or no investment expertise.”).

²⁷⁵ See *supra* Part III.A. Not everyone believes that the state guarantees are less valuable than PBGC guarantees. See, e.g., Barry Burr, *Study finds little difference in pension guarantee between PBGC and annuities*, PENSIONS & INVESTMENTS (Mar. 21, 2016), http://www.pionline.com/article/20160321/PRINT/160329995/study-finds-little-difference-in-pension-guarantee-between-pbgc-and-annuities?utm_campaign=saxo_rss&utm_source=rss02_rss&utm_medium=rss.

In recent years, we have seen a significant increase in these pension de-risking transactions. According to one recent study of private pension plans, more than one million participants were affected by de-risking from 2009–2013.²⁷⁶ There were \$8.5 billion in pension buy-out transactions in 2014, and more than \$8 billion in the first three-quarters of 2015,²⁷⁷ and de-risking transactions are expected to continue to rise.²⁷⁸

Increasingly, plan sponsors—especially those with frozen defined benefit plans—view their defined benefit plans as legacy liabilities that are no longer a strategic part of their current compensation packages. Through lump sum risk transfers and insurance annuity risk transfers, plan sponsors can reduce the number of plan participants. As a result a plan sponsor can save money by reducing the plan’s administrative costs and its ever-increasing PBGC premiums.²⁷⁹ Removing participants from the plan also reduces the size of the pension and so reduces the impact of market volatility on pension plan funding and contribution rates (and on corporate balance sheets). Also, as already-mentioned, until the new mortality table regulations come into effect in 2017 or later, plan sponsors can still use the currently-required mortality tables to calculate lump sums—tables that reflect shorter life expectancies than the new mortality tables.²⁸⁰ All in all, it is less expensive for plans to enter into lump sum risk transfers sooner rather than later.²⁸¹

²⁷⁶ Neela Ranade, Armando Saavedra & Tim Rhodes, *Risk Transfer Study Plan Years 2009–2013* 25 (2015), <http://www.pbgc.gov/documents/Risk-Transfer-with-Notes-December-2015.pdf> (study of Form 5500 filings compiled by the PBGC for plans with 1000 or more participants).

²⁷⁷ Rob Kozlowski, *More Plans than Ever Solve Liabilities Problem by Dumping Them*, PENSIONS & INVESTMENTS (Feb. 22, 2016) <http://www.pionline.com/article/20160222/PRINT/302229979>. See also Citi GPS: Global Perspectives & Solutions, *The Coming Pensions Crisis*, *supra* note 139, at 61 fig.41 (listing notable recent pension risk transfer transactions in the United States and the United Kingdom); Amy Kessler, William McCloskey & Arnaud Benoussan, *The Pension Risk Transfer Market at \$240 Billion: Innovation, Globalization, and Growth*, PENSION & LONGEVITY RISK TRANSFER FOR INST. INVESTORS 18 (2015).

²⁷⁸ See, e.g., *De-Risking and Rescue Plan Petitions Expected to Rise*, 43 BNA PENSION & BENEFITS REP. 128 (2016).

²⁷⁹ See, e.g., PENSION BENEFIT GUAR. CORP., *Premium Rates*, *supra* note 102 (showing scheduled increases through 2019).

²⁸⁰ See *supra* notes 218–220 and accompanying text.

²⁸¹ On the other hand, there is no similar cost savings for an insurance annuity risk transfer as insurance companies have already taken the new life expectancy

Lump sum risk transfers and insurance annuity risk transfers are still relatively expensive in today's low-interest-rate environment, and they present significant challenges for currently-underfunded defined benefit plans. Pertinent here, higher interest rates generally have a bigger effect on a plan's liabilities than on its assets.²⁸² Among other things, that means that (if and) when market interest rates increase, pension plan funding ratios will improve.²⁸³ As a result, many currently underfunded plans would "become" fully funded, and once plans are 110 percent funded, many observers believe that many of those plans would then implement de-risking and termination strategies.²⁸⁴ As more fully explained in Part III.E.3.a below, it is fairly easy for a plan sponsor to terminate a fully funded plan, and participants in those "standard terminations" generally get lump sum distributions or insurance annuities: there is no way for a participant to stay with a plan that is terminating.

3. The Current Rules Governing Pension Risk Transfers

A variety of ERISA rules can have an impact on lump sum risk transfers and insurance annuity risk transfers.

a. *Standard Terminations*

It is fairly easy for a plan sponsor to terminate a fully funded defined benefit plan.²⁸⁵ In general, these standard terminations involve purchasing

projections into account in pricing their annuities. Once a plan adopts the new mortality tables, however, annuities will look relatively better compared to the plan's liability.

²⁸² See, e.g., INTERNATIONAL MONETARY FUND, GLOBAL FINANCIAL STABILITY REPORT: GRAPPLING WITH CRISIS LEGACIES 75 (Sept. 2011), <https://www.imf.org/External/Pubs/FT/GFSR/2011/02/pdf/text.pdf>.

²⁸³ Rich White, *Is Your Defined-Benefit Pension Plan Safe?*, INVESTOPEDIA (Feb. 19, 2008), <http://www.investopedia.com/articles/retirement/08/safe-db-plan.asp> (noting a defined benefit plan's funding ratio is the ratio of its assets to its liabilities).

²⁸⁴ See, e.g., Sammer, *Companies Eye Pension De-Risking*, *supra* note 271; see also *Taking the Next Step in Pension Risk Management*, MERCER 4 (July 2015), <http://www.mercer.com/content/dam/mercer/attachments/global/Retirement/mercer-cfo-research-pension-risk-survey-2015.pdf> (showing that a large percentage of the 213 large companies surveyed were likely or very likely to undertake risk transfers in 2015 or 2016).

²⁸⁵ See generally ERISA § 4041(b)(1)(D), 29 U.S.C. § 1341(b)(1)(D) (2012);

annuities from an insurer, although participants can also be offered lump sum distributions.²⁸⁶ A terminating plan can only require a participant to accept a lump sum if the present value of her benefit is \$5,000 or less.²⁸⁷ A typical standard termination involves numerous steps including: calculating individual participant benefit amounts and payment form options, communicating information to plan participants, and distributing the assets. The whole process typically takes 12 to 18 months.²⁸⁸

Unless the participant elects otherwise, she will receive an insurance annuity that is equivalent to her pension. As already mentioned, the selection of an annuity provider is a fiduciary decision, and the plan sponsor must choose the safest available provider.²⁸⁹ A key step in any standard termination is providing an individualized notice of plan benefits to each participant.²⁹⁰ These notices of plan benefits include general information about the plan and the data used to calculate each participant's benefit, and they may also include the plan's benefit election form. When a lump sum alternative is offered to a participant, the minimum lump sum amount must be determined in accordance with the relative valuation rules, and the notice of plan benefits must explain the relative value of the lump sum when compared to the participant's lifetime pension benefit.²⁹¹

Standard Terminations, PENSION BENEFIT GUAR. CORP., <http://www.pbgc.gov/prac/terminations/standard-terminations.html> (last visited July 21, 2016); *Retirement Plans FAQs Regarding Plan Terminations*, INTERNAL REVENUE SERV., <http://www.irs.gov/Retirement-Plans/Retirement-Plans-FAQs-regarding-Plan-Terminations> (last updated Feb. 19, 2016); Harold J. Ashner, *PBGC Issues: Planning a Standard Termination—A Checklist for Practitioners*, 16 J. PENSIONS & BENEFITS 67 (2009), http://www.keightleyashner.com/publications/Pensions_Benefits_012009.pdf; Blaine Brickhouse, *Path to Defined Benefit Plan Termination*, FINDLEY DAVIES, <http://www.findleydavies.com/images/ServiceLineLeftThumbnailsAndPDFs/Summary-of-the-Pension-Plan-Termination-Process-3-25-14-with-new-logo.pdf> (last visited July 29, 2016); *Plan Termination: Getting It Done!*, SOC'Y OF ACTUARIES (Oct. 16-19, 2011), <https://www.soa.org/files/pd/annual-mtg/2011-chicago-annual-mtg-118-4.pdf>; American Bar Association Retirement Funds, *Plan Termination*, PLAN ADM'R GUIDE (2015), <http://www.aba-retirement.com/ePAG/aba-0h0-plan-termination-web-.html>.

²⁸⁶ ERISA § 4041(b)(3)(A), 29 U.S.C. § 1341(b)(3)(A) (2012); 29 C.F.R. § 4041.28(c) (2015).

²⁸⁷ I.R.C. § 411(a)(11) (2012). See *supra* notes 221–225 and accompanying text.

²⁸⁸ Brickhouse, *Path to Defined Benefit Plan Termination*, *supra* note 285, at 1.

²⁸⁹ See *supra* Part III.B.2.

²⁹⁰ 29 C.F.R. § 4041.24 (2015).

²⁹¹ I.R.C. § 411(c)(3) (2012); Treas. Reg. § 1.411(c)-1(e) (1977). See *supra* Part III.B.1.

b. *Lump Sum Risk Transfers*

In a typical lump sum risk transfer, the employer amends its defined benefit plan to provide participants with a choice between the lifetime pension benefit promised by the plan and a lump sum distribution that has an actuarially-equivalent present value.²⁹² Usually, the employer makes its “lump sum window” offer available to separated participants (also known as terminated deferred vested participants), and they are given a window of time (e.g., 90 days) to make their choice. For example, a separated participant who is not yet in pay status could be offered a lump sum that is the actuarial equivalent of her promised lifetime pension benefit. As more fully explained in Part V.A.5 below, however, while that lump sum is the actuarial equivalent of her promised pension, because of the way that retail annuity markets work, that lump sum could almost never be enough to buy a retail annuity that would replicate the promised lifetime pension benefit.²⁹³

ERISA and the Internal Revenue Code impose a number of limits on the ability of plan sponsors to engage in lump sum risk transfers. At the outset, a plan sponsor’s decision to implement a lump sum risk transfer is a matter of plan design that is viewed as a settlor function rather than a fiduciary function.²⁹⁴ On the other hand, when the plan sponsor implements that lump sum risk transfer, the plan sponsor acts as a fiduciary.²⁹⁵

Also, whenever the plan sponsor makes a lump sum distribution, the plan sponsor must comply with the relative valuation rules.²⁹⁶ Also, as already-mentioned, until the new mortality table regulations come into effect in 2017 or later, plan sponsors can still use the currently-required mortality

²⁹² See, e.g., *supra* note 271 and accompanying text.

²⁹³ See, e.g., U.S. GOV’T ACCOUNTABILITY OFF., GAO-15-74, PRIVATE PENSIONS: PARTICIPANTS NEED BETTER INFORMATION WHEN OFFERED LUMP SUMS THAT REPLACE THEIR LIFETIME BENEFITS, *supra* note 268, at 25–29.

²⁹⁴ A “settlor” is the person who creates a trust. See, e.g., W.J. Stewart, *Settlor*, COLLINS DICTIONARY OF LAW (2006), <http://legal.dictionary.thefreedictionary.com/settlor>.

²⁹⁵ ERISA § 404, 29 U.S.C. § 1104 (2008); I.R.C. § 401(a) (2016). See also Dana Muir & Norman Stein, *Two Hats, One Head, No Heart: The Anatomy of the ERISA Settlor/Fiduciary Distinction*, 93 N.C. L. REV. 459 (2015); Lee v. Verizon Communications, Inc., 623 F. App’x 132, 2015 U.S. App. LEXIS 14588 (5th Cir. Aug 17, 2015).

²⁹⁶ I.R.C. § 411(c)(3) (2014); Treas. Reg. § 1.411(c)-1(e) (2016). See *supra* notes 211–220 and accompanying text.

tables to calculate lump sums—tables that reflect shorter life expectancies than the new mortality tables.²⁹⁷

The Internal Revenue Code used to require plan sponsors to use low 30-year-Treasury-bill interest rates to determine the minimum value of the lump sum, but now plan sponsors can use higher interest rates—calculated using three different corporate interest rates based on segments of the corporate bond yield curve.²⁹⁸ These higher “applicable interest rates” have made lump sum distributions less expensive for plan sponsors—and less generous for participants. In addition, the interest rules permit plan sponsors to select an applicable interest rate from up to 17 months prior to the month in which the lump sum offer is made. That means that a plan sponsor can gain a financial advantage for itself by selecting a so-called “lookback” interest rate from up to 17 months earlier—when that interest rate is higher (and so results in lower lump sums) than the rate that prevails at the time the lump sum offer is made.²⁹⁹

Another rule lets plan sponsors ignore many additional pension plan benefits when calculating lump sum distribution amounts.³⁰⁰ For example, a plan sponsor can calculate the lump sum for a separated participant based on that participant’s normal retirement benefit, even though that participant might have eventually been eligible for a subsidized early retirement benefit.³⁰¹ The Pension Protection Act of 2006 added new benefit restrictions that generally prohibit pension risk transfers that result in the plan having a funding ratio after the transaction that is below 80 percent: basically, defined benefit plans that fall below 80 percent are prevented from paying out lump sums.³⁰²

Historically, plan sponsors have usually implemented a lump sum strategy by offering the lump sum to separated participants, but more recently plans were also offering lump sums to retirees already in pay status (e.g., already receiving monthly pension benefits).³⁰³ Now, however, IRS

²⁹⁷ See *supra* notes 218–220 and accompanying text.

²⁹⁸ See *supra* notes 215–217 and accompanying text.

²⁹⁹ Once an interest rate or other variable is set in a plan, it may later end up working against the plan sponsor, for example, if interest rates increase after the lump sum window offer locks in at a relatively lower interest rate.

³⁰⁰ See, e.g., U.S. DEP’T OF LABOR, ADVISORY COUNCIL ON EMP. WELFARE AND PENSION BENEFIT PLANS, *Private Sector Pension De-risking and Participant Protections*, *supra* note 270, at 21.

³⁰¹ *Id.*

³⁰² ERISA § 206(g), 29 U.S.C. § 1056 (2014); I.R.C. § 436(c) (2014); Notice 2011-96, 2011-52 I.R.B. 915.

³⁰³ See, e.g., U.S. DEP’T OF LABOR, ADVISORY COUNCIL ON EMP. WELFARE AND

Notice 2015-49 prevents plan sponsors from implementing lump sum risk transfers for retirees in pay status.³⁰⁴ More specifically, Notice 2015-49 informs taxpayers that the Treasury and the IRS intend to amend the required minimum distribution rules to prohibit defined benefit plans from replacing ongoing annuity payments with a lump sum payment or any other form of accelerated payment.³⁰⁵

All in all, ERISA and the Internal Revenue Code provide a number of protections and disclosures for participants (and beneficiaries) who are offered lump sum alternatives to their lifetime pension benefits. The following disclosures are currently required in a lump sum risk transfer:³⁰⁶

PENSION BENEFIT PLANS, *Private Sector Pension De-risking and Participant Protections*, *supra* note 270, at 16.

³⁰⁴ Notice 2015-49, 2015-30 I.R.B. 79. Notice 2015-49 also provides that, with certain exceptions, the regulations contemplated will be effective retroactively back to July 9, 2015. *Id.* See also Zorast Wadia, *De-Risking Your Pension Plan: Do New Regulations Make 2016 the Best Time to Offer Lump-Sum Distributions?*, 28 BENEFITS L.J. 1 (2015), <http://us.milliman.com/uploadedFiles/insight/2015/de-risking-pension-plan.pdf>; Elizabeth Thomas Dold & David N. Levine, *Employee Benefits Corner: IRS Ends Lump Sum Windows for Individuals in Pay Status*, 93 TAXES THE TAX MAG. 27 (2015), http://www.groom.com/media/publication/1622_IRS_Ends_Lump_Sum_Windows_for_Individuals_in_Pay_Status.pdf. Also, applicants requesting determination letters for their defined benefit (DB) plans now need to tell the IRS whether the plan has lump-sum risk transfer language in it, and, if it does, to show how the plan satisfies one of the conditions in Notice 2015-49. *New Process for Defined Benefit Determination Letter Applications*, INTERNAL REVENUE SERV., <https://www.irs.gov/retirement-plans/new-process-for-defined-benefit-determination-letter-applications> (last updated June 29, 2016).

³⁰⁵ I.R.C. § 401(a)(9) generally requires plans to make minimum required distributions to retirees over age 70½, and it is clear that the regulations contemplated in Notice 2015-49 will bar lump sum distributions to those retirees over age 70½ who are in pay status. On the other hand, some analysts wonder whether those regulations will be broad enough to reach retirees under age 70½. See, e.g., *IRS Shuts Down Pension Plan De-Risking Technique of Offering Lump Sums to Retirees in Pay Status*, VENABLE (July 27, 2015), <https://www.venable.com/irs-shuts-down-pension-plan-de-risking-technique-of-offering-lump-sums-to-retirees-in-pay-status-07-27-2015/>. In passing, it should be noted that Notice 2015-49 marks a reversal of the position that the IRS had taken in a number of private letter rulings—rulings that, in effect, had permitted plan sponsors to offer lump sum distributions to participants already in pay status. See, e.g., I.R.S. Priv. Ltr. Rul. 401.06-01 (Apr. 19, 2012); I.R.S. Priv. Ltr. Rul. 201228051 (Apr. 19, 2012).

³⁰⁶ This paragraph follows *Model Notices and Disclosures for Pension Risk Transfers: Hearing Before the Advisory Council on Employee Welfare and Pension Benefit Plans* (May 28, 2015) (statement of Robert S. Newman, Covington &

- (1) the material features of the optional forms of benefit available under the plan;³⁰⁷
- (2) the right, if any, to defer receipt of the distribution;³⁰⁸
- (3) the consequences of failing to defer;³⁰⁹
- (4) a description of the optional forms available under the plan, including: the amount payable in each form, the conditions for eligibility for each form, the relative value of the form compared to the qualified joint and survivor annuity (QJSA), and an explanation of relative value;³¹⁰ and
- (5) an explanation of the ability of the participant to roll over the lump sum distribution to another tax-qualified retirement plan or individual retirement arrangement, including the tax effects of doing so (the rollover notice).³¹¹

In addition, plan sponsors and their advisers typically provide additional communication materials.³¹² Needless to say, choosing between an annuity and a lump-sum payout is a “cognitively challenging task.”³¹³

Burling LLP), <http://www.dol.gov/ebsa/pdf/erisaadvisorycouncil2015risk10.pdf>.

³⁰⁷ Treas. Reg. § 1.411(a)-11(c)(2)(i) (as amended in 2006).

³⁰⁸ *Id.*

³⁰⁹ Notice 2007-7, 2007-1 C.B. 395, Q&A-32, 33; Prop. Treas. Reg. § 1.411(a)-11(c)(2)(vi), 73 Fed. Reg. 59575 (Oct. 9, 2008).

³¹⁰ Treas. Reg. § 1.417(a)(3)-1 (as amended in 2006); Treas. Reg. § 1.417(e)-1 (as amended in 2003).

³¹¹ I.R.C. § 402(f) (2014), Treas. Reg. §§ 1.402(f)-1, 31.3405(c)-1 (as amended in 2007); Treas. Reg. §§ 1.402(f)-1 (as amended in 2007), 31.3405(c)-1 (as amended in 2007). The IRS has provided safe harbor notices. See *Notice 2009-68*, 2009-2 C.B. 423, updated by Notice 2014-54, 2014-41 I.R.B. 670.

³¹² See, e.g., *Model Notices and Disclosures for Pension Risk Transfers: Hearing Before the Advisory Council on Employee Welfare and Pension Benefit Plans 1–2* (May 28, 2015) (statement of Craig Rosenthal, Mercer, on behalf of the American Benefits Council), <http://www.dol.gov/ebsa/pdf/erisaadvisorycouncil2015risk11.pdf> (on file with author).

³¹³ *Model Notices and Disclosures for Pension Risk Transfers: Hearing Before the Advisory Council on Employee Welfare and Pension Benefit Plans* (May 28, 2015) (statement of Erzo F.P. Luttmer, Dartmouth College), <http://www.dol.gov/ebsa/pdf/erisaadvisorycouncil2015risk1.pdf>. See also Michael Kitces, *How to Evaluate the Pension Versus Lump Sum Decision, and Strategies for Maximization*, KITCES.COM (July 22, 2015), <https://www.kitces.com/blog/how-to-evaluate-the->

c. *Insurance Annuity Risk Transfers*

In an insurance annuity risk transfer, the plan sponsor replaces the participants' pension benefits with retail annuities.³¹⁴ Basically, the plan sponsor purchases a group annuity contract, and the insurer distributes annuity certificates to the covered individuals.³¹⁵ Under the minimum funding rules, however, the plan cannot purchase the group annuity unless the plan remains at least 80 percent funded after the transaction.³¹⁶ As with standard terminations, the selection of an annuity provider is a fiduciary function, and the plan sponsor must choose the safest available provider.³¹⁷ After the distribution of the certificates to individual plan participants, those individuals cease to be covered by the plan.³¹⁸ That should also free the plan sponsor from any further fiduciary responsibilities with respect to those former participants.³¹⁹

Insurance annuity risk transfers totaled \$14.4 billion in 2015, up 54 percent from the previous year.³²⁰ Buy-out products accounted for \$13.6 billion (95 percent) of the total group annuity risk transfer market in 2015;

pension-versus-lump-sum-decision-and-strategies-for-maximization/; *Annuity or Lump Sum?*, PENSION BENEFIT GUAR. CORP. (July 21, 2016), <http://www.pbgc.gov/wr/benefits/annuity-or-lump-sum.html> (offering some advice for making the choice between taking an annuity or a lump sum).

³¹⁴ See, e.g., Margaret G. McDonald & Scott E. Gaul, *Preparing for Pension Risk Transfer*, PRUDENTIAL RET. INS. AND ANNUITY CO. (2015), http://pensionrisk.prudential.com/pdfs/prep-for-prt_prtwp004_0263513-00004-00_2015-06-15.pdf (outlining the steps involved in buy-out transactions).

³¹⁵ See, e.g., *Private Sector Pension De-Risking and Participant Protections: Hearing Before the Advisory Council on Employee Welfare and Pension Benefit Plans 4-5* (June 5, 2013) (statement of Robert S. Newman, Covington & Burling LLP), <http://www.dol.gov/ebsa/pdf/covingtonburling060513.pdf>.

³¹⁶ *Id.* at 4; ERISA § 206(g), 29 U.S.C. § 1056(g) (2012); I.R.C. § 436(c) (2012).

³¹⁷ See *supra* Part III.E.3.a; see also Ellen Shaer, *Pension Plans: To Terminate or Not to Terminate*, CAPTRUST (Feb. 29, 2016), <http://www.captrustadvisors.com/resources/institutional-consulting/to-terminate-or-not-to-terminate/>.

³¹⁸ 29 C.F.R. § 2510.3-3(d)(2)(ii) (2015).

³¹⁹ 29 C.F.R. § 2509.95-1(b) (2015).

³²⁰ *Group Annuity Risk Transfer Sales Top \$14 Billion in 2015*, LIMRA Secure Retirement Institute Reports, LIFE INS. MKTG. & RESEARCH ASS'N (LIMRA) (Feb. 29, 2016), [http://www.limra.com/Posts/PR/News_Releases/Group_Annuity_Risk_Transfer_Sales_Top_\\$14_Billion_in_2015,_LIMRA_Secure_Retirement_Institute_Reports.aspx](http://www.limra.com/Posts/PR/News_Releases/Group_Annuity_Risk_Transfer_Sales_Top_$14_Billion_in_2015,_LIMRA_Secure_Retirement_Institute_Reports.aspx).

and single premium buy-ins accounted for just \$7.2 million of risk transfers.³²¹

4. The ERISA Advisory Council's Recent Focus on Model Notices and Disclosures for Pension Risk Transfers

Building on its prior work,³²² the ERISA Advisory Council recently focused on the information that participants need to make informed decisions when they are faced with lump sum risk transfers and insurance annuity risk transfers.³²³ More specifically, in 2015, the ERISA Advisory Council developed draft model notices and disclosures that can be used by plan sponsors, participants, and the public.³²⁴ On November 4, 2015, the ERISA Advisory Council presented its findings to the U.S. Department of Labor, and its final report includes model notices for lump sum risk transfers and for insurance annuity risk transfers.³²⁵ In the end, the guidance that is

³²¹ *Id.* See also John Manganaro, *Pension Risk Transfers Topped \$14 Billion Last Year*, PLANADVISER (Feb. 29, 2016), <http://www.planadviser.com/Pension-Risk-Transfers-Topped-14-Billion-Last-Year/>.

³²² U.S. DEP'T OF LABOR, ADVISORY COUNCIL ON EMP. WELFARE AND PENSION BENEFIT PLANS, *Private Sector Pension De-risking and Participant Protections*, *supra* note 270.

³²³ U.S. DEP'T OF LABOR, ADVISORY COUNCIL ON EMP. WELFARE AND PENSION BENEFIT PLANS, *Model Notices and Disclosures for Pension Risk Transfers* (2015), <http://www.dol.gov/ebsa/pdf/ACmodelnotice1.pdf>.

³²⁴ *Id.*; U.S. DEP'T OF LABOR, ADVISORY COUNCIL ON EMP. WELFARE AND PENSION BENEFIT PLANS, *Model Notices and Disclosures for Pension Risk Transfers* (Nov. 2015), <https://www.dol.gov/ebsa/pdf/2015ACreport2.pdf>. See also CONSUMER FIN. PROT. BD., *Pension Lump-sum Payouts and Your Retirement Security* (Jan. 2016), http://files.consumerfinance.gov/f/201601_cfpb_pension-lump-sum-payouts-and-your-retirement-security.pdf. The author was privileged to testify before the Advisory Council. *Model Notices and Disclosures for Pension Risk Transfers: Hearing Before the Advisory Council on Employee Welfare and Pension Benefit Plans* (Aug. 18, 2015) (statement of Jonathan Barry Forman, Univ. of Okla. Coll. of Law), <https://www.dol.gov/ebsa/pdf/FormanRiskTransfer081815.pdf>.

³²⁵ U.S. DEP'T OF LABOR, ADVISORY COUNCIL ON EMP. WELFARE AND PENSION BENEFIT PLANS, *Model Notices and Disclosures for Pension Risk Transfers*, *supra* note 324, at 34 (lump sum notice) & 40 (insurance company risk transfer notice); *ERISA Advisory Council Presents Recommendations to DOL on Lifetime Plan Participation, Defined Benefit Plan De-Risking*, VOYA (Dec. 2015), <https://investments.voya.com/idc/groups/public/documents/retirement/144575.pdf>; U.S. DEP'T OF LABOR, ADVISORY COUNCIL ON EMP. WELFARE AND PENSION

ultimately issued by the U.S. Department of Labor may have a significant impact on the size and nature of the defined benefit pension plan system and on the lifetime incomes of its participants.³²⁶

IV. THE ROLE FOR ANNUITIES AND OTHER LIFETIME INCOME MECHANISMS

A. AN OVERVIEW OF THE ROLE OF ANNUITIES

As Part II.C.3 above showed, traditional defined benefit pension plans have been in decline for decades. Individuals now have the primary responsibility to participate in, contribute to, and manage their retirement savings accounts throughout their working years; and they must also manage all of their retirement savings throughout their retirement years. These are daunting tasks.³²⁷ To have adequate income throughout retirement, individuals have to make good financial choices through their working years and beyond. They need to make wise choices about when to retire, when to claim Social Security benefits, how to plan for an unknown length of retirement, how to plan for medical expenses and long-term care, how to use a home to provide retirement income, how to manage a retirement portfolio, and how to convert accumulated retirement savings into a lifetime income stream.³²⁸

That is where traditional pensions, annuities, and similar lifetime income products come in. Although estimates vary, it seems that relatively few retirees receive income from traditional pensions and annuities.³²⁹

BENEFIT PLANS, *Lump Sum Notice, etc.* (Nov. 2015), <http://www.americanbenefitscouncil.org/pub/4d76162e-ca83-84d3-e1c3-705cf3b07458>.

³²⁶ Ideally, those disclosure requirements should be designed to give participants the information that they need to make informed decisions. At the same time, however, those disclosure requirements should not be so burdensome on plan sponsors that it spurs them to terminate their plans.

³²⁷ See, e.g., Pamela Perun, *Retirement Savings: Confronting the Challenge of Longevity*, THE ASPEN INST. INITIATIVE ON FIN. SEC. (2010), http://www.aspeninstitute.org/sites/default/files/content/docs/pubs/ConfrontingLongevity_AspenIFS.pdf.

³²⁸ See, e.g., *Retiree Lifetime Income: Choices & Considerations*, AM. ACAD. OF ACTUARIES 1, 1–7 (Oct. 2015), http://actuary.org/files/Retiree_Choices_IB_102215.pdf.

³²⁹ See, e.g., Craig Copeland, *Pension Income of the Elderly and Characteristics of Their Former Employers*, 28(3) EMP. BENEFIT RES. INST. NOTES 2 (2007),

According to one estimate, in 2010, 44 percent of retirees received income from a traditional pension and another 10 percent received income from an annuity.³³⁰ Another study suggests that only around one-third of retirees receive income from annuities, but for the majority, these instruments provide just 4 percent of their income.³³¹

It is not altogether clear what the “right” level of annuitization is.³³² Studies do show that annuitization helps reduce poverty in old age³³³ and that retirees who receive lifetime income from annuities or traditional pensions were generally more satisfied than those without such lifetime income.³³⁴ All in all, while some individuals with low levels of retirement savings might be better off using their savings for emergencies rather than annuitizing them,³³⁵

https://www.ebri.org/pdf/notespdf/ebri_notes_03-20071.pdf.

³³⁰ Steve Nyce & Billie Jean Quade, *Annuities and Retirement Happiness*, TOWERS WATSON INSIDER 1, 9 n.1 (Sept. 2012), <https://www.towerswatson.com/en-US/Insights/Newsletters/Americas/insider/2012/Annuities-and-Retirement-Happiness>.

³³¹ Danielle Andrus, *One-Third of Retirees Receive Annuity Income*, THINKADVISER (Sept. 23, 2011), <http://www.thinkadvisor.com/2011/09/23/one-third-of-retirees-receive-annuity-income>.

³³² See, e.g., Barry P. Bosworth, Gary Burtless & Mattan Alalouf, *Do Retired Americans Annuitize Too Little? Trends in the Share of Annuitized Income*, B.C. CTR. FOR RET. RES. (Working Paper No. 2015-9, June 2015), http://crr.bc.edu/wp-content/uploads/2015/06/wp_2015-9.pdf (finding little evidence that the annuity-like share of total income has fallen for aged families).

³³³ See, e.g., Constantijn W.A. Panis & Michael J. Brien, *Implications of Expanded Annuitization for Old-Age Well-being*, DELOITTE (Sept. 4, 2015), <http://www.dol.gov/ebsa/pdf/implicationsofexpandedannuitizationforoldagewellbeing.pdf>; Natalia S. Orlova, Matthew S. Rutledge & April Yanyuan Wu, *The Transition from Defined Benefit to Defined Contribution Pensions: Does It Influence Elderly Poverty?*, B.C. CTR. FOR RET. RES. (Working Paper No. 2015-17, July 2015), http://crr.bc.edu/wp-content/uploads/2015/06/wp_2015-17.pdf (finding that households with pensions that are annuitized with the joint-and-survivor life option and that do not take lump sum distributions before age 55 are best able to avoid income and asset poverty).

³³⁴ See, e.g., Panis & Brien, *supra* note 333; Nyce & Quade, *Annuities and Retirement Happiness*, *supra* note 330; Keith A. Bender & Natalia A. Jivan, *What Makes Retirees Happy?*, B.C. CTR. FOR RET. RES. (Issue Brief No. 28, Feb. 2005), http://crr.bc.edu/wp-content/uploads/2005/02/ib_28.pdf; Constantijn Panis, *Annuities and Retirement Well-Being*, in PENSION DESIGN AND STRUCTURE: NEW LESSONS FROM BEHAVIORAL FINANCE 259, 259–274 (Olivia S. Mitchell & Stephen P. Utkus eds., 2004).

³³⁵ See, e.g., Cotton, *Retirement Savings and Annual Spending*, *supra* note 130; STAFF OF THE J. COMM. ON TAXATION, 114TH CONG., PRESENT LAW AND

it seems likely that many individuals would be better off if more of their retirement savings was annuitized.

Unfortunately, people rarely choose to buy annuities voluntarily.³³⁶ The demand for annuities is significantly lower than expected, and this shortfall has come to be known as the “annuity puzzle.”³³⁷ Some of the reasons for the low demand for annuities include: the existence of alternative annuities such as Social Security, Supplemental Security Income, and traditional defined benefit plans; a willingness to rely on phased distributions from defined contribution plans, IRAs, and other retirement savings vehicles; the desire to leave bequests; the incompleteness or inefficiencies in the retail annuity market that lead to poor prices for retail annuities; and the behavioral and cultural challenges involved in getting individuals to make decisions about complex investments like annuities.³³⁸ There are also

BACKGROUND RELATING TO TAX-FAVORED RETIREMENT SAVING AND CERTAIN RELATED LEGISLATIVE PROPOSALS, *supra* note 37, at 34 (noting that for some individuals Social Security benefits may provide sufficient lifetime retirement income).

³³⁶ See, e.g., AM. ACAD. OF ACTUARIES, *Risky Business: Living Longer Without Income for Life: Information for Current and Future Retirees*, *supra* note 131 (explaining the advantage of annuities in generating lifetime income).

³³⁷ See, e.g., Shlomo Benartzi, Alessandro Previtero & Richard H. Thaler, *Annuity Puzzles*, 25(4) J. ECON. PERSP. 143, 154-57 (2011) (discussing behavioral and institutional factors leading to the low demand for annuities, and noting that only 21 percent of defined contribution plans in the United States offer annuities as an option); Franco Modigliani, *Life Cycle, Individual Thrift, and the Wealth of Nations*, 76 AM. ECON. REV. 3, 297, 307 (1986) (“[I]t is a well-known fact that annuity contracts, other than in the form of group insurance through pension systems, are extremely rare.”); Menahem E. Yaari, *Uncertain Lifetime, Life Insurance, and the Theory of the Consumer*, 32 REV. ECON. STUD. 2, 137 (1965) (analyzing the effect of the uncertainty of lifespan on consumer behavior).

³³⁸ See, e.g., Robert Holzmann, *Addressing Longevity Risk through Private Annuities: Issues and Options* (Revised Draft Mar. 30, 2015), <http://international-pension-workshop.com/papers-pdf/Holzmann.pdf>; Lee M. Lockwood, *Bequest Motives and the Annuity Puzzle*, 15 REV. ECON. DYNAMICS 2, 226 (2012) (suggesting that people with bequest motives may be better off not annuitizing any wealth); Kelli Hueler, Paula Hogan & Anna Rappaport, *Public Policy and Consumer Disclosure for the Income Annuity Market*, 46 J. MARSHALL L. REV. 3, 795, 807 (2013) (noting that low annuitization rates may indicate problems in the marketplace); Pinar Çebi, *Can Annuities Enhance Retirement Lifestyles?*, AM. COUNCIL FOR CAP. FORMATION, 4-5 (Apr. 2006), <http://accf.org/wp-content/uploads/2012/03/annuitiesWhitepaper.pdf> (discussing why individuals do not purchase annuities).

constraints on the supply of lifetime annuities, including inefficient regulation of annuity markets and the limited availability of inflation-adjusted and longevity assets that can be matched against insurer annuity-related liabilities.³³⁹

Before moving on to considering options for reforming the legal rules governing annuities and pension distributions in the United States, this Part of the Article provides a little bit more background on annuities and annuitization. At the outset, this Part explains the mathematics of converting a lump sum into an annuity (and vice versa) and looks at how retail annuities compare with actuarially fair annuities.³⁴⁰ This Part also explores the role of annuitization around the world. Finally, this Part explores some of the cultural and economic challenges to increasing annuitization in the United States.

B. THE MATHEMATICS OF CONVERTING A LUMP SUM INTO AN ANNUITY (AND VICE VERSA)

The mathematics of converting a lump sum into an actuarially fair lifetime annuity is pretty straightforward. If an individual has a fixed principal sum to invest today, and we know the interest rate that she can earn and how long she is expected to live, we can determine the annuity amount

³³⁹ See, e.g., Holzmann, *Addressing Longevity Risk through Private Annuities: Issues and Options*, *supra* note 338, at 11–18. (there is not yet much of a market in longevity bonds—bonds that would pay returns that would be linked to the survivorship of a given cohort, say, 65-year-old American males born in 1945. See, e.g., *id.* at 16–18; Pablo Antolin & Hans Blommestein, *Governments and the Market for Longevity-Indexed Bonds*, ORG. FOR ECON. COOPERATION AND DEV., (2007), <http://www.oecd.org/pensions/insurance/37977290.pdf>; David Blake, Tom Boardman & Andrew Cairns, *The Case for Longevity Bonds*, B.C. CTR. FOR RET. RES. (Issue Brief No. 10-10, 2010), http://crr.bc.edu/wp-content/uploads/2010/06/IB_10-10-508.pdf; Abraham & Harris, *The Market for Longevity Annuities*, *supra* note 153, at 23–24.

³⁴⁰ An actuarially fair annuity is one without insurance agent commissions or insurance company reserves, risk-taking, and profits. See also Guan Gong & Anthony Webb, *Evaluating the Advanced Life Deferred Annuity—An Annuity People Might Actually Buy* 1 n.1, B.C. CTR. FOR RET. RES. (Working Paper No. 2007-15, June 2007), http://crr.bc.edu/wp-content/uploads/2007/09/wp_2007-15.pdf (defining “an actuarially fair annuity as one whose expected return, discounted by an interest rate and annual survival probabilities derived from population mortality tables, equals the premium paid”).

that that person (i.e., the annuitant) will receive each period.³⁴¹ For example, if an individual has \$100,000 to invest in an annuity today, can earn 5 percent interest per year, and can expect to receive 20 annual annuity payments (i.e., live for 20 years), a simple annuity calculator shows that each annual annuity payment would be \$8024.26.³⁴² Annuities typically make monthly payments, but the mathematical principles are the same for yearly or monthly annuities.

By the same token, the mathematics of converting a lifetime annuity into a lump sum is also quite straightforward. Basically, a lump sum value is determined by converting a stream of projected future benefit payments into a present value.³⁴³ Again, the mathematics is pretty straightforward: we just need to know the applicable interest rate and the number of future benefit payments that the individual expects to receive.³⁴⁴ The interest rate (also known as the discount rate) is the rate of return that can be earned on the investment, and it is determined by market forces. The number of future benefit payments that the individual is expected to receive is extrapolated from a mortality table. In our example, when the discount rate is 5 percent, the present value of a stream of 20 annual payments of \$8024.26

³⁴¹ The general formula to solve for the periodic annuity amount is: $w = [P(1 + r)^{Y-1}r] / [(1 + r)^Y - 1]$, where P is the present value (= starting principal) of a stream of annual withdrawal amounts (w) given an interest rate (r) over a number of Years (Y). See, e.g., MONEY CHIMP, *Annuity*, <http://www.moneychimp.com/articles/finworks/fmpayout.htm> (last visited July 21, 2016).

³⁴² See MONEY CHIMP, *Annuity Calculator*, http://www.moneychimp.com/calculator/annuity_calculator.htm (last visited July 21, 2016) (starting Principal: \$100,000.00; growth rate: 5 percent; years to pay out: 20 years; payouts at: the end of each year; to get Annual Payout Amount = \$8024.26).

³⁴³ See, e.g., U.S. GOV'T ACCOUNTABILITY OFF., GAO-15-74, PRIVATE PENSIONS: PARTICIPANTS NEED BETTER INFORMATION WHEN OFFERED LUMP SUMS THAT REPLACE THEIR LIFETIME BENEFITS, *supra* note 268, at 60.

³⁴⁴ Here is a very simple present value example. Suppose you have \$1000 today, and you can earn 10 percent annual interest on an investment. That means you could earn \$100 interest in a year ($\$100 = 10 \text{ percent} \times \1000), and if you made that investment and held it for one year, you would have \$1100 at the end of the year ($\$1100 = \$1000 + \$100$), and the present value of the right to receive \$1100 in one year is \$1000. Similarly, if you kept your money in that investment for another year (two years total), it would grow to \$1210 ($\$110 = 10 \text{ percent} \times \1100 ; $\$1210 = \$1100 + \$110$); and the present value of the right to receive \$1210 in two years is \$1000. The general formula for the present value of a stream of annuity payments is: $P = w[(1 + r)^Y - 1] / [(1 + r)^Y r]$ where P is the present value (= starting principal) of a stream of annual withdrawal amounts (w) given an interest rate (r) over a number of Years (Y), see, e.g., MONEY CHIMP, *Annuity*, *supra* note 341.

commencing one year from today is \$100,000.³⁴⁵ In short, the present value of a 20-year, \$8024.26-per-year annuity is \$100,000 (that is, when a 5 percent interest rate and a 20-year life expectancy are the correct actuarial assumptions). Accordingly, \$100,000 would be the minimum actuarially-equivalent lump sum that must be offered to a participant getting a lump sum distribution instead of an \$8024.26 per year pension.³⁴⁶

C. RETAIL ANNUITIES VERSUS ACTUARIALLY FAIR ANNUITIES

Compared to actuarially fair annuities,³⁴⁷ retail annuities can be quite expensive. Indeed, experts estimate that the typical insurance company lifetime annuity has a 12 percent “load” factor due to the combination of administrative expenses and adverse selection.³⁴⁸ That is, the typical retail lifetime annuity provides benefits that are worth just 88 percent of an actuarially fair annuity (i.e., a “money’s worth ratio” of 88 percent).³⁴⁹ Put differently, the payouts from actuarially fair annuities would be around 15 percent higher than what can actually be purchased in current annuity markets.³⁵⁰

³⁴⁵ See MONEY CHIMP, *Present Value of an Annuity Calculator*, http://www.moneychimp.com/calculator/present_value_annuity_calculator.htm (last visited July 21, 2016) (Annual payout: \$8024.26; growth rate: 5 percent; years to pay out: 20 years; make payouts at: the end of each year; calculate and get present value = \$100,000.02).

³⁴⁶ See *supra* Parts III.B.1 & III.E.3.b (discussing the relative valuation rules used to compute lump sum payouts).

³⁴⁷ See *supra* note 340 and accompanying text.

³⁴⁸ See, e.g., MARK J. WARSHAWSKY, *RETIREMENT INCOME: RISKS AND STRATEGIES* 66 (2012) (“[D]ue to a combination of administrative costs and selection effects, the nominal annuity is assumed to have a money’s worth ratio of 0.88, that is, the couple faces a 12 percent load factor on their annuity purchase.”).

³⁴⁹ *Id.*

³⁵⁰ *Id.*; see also James Poterba, Steven Venti & David Wise, *The Composition and Drawdown of Wealth in Retirement*, 25(4) J. ECON. PERSP. 95, 102 tbl.3 (Fall 2011) (showing that the actuarially fair lifetime annuity for a 65-year-old-man in 2008 was 9.95 percent while the *Annuity Shopper* price for a retail lifetime annuity at that time was just 8.46 percent, indicating a load factor of 17.6 percent [17.6 percent = 9.95 percent/8.46 percent – 100 percent]); Jeffrey R. Brown, Olivia S. Mitchell & James M. Poterba, *The Role of Real Annuities and Indexed Bonds in an Individual Accounts Retirement Program*, RISK ASPECTS OF INVESTMENT-BASED SOCIAL SECURITY REFORM 321, 321–322 (John Y. Campbell & Martin Feldstein, eds., 2001) (“[T]he expected present value of annuity payouts is typically below the purchase price of the annuity”); James M. Poterba & Mark Warshawsky, *The*

Basically, individuals are rarely able to purchase actuarially fair annuities in the retail annuities market. In that regard, however, it is worth emphasizing that, in effect, the Social Security system does allow workers to buy actuarially fair lifetime annuities merely by delaying retirement beyond age 62.³⁵¹

Finally, it is worth noting that there are a few other problems with annuity markets in the United States. One problem has to do with the rates of return on annuities. While many analysts believe that stocks do better than bonds in the long run,³⁵² retail prices for annuities are tied to the relatively low yields that accompany bond rates.³⁵³ That can make annuities relatively unattractive investments compared to stock-based mutual funds.³⁵⁴

Costs of Annuity Retirement Payouts from Individual Accounts, in ADMINISTRATIVE ASPECTS OF INVESTMENT-BASED SOCIAL SECURITY REFORM 173, 173–174 (John B. Shoven, ed., 2000) (“The cost of such annuities, including both administrative and sales costs, the ‘adverse selection’ costs associated with voluntary purchase behavior, and return on capital for the insurance company offering the annuity policy, affect the retirement income that the participant receives for a given level of wealth accumulation.”); Benjamin M. Friedman & Mark J. Warshawsky, *The Cost of Annuities: Implications for Saving Behavior and Bequests*, 105(1) Q. J. ECON. 135, 152 (1990) (arguing that actuarially-unfair annuity costs are a cause of lack of public participation in the individual lifetime annuity market); Olivia S. Mitchell, James M. Poterba, Mark J. Warshawsky & Jeffrey R. Brown, *New Evidence on the Money’s Worth of Individual Annuities*, 89 AM. ECON. REV. 1299, 1309 (1999) (finding that a typical retiree “would perceive a noticeable ‘transaction cost’ when purchasing an annuity from a retail insurance carrier”); Elizabeth Bauer, *Decumulation for a New Generation*, in Soc’y of Actuaries, *Diverse Risks: 2016 Call for Essays*, *supra* note 130, at 28.

³⁵¹ See *supra* notes 24–27 and accompanying text.

³⁵² Jonathan Burton, *Stocks or Bonds? The Pros Say...*, WALL STREET JOURNAL (Jan. 9, 2011), <http://www.wsj.com/articles/SB1000142405297020479110457710837231308403>. See generally JEREMY J. SIEGEL, STOCKS FOR THE LONG RUN (5th ed., 2014).

³⁵³ Oakley, *Retirement Security Risks: What Role can Annuities Play in Easing Risks in Public Pension Plans?*, *supra* note 1, at 16–17.

³⁵⁴ Certainly, the prices of fixed annuities are tied to bond prices. On the other hand, variable annuities typically allow the annuitant to invest in equities, at least during the accumulation phase. See, e.g., U.S. SEC. AND EXCH. COMM’N, *Variable Annuities: What You Should Know*, *supra* note 141. For example, TIAA’s College Retirement Equity Funds (CREF) operates eight investment accounts that differ by objective: stocks, bonds, money market, and social choice. See *Prospectus, College Retirement Equities Fund*, TIAA GLOBAL ASSET MANAGEMENT 26 (May 1, 2016). https://www.tiaa.org/public/pdf/cref_prospectus.pdf.

Another problem is that there is relatively little disclosure of the fees that insurance companies and agents charge for annuities.³⁵⁵ In the end that means that annuities are sold not bought, and the financial advisers and insurance agents selling annuities “can put their own financial interests ahead of the interests of the person they are advising.”³⁵⁶ In that regard, agents may be motivated to sell products that will generate bigger fees, perks, or even kickbacks.³⁵⁷ The U.S. Department of Labor’s new fiduciary conflict-of-interest rule should help improve retail annuity prices, at least with respect to the sale of annuities to pension plan participants and IRA holders.³⁵⁸

D. THE DEMOGRAPHICS OF LIFE EXPECTANCY

While lifetime pensions and annuities offer a great way to protect against longevity risk, annuities may be more valuable for some demographic groups than others. In that regard, life expectancy varies with such demographic factors as gender, income, educational level, and race and Hispanic origin.³⁵⁹ Indeed, as already mentioned, women tend to live longer than men,³⁶⁰ and because of that, insurance companies tend to make smaller

³⁵⁵ Oakley, *Retirement Security Risks: What Role can Annuities Play in Easing Risks in Public Pension Plans?*, *supra* note 1, at 16; Hueler et al., *Public Policy and Consumer Disclosure for the Income Annuity Market*, *supra* note 338.

³⁵⁶ Memorandum from Office of Senator Elizabeth Warren, *Villas, Castles, and Vacations: How Perks and Giveaways Create Conflicts of Interest in the Annuity Industry 2* (Oct. 2015) (on file with Office of Senator Elizabeth Warren at http://www.warren.senate.gov/files/documents/2015-10-27_Senator_Warren_Report_on_Annuity_Industry.pdf).

³⁵⁷ *Id.* at 2. The report notes that in addition to cash compensation to annuity sellers, companies “may offer “non-cash compensation” such as merchandise, gifts, marketing support, sponsorships, seminars, entertainment and travel expenses.” *Id.* at 7 n.44 (quoting from a variable annuity contract prospectus of Lincoln National Life Insurance Company); *see also* Lincoln National Life Insurance Company, Lincoln ChoicePlus AssuranceSM (B Share) Individual Variable Annuity Contracts Lincoln Life Variable Annuity Account N 135 (May 1, 2015) (unpublished manuscript), <http://vpx.newriver.com/print.asp?clientid=lfgvpx&fundid=53422E439&doctype=pros>.

³⁵⁸ *See supra* notes 90–91 and accompanying text.

³⁵⁹ *See, e.g., National Center for Health Statistics: Life Expectancy*, CTR. FOR DISEASE CONTROL, <http://www.cdc.gov/nchs/fastats/life-expectancy.htm> (last visited Apr. 27, 2016) (various sources of data related to life expectancy); Forman, *Supporting the Oldest Old: The Role of Social Insurance, Pensions, and Financial Products*, *supra* note 161, at 384–85 and sources cited therein.

³⁶⁰ *See supra* note 2 and accompanying text.

lifetime annuity payments to women than to same-age men,³⁶¹ although pension plans are not permitted to discriminate in that way.³⁶² It is also well established that people with higher incomes tend to live longer than people with lower incomes.³⁶³ Also, healthy individuals tend to live longer than unhealthy individuals.³⁶⁴ All in all, policymakers need to bear in mind that some policies to encourage greater annuitization might have undesirable distributional consequences.³⁶⁵

E. WHAT CAN WE LEARN FROM OTHER COUNTRIES?

The demand for and supply of lifetime annuities are consistently low in most of the world, although there are a few notable exceptions.³⁶⁶ The gold

³⁶¹ See *supra* notes 144–147 and accompanying text.

³⁶² See *supra* note 106 and accompanying text.

³⁶³ See, e.g., U.S. GOV'T ACCOUNTABILITY OFF., GAO-16-354, RETIREMENT SECURITY: SHORTER LIFE EXPECTANCY REDUCES PROJECTED LIFETIME BENEFITS FOR LOWER EARNERS 21 (2016) <http://www.gao.gov/assets/680/676086.pdf> (discussing studies that show that lower-income men approaching retirement, live on average 3.6 to 12.7 fewer years than higher-income men). See also Raj Chetty et al., *The Association Between Income and Life Expectancy in the United States, 2001–2014*, 315 (16) J. OF THE AM. MED. ASS'N 1750 (2016); Forman, *Supporting the Oldest Old: The Role of Social Insurance, Pensions, and Financial Products*, *supra* note 161, at 384–385 and sources cited therein.

There is also some evidence that working longer may lead to living longer. See, e.g., Chenkai Wu, Michelle C. Odden, Gwenith G. Fisher & Robert S. Stawski, *Association of retirement age with mortality: a population-based longitudinal study among older adults in the USA*, J. EPIDEMIOLOGY & COMMUNITY HEALTH (Mar. 21, 2016), <http://jech.bmj.com/content/early/2016/03/21/jech-2015-207097> (suggesting that early retirement may be a risk factor for mortality and that prolonging working life may provide survival benefits).

³⁶⁴ For example, mortality tables show that healthy individuals have lower death probabilities than the general population. See, e.g., Soc'y of Actuaries, *RP-2014 Rates; Total Dataset*, *supra* note 219 (comparing death probabilities at various ages for employees, healthy annuitants, and disabled retirees). An individual's death probability is her probability of dying within one year. See, e.g., SOC. SEC. ADMIN., *Period Life Table, 2013*, *supra* note 132.

³⁶⁵ In that regard, for example, life expectancy differences reduce the progressivity of the Social Security system. U.S. GOV'T ACCOUNTABILITY OFF., GAO-16-354, RETIREMENT SECURITY: SHORTER LIFE EXPECTANCY REDUCES PROJECTED LIFETIME BENEFITS FOR LOWER EARNERS, *supra* note 363, at 33–35.

³⁶⁶ See, e.g., Holzmann, *Addressing Longevity Risk through Private Annuities: Issues and Options*, *supra* note 338, at 1; Çebi, *Can Annuities Enhance Retirement*

standard is probably the Netherlands, where benefits from occupational pensions must be paid out in the form of an inflation-indexed annuity to qualify for tax benefits.³⁶⁷

In many countries, however, participants can choose among lump sum distributions, phased withdrawals, and annuities, just as they often can in the United States. Experiences vary, but there are at least a few countries where participants generally select annuitization. For example, in Switzerland, around 80 percent of retirement savings accumulations are converted to lifetime annuities;³⁶⁸ and, in Chile, 70 percent of retirees choose lifetime annuitization of their public pension benefits over the phased-withdrawal alternative.³⁶⁹ On the other hand, annuitization in Australia is extremely rare.³⁷⁰ For example, in 2012, half of those who accessed their

Lifestyles?, *supra* note 338, at 6; Ken Hohman, *Lifetime Income: An International Worry*, BRYAN, PENDLETON, SWATS & MCALLISTER, LLC, DEVELOPMENTS, WELLS FARGO 2 (Jan./Feb. 2016), https://www08.wellsfargomedia.com/assets/pdf/commercial/retirement-employee-benefits/bpsm/dev_2016-jan-feb.pdf (discussing lifetime income in the U.S., Australia, and the United Kingdom – worrying that “there is an international concern of a cohort of 85-year-old retirees running out of money”); Mitchell & Piggot, *Turning Wealth into Lifetime Income: The Challenge Ahead*, in SECURING LIFELONG RETIREMENT INCOME: GLOBAL ANNUITY MARKETS AND POLICY, *supra* note 142, at 1, 3–5; Robert Rocha, Dimitri Vitas & Heinz P. Rudolph, *Annuities and Other Retirement Products: Designing the Payout Phase*, WORLD BANK 179 (2011), <https://openknowledge.worldbank.org/bitstream/handle/10986/2272/600520PUB0ID181rement09780821385739.pdf?sequence=1>.

³⁶⁷ John A. Turner & Nari Rhee, *Lessons for Private Sector Retirement Security from Australia, Canada, and the Netherlands*, NAT’L INST. ON RET. SEC. (Issue Brief, Aug. 2013), at 20, http://www.nirsonline.org/storage/nirs/documents/International%20Paper/final_international_august_2013.pdf.

³⁶⁸ Holzmann, *Addressing Longevity Risk through Private Annuities: Issues and Options*, *supra* note 338, at 2; Monika Büttler & Federica Teppa, *The Choice Between an Annuity and a Lump Sum: Results from Swiss Pension Funds*, 91(10) J. PUB. ECON. 1944 (2007), http://www.dnb.nl/en/binaries/Buetler_Teppa_JPub_07_tcm47-172517.pdf; *see also* Büttler & Staubli, *Payouts in Switzerland: Explaining Developments in Annuitization*, in SECURING LIFELONG RETIREMENT INCOME: GLOBAL ANNUITY MARKETS AND POLICY, *supra* note 142, at 195.

³⁶⁹ Holzmann, *Addressing Longevity Risk through Private Annuities: Issues and Options*, *supra* note 338, at 2; *see also* Ruiz & Mitchell, *Pension Payouts in Chile: Past, Present, and Future Prospects*, in SECURING LIFELONG RETIREMENT INCOME: GLOBAL ANNUITY MARKETS AND POLICY, *supra* note 142, at 106.

³⁷⁰ Julie Agnew, *Australia’s Retirement System: Strengths, Weaknesses, and Reforms*, B.C. CTR. FOR RET. RES. (Issue Brief No. 13-5, Apr. 2013), http://crr.bc.edu/wp-content/uploads/2013/04/IB_13-5-508.pdf; *The Challenge of*

Superannuation Funds took lump sums, and 98 percent of the rest chose phased withdrawal over an annuity.³⁷¹ The United Kingdom used to have high levels of annuitization, but it recently moved away from requiring retirees to purchase annuities,³⁷² and even more recently, it gave existing annuity holders more freedom to sell their existing annuity contracts.³⁷³

When coupled with the shift towards more lump sum distributions that we see in the United States, it seems that the international trend favors giving individuals more choices about how to manage their retirement

Longevity Risk: Making Retirement Income Last a Lifetime, *supra* note 1, at 13–16.

³⁷¹ Agnew, *Australia's Retirement System: Strengths, Weaknesses, and Reforms*, *supra* note 370, at 4. Lump sum benefit payments were 51.4 percent of total benefit payments in the year ending June 30, 2015, and 48.6 percent were pension benefits (including phased withdrawals and annuities). *Statistics: Annual Superannuation Bulletin*, AUSTL. PRUDENTIAL REL. AUTHORITY at 2, 7, tbl.4 (June 2015), <http://www.apra.gov.au/Super/Documents/2016ASBPdf201506.pdf>. See also Jonathan Barry Forman & Gordon D. Mackenzie, *Optimal Rules for Defined Contribution Plans: What Can We Learn from the U.S. and Australian Pension Systems?*, 66(3) TAX LAW. 613, 645 (Spring 2013); Bateman & Piggott, *Too Much Risk to Insure? The Australian (non-) Market for Annuities*, in SECURING LIFELONG RETIREMENT INCOME: GLOBAL ANNUITY MARKETS AND POLICY, *supra* note 142, at 50.

³⁷² See, e.g., Dan Hyde, *Budget 2014: How Will the New Pensions System Work?*, THE TELEGRAPH (Mar. 20, 2015), <http://www.telegraph.co.uk/finance/personalfinance/pensions/10710606/Budget-2014-How-will-the-new-pensions-system-work.html>; *Pension Flexibility*, HM REVENUE & CUSTOMS UK.GOV (Mar. 16, 2016), <https://www.gov.uk/government/publications/pension-flexibility-2016/pension-flexibility-2016>; Joseph A. Tomlinson, *Eyewitness to History in the UK*, RET. INCOME J. (Mar. 20, 2014), <http://retirementincomejournal.com/issue/march-20-2014/article/eyewitness-to-history-in-the-uk>; HM TREASURY, REMOVING THE REQUIREMENT TO ANNUITISE BY AGE 75 (2010), https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/81232/consult_age_75_annuity.pdf. See also Cannon & Tonks, *Compulsory and Voluntary Annuity Markets in the United Kingdom*, in SECURING LIFELONG RETIREMENT INCOME: GLOBAL ANNUITY MARKETS AND POLICY, *supra* note 142, at 171; *The Challenge of Longevity Risk: Making Retirement Income Last a Lifetime*, *supra* note 1, at 17–21.

³⁷³ See, e.g., Tanya Jefferies, *Five Million Pensioners Given Chance to Offload Unwanted Annuities for Cash from April 2017*, THIS IS MONEY (Dec. 15, 2015), <http://www.thisismoney.co.uk/money/pensions/article-3360602/Pensioners-given-chance-offload-unwanted-annuities-cash-April-2017.html>; *Existing pensioners to be allowed to 'sell' annuities from 2016, UK government announces*, OUT-LAW.COM (Mar. 17, 2015), <http://www.out-law.com/en/articles/2015/march/existing-pensioners-to-be-allowed-to-sell-annuities-from-2016-uk-government-announces/>.

savings, even if those choices result in less annuitization. Still, there is a lot that the United States can learn from other countries about how to help Americans get secure streams of lifetime income.³⁷⁴ For example, the United States can probably learn from the various strategies that other countries use to increase participants' knowledge and understanding of their spend-down options.³⁷⁵ Some countries also make it harder for financial advisers to charge high commissions or offer inappropriate investment advice.³⁷⁶

Many countries also use incentives and withdrawal rules to help encourage annuitization.³⁷⁷ For example, in Switzerland, some plans use annuities as the default form of distribution, although participants can opt out.³⁷⁸ Several countries require participants to meet certain minimum-retirement-income requirements if they want to withdraw all or part of their defined contribution plan assets as a lump sum.³⁷⁹ Also, while plan sponsors in the United States have a fiduciary obligation to assess the financial stability of the insurance companies that sell annuities to the plans, plan sponsors in many countries have no such obligation.³⁸⁰ Instead, plan sponsors in those countries can simply rely on insurance regulators and industry standards to oversee and monitor annuity providers.³⁸¹

All in all, the international trend seems to be to give participants access to multiple spend-down options. At the same time, however, many countries are trying to find strategies to increase participants' knowledge and understanding of annuity options, and they are also using withdrawal rules and limits on lump sum distributions to encourage participants to select those annuity options.

F. CHALLENGES TO ANNUITIZATION IN THE UNITED STATES

There are a number of cultural and economic challenges to increasing annuitization in the United States. In particular, as Part II.F above showed, many Americans have simply not saved enough in their retirement

³⁷⁴ See, e.g., U.S. GOV'T ACCOUNTABILITY OFF., GAO-14-9, 401(K) PLANS: OTHER COUNTRIES' EXPERIENCES OFFER LESSONS IN POLICIES AND OVERSIGHT OF SPEND-DOWN OPTIONS (Nov. 2013), <http://www.gao.gov/assets/660/659169.pdf>.

³⁷⁵ *Id.* at 24–32.

³⁷⁶ *Id.* at 34.

³⁷⁷ *Id.* at 32–33, 35–37.

³⁷⁸ *Id.* at 32.

³⁷⁹ *Id.* at 35.

³⁸⁰ *Id.* at 37–39.

³⁸¹ *Id.*

plans or otherwise to make annuitization practical. Americans also have a woefully low level of financial literacy, and that limited financial literacy makes it hard for them to conduct meaningful retirement planning.³⁸² Annuities are particular hard for individuals to understand and appreciate.³⁸³ For example, individuals often underestimate their life expectancies and overvalue the modest lump sums that they have accumulated.³⁸⁴

V. OPTIONS FOR REFORM

This Part considers a variety of possible legislative and regulatory changes that could encourage greater annuitization of retirement savings.

A. INCREASE AND PRESERVE RETIREMENT SAVINGS

1. Encourage Workers to Save More for Retirement

At the outset, government policies could be designed to encourage workers to save more for retirement.³⁸⁵ If workers saved more during their

³⁸² See, e.g., Annamaria Lusardi & Olivia S. Mitchell, *The Economic Importance of Financial Literacy: Theory and Evidence*, 52(1) J. OF ECON. LIT. 5 (2014); U.S. GOV'T ACCOUNTABILITY OFF., GAO-16-242, RETIREMENT SECURITY: BETTER INFORMATION ON INCOME REPLACEMENT RATES NEEDED TO HELP WORKERS PLAN FOR RETIREMENT 4–5 (2016), <http://www.gao.gov/assets/680/675526.pdf>; FINRA Investor Education Foundation, *Financial Capability in the United States 2016* (2016), http://www.usfinancialcapability.org/downloads/NFCS_2015_Report_Natl_Findings.pdf.

³⁸³ See, e.g., John Beshears, James J. Choi, David Laibson, Brigitte C. Madrian & Stephen P. Zeldes, *What Makes Annuitization More Appealing?*, 116 J. PUB. ECON. 2 (Aug. 2014), <http://www.sciencedirect.com/science/article/pii/S004727271300114X>.

³⁸⁴ See, e.g., Soc'y of Actuaries, *Key Findings and Issues: Longevity: 2011 Risks and Process of Retirement Survey Report* 4, 9 (June 2012), <https://www.soa.org/research/research-projects/pension/research-post-retirement-needs-and-risks.aspx> (finding that more than half of survey respondents underestimated population longevity); Rafaloff, *supra* note 274 (noting that “participants tend to underestimate future income needs and overestimate the wealth effect a lump sum offer conveys”).

³⁸⁵ U.S. GOV'T ACCOUNTABILITY OFF., GAO-16-408, RETIREMENT SECURITY: LOW DEFINED CONTRIBUTION SAVINGS MAY POSE CHALLENGES, *supra* note 190, at 26–42 (discussing a variety of individual and employer decisions that could substantially raise defined contribution plan savings rates, especially for low-income workers).

careers, they would have larger nest eggs at retirement and a greater ability to buy annuities and other lifetime income products. Perhaps the best way to increase retirement savings would be for the United States to adopt a mandatory universal pension system like Australia, Singapore, and Chile have done.³⁸⁶ A recent proposal would require employees without a pension plan to contribute 3 percent of pay to new guaranteed retirement accounts that would provide lifetime annuities.³⁸⁷

A less intrusive federal mandate would be to require employers without plans to at least offer automatic payroll-deduction IRAs to their employees.³⁸⁸ The United Kingdom's new National Employment Savings

³⁸⁶ See, e.g., U.S. GOV'T ACCOUNTABILITY OFF., GAO-09-642, PRIVATE PENSIONS: ALTERNATIVE APPROACHES COULD ADDRESS RETIREMENT RISKS FACED BY WORKERS BUT POSE TRADE-OFFS 20-26 (2009), <http://www.gao.gov/new.items/d09642.pdf>; TERESA GHILARDUCCI, WHEN I'M SIXTY-FOUR: THE PLOT AGAINST PENSIONS AND THE PLAN TO SAVE THEM 260-92 (2008); Forman & Mackenzie, *Optimal Rules for Defined Contribution Plans: What Can We Learn from the U.S. and Australian Pension Systems?*, *supra* note 371, at 625; Jonathan Barry Forman, *Should We Replace the Current Pension System with a Universal Pension System?*, 16(2) J. PENSION BENEFITS 48 (2009); Jonathan Barry Forman & Adam Carasso, *Tax Considerations in a Universal Pension System*, URBAN-BROOKINGS TAX POL'Y CTR. (Dec. 20, 2007), <http://www.urban.org/publications/411593.html>.

³⁸⁷ See, e.g., GHILARDUCCI, WHEN I'M SIXTY-FOUR: THE PLOT AGAINST PENSIONS AND THE PLAN TO SAVE THEM, *supra* note 386; Teresa Ghilarducci & Hamilton E. James, Opinion, *A Smarter Plan to Make Retirement Savings Last*, N.Y. TIMES (Jan. 2, 2016), http://www.nytimes.com/2016/01/02/opinion/a-smarterplan-to-make-retirement-savings-last.html?_r=0.

³⁸⁸ U.S. DEP'T OF THE TREASURY, *General Explanations of the Administration's Fiscal Year 2017 Revenue Proposals* 134 (Feb. 2016), <https://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2017.pdf>; U.S. GOV'T ACCOUNTABILITY OFF., GAO-13-699, AUTOMATIC IRAS: LOWER-EARNING HOUSEHOLDS COULD REALIZE INCREASES IN RETIREMENT INCOME (2013), <http://www.gao.gov/assets/660/657171.pdf>; William G. Gale & David C. John, *The President's 2013 Budget Would Enable Almost All Americans to Save for Retirement*, BROOKINGS (Feb. 15, 2012), http://www.brookings.edu/opinions/2012/0215_budget_retirement_gale_john.aspx; J. Mark Iwry & David C. John, *Pursuing Universal Retirement Security Through Automatic IRAs*, BROOKINGS (July 1, 2009), <https://www.brookings.edu/research/pursuing-universal-retirement-security-through-automatic-iras-2/>; Benjamin H. Harris & Rachel M. Johnson, *Economic Effects of Automatic Enrollment in Individual Retirement Accounts*, AARP PUB. POL'Y INST. (Research Report No. 2012-04, 2012), http://www.aarp.org/content/dam/aarp/research/public_policy_institute/econ_sec/2012/Economic-Effects-of-Auto-IRA-Research-Report-AARP-ppi-econ-

Trust (NEST) program is an example of this type of mandate.³⁸⁹ Pertinent here, the Obama Administration recently rolled out no-fee retirement savings accounts known as myRAs, short for My Retirement Account.³⁹⁰ A number of state governments in the United States are also considering requiring employers to at least offer pension plans to their uncovered workers.³⁹¹ In that regard, the U.S. Department of Labor recently issued guidance that will make it easier for state governments to set up state-managed retirement plans for private-sector workers.³⁹² In general, automatically enrolling workers

sec.pdf; Benjamin H. Harris & Ilana Fischer, *The Population of Workers Covered by the Auto IRA: Trends and Characteristics*, AARP PUB. POL'Y INST. (Research Report No. 2012-03, 2012), http://www.aarp.org/content/dam/aarp/research/public_policy_institute/econ_sec/2012/Population-of-Workers-Auto-IRA-Trends-and-Characteristics-Research-Report-AARP-ppi-econ-sec.pdf (finding that between 24 million and 43 million workers—approximately one-quarter of the workforce—would be eligible for automatic enrollment in the proposals then under consideration in Congress). The U.S. Government Accountability Office estimates that if all employees were offered a defined contribution plan by their employees, savings would go up by around 18 percent. U.S. GOV'T ACCOUNTABILITY OFF., GAO-16-408, RETIREMENT SECURITY: LOW DEFINED CONTRIBUTION SAVINGS MAY POSE CHALLENGES, *supra* note 190, at 31–33.

³⁸⁹ See, e.g., Steven S. Sass, *The U.K.'s Ambitious New Retirement Savings Initiative*, B.C. CTR. FOR RET. RES. (Issue in Brief No. 14-5, Mar. 2014), http://crr.bc.edu/wp-content/uploads/2014/03/IB_14-5-508.pdf.

³⁹⁰ See, e.g., U.S. DEP'T OF THE TREASURY, *myRA*, <https://myra.gov> (last visited July 21, 2016); U.S. DEP'T OF THE TREASURY, *U.S. Treasury Launches myRA (my Retirement Account) to Help Bridge America's Retirement Savings Gap* (Nov. 4, 2015), <https://www.treasury.gov/press-center/press-releases/Pages/jl0250.aspx>.

³⁹¹ See, e.g., U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-15-556, RETIREMENT SECURITY: FEDERAL ACTION COULD HELP STATE EFFORTS TO EXPAND PRIVATE SECTOR COVERAGE 25–49 (2015), <http://www.gao.gov/assets/680/672419.pdf>; and sources cited at AARP, *State Policy: State Retirement Savings Resource Center*, <http://www.aarp.org/ppi/state-retirement-plans/state-policy> (last visited July 21, 2016).

³⁹² U.S. DEP'T OF LABOR, EMP. BENEFITS SEC. ADMIN., *State Retirement Initiatives Get Guidance from US Labor Department* (Press Release No. 15-2218-NAT, Nov. 16, 2015), <https://www.dol.gov/opa/media/press/ebsa/EBSA20152218.htm>; U.S. DEP'T OF LABOR, EMP. BENEFITS SEC. ADMIN., *Interpretive Bulletin Relating to State Savings Programs That Sponsor or Facilitate Plans Covered by the Employee Retirement Income Security Act of 1974*, 29 C.F.R. Part 2509 (2015), <https://webapps.dol.gov/federalregister/PdfDisplay.aspx?DocId=28540>; U.S. GOV'T ACCOUNTABILITY OFF., GAO-15-556, RETIREMENT SECURITY: FEDERAL ACTION COULD HELP STATE EFFORTS TO EXPAND PRIVATE SECTOR COVERAGE, *supra* note 391, at 51.

into these types of individual retirement savings accounts should achieve higher levels of participation.³⁹³ Automatic enrollment and similar behavioral economics nudges are not likely to solve the problem of inadequate retirement savings,³⁹⁴ but they are better than nothing.

There are also a variety of other proposals to expand the current voluntary pension system. For example, both Congress and the Obama Administration recommended amending ERISA to permit unaffiliated employers to join multiple-employer plans (MEPs).³⁹⁵ The Obama Administration also recommended expanding to expand coverage to allow long-term, part-time workers to participate in existing retirement plans.³⁹⁶ Under the proposal, employees who have worked at least 500 hours a year for three years for an employer with a 401(k) plan would be allowed to contribute to the plan.³⁹⁷

The Obama Administration also recommended tripling the retirement plan start-up tax credit for small businesses—from the current maximum of \$500 per year for three years to a maximum of \$1500 per year for four years.³⁹⁸ Also, many believe that making the \$1000 retirement saver's tax credit refundable would help encourage low-income workers to save for retirement.³⁹⁹ Finally, the U.S. Government Accountability Office

³⁹³ Eduardo Porter, *Nudges Aren't Enough for Problems Like Retirement Savings*, Editorial, N.Y. TIMES (Feb. 23, 2016), <http://www.nytimes.com/2016/02/24/business/economy/nudges-arent-enough-to-solve-societys-problems.html>.

³⁹⁴ *Id.*

³⁹⁵ U.S. DEP'T OF THE TREASURY, *General Explanations of the Administration's Fiscal Year 2017 Revenue Proposals*, *supra* note 388, at 147; STAFF OF THE J. COMM. ON TAXATION, 114TH CONG., PRESENT LAW AND BACKGROUND RELATING TO TAX-FAVORED RETIREMENT SAVING AND CERTAIN RELATED LEGISLATIVE PROPOSALS, *supra* note 37, at 65–71.

³⁹⁶ U.S. DEP'T OF THE TREASURY, *General Explanations of the Administration's Fiscal Year 2017 Revenue Proposals*, *supra* note 388, at 140; STAFF OF THE J. COMM. ON TAXATION, 114TH CONG., PRESENT LAW AND BACKGROUND RELATING TO TAX-FAVORED RETIREMENT SAVING AND CERTAIN RELATED LEGISLATIVE PROPOSALS, *supra* note 37, at 77–80.

³⁹⁷ U.S. DEP'T OF THE TREASURY, *General Explanations of the Administration's Fiscal Year 2017 Revenue Proposals*, *supra* note 388, at 140.

³⁹⁸ *Id.* at 136–37.

³⁹⁹ *See, e.g.*, William G. Gale, David C. John & Spencer Smith, *New Ways to Promote Retirement Savings*, AARP PUB. POL'Y INST. 19–24 (Research Report No. 2012-9, Oct. 2012), http://www.aarp.org/content/dam/aarp/research/public_policy_institute/econ_sec/2012/new-ways-promote-retirement-saving-AARP-pp-econ-sec.pdf.

estimates that the elimination of pension eligibility and vesting waiting-periods would increase retirement savings by 10 percent overall, and by 15 percent for low-income workers.⁴⁰⁰

2. Help Participants Get Better Returns on Their Retirement Savings

In addition to getting workers to save more, government policies could encourage workers to do a better job with their investments. In that regard, the qualified default investment alternatives (QDIA) regulations have already helped move millions of participants away from low-yield, stable-value bond funds and towards better-diversified investments like target-date funds.⁴⁰¹ The U.S. Department of Labor could clarify those QDIA regulations⁴⁰² and also make it easier for plan sponsors to include annuities in their line-up of QDIA investment alternatives.⁴⁰³

The government could also do a better job of regulating the fees and expenses associated with retirement plans. In that regard, high fees can significantly reduce the size of retirement nest eggs.⁴⁰⁴ The U.S. Department of Labor's new fiduciary conflict-of-interest rule should help.⁴⁰⁵ Managing retirement savings is a challenging task,⁴⁰⁶ and, as a result, many Americans

⁴⁰⁰ U.S. GOV'T ACCOUNTABILITY OFF, GAO-16-408, RETIREMENT SECURITY: LOW DEFINED CONTRIBUTION SAVINGS MAY POSE CHALLENGES, *supra* note 191, at 36–37.

⁴⁰¹ See *supra* notes 254–261 and accompanying text.

⁴⁰² U.S. GOV'T ACCOUNTABILITY OFF., GAO-15-578, 401(K) PLANS: CLEARER REGULATIONS COULD HELP PLAN SPONSORS CHOOSE INVESTMENTS FOR PARTICIPANTS (2015), <http://www.gao.gov/assets/680/672140.pdf>.

⁴⁰³ Jeffrey Brown, Opinion, *Income As the Outcome: Reframing The 401(k) Plan*, FORBES.COM (Feb. 17, 2014), <http://www.forbes.com/>.

⁴⁰⁴ See, e.g., Jonathan Barry Forman, *The Future of 401(k) Plan Fees*, 2007 N.Y.U. REV. OF EMP. BENEFITS & EXEC. COMP. 9-1. See also Sean Collins, Sarah Holden, James Duvall & Elena Barone, *The Economics of Providing 401(k) Plans: Services, Fees, and Expenses*, 2015, 22(4) ICI RES. PERSP. (July 2016), <https://www.ici.org/pdf/per22-04.pdf> (showing that the fees paid by 401(k) plan participants for investing in mutual funds have fallen substantially since 2000).

⁴⁰⁵ See *supra* notes 90–91 and accompanying text.

⁴⁰⁶ For example, pension plan participants need to decide whether to keep their money in the retirement plan, roll it over to an IRA, or take a lump sum distribution. Moreover, participants and former participants face a dizzying array of investment alternatives, including savings accounts, money market accounts, mutual funds, exchange-traded funds, individual stocks and bonds, and annuities. See e.g., Sally Herigstad, *6 Surprising IRA Investment Option*, BANKRATE.COM,

seek investment advice from financial advisers.⁴⁰⁷ Often, however, the compensation that those financial advisers receive can vary depending on the investment products that the savers choose.⁴⁰⁸ That opened the door to conflicted advice that could put the rewards for the adviser ahead of the best interests of the savers. That conflicted advice can easily result in lower investment returns (net of fees). For example, a recent study by President Barack Obama's Council of Economic Advisors estimated that conflicted advice led to returns that are about one percentage point lower each year,⁴⁰⁹ and that, over a 30-year retirement, a retiree receiving such conflicted advice would lose an estimated 12 percent of her savings.⁴¹⁰ Eventually, the new fiduciary conflict-of-interest rule should result in better advice at lower costs for pension plan participants and IRA holders, and that should translate into higher returns on their retirement savings.⁴¹¹

Another way to help retirees get better returns on their retirement savings would be to encourage retirees to keep their savings in their relatively low-cost pension plans, as opposed to rolling their balances over into relatively higher-cost IRAs. Because there are economies of scale, pension plans tend to have much lower fees per participant than IRAs.⁴¹² Unfortunately, the vast majority of retirees move their defined-contribution plan savings to IRAs soon after they retire. For example, according to a recent Vanguard study, after five years less than 20 percent of participants

<http://www.bankrate.com/finance/retirement/6-surprising-ira-investment-options-7.aspx> (last updated Sept. 23, 2016).

⁴⁰⁷ Choosing a financial adviser is itself a challenging task. *See, e.g., Know Your Financial Adviser*, CONSUMER FIN. PROTECTION BUREAU, http://files.consumerfinance.gov/f/201311_cfpb_flyer_senior-financial-advisors.pdf (last visited July 22, 2016).

⁴⁰⁸ *See, e.g.,* Memorandum from Office of Senator Elizabeth Warren, *supra* note 356.

⁴⁰⁹ COUNCIL OF ECON. ADVISERS, EXEC. OFF. OF THE PRESIDENT, *The Effects of Conflicted Investment Advice on Retirement Savings* 2 (2015), https://www.whitehouse.gov/sites/default/files/docs/cea_coi_report_final.pdf.

⁴¹⁰ *Id.* at 3. Given that some \$1.7 trillion of IRA assets are invested in products that generate payments to financial advisers that generate conflicts of interest, the Council of Economic Advisors estimated that conflicted advice cost those savers about \$17 billion a year. *Id.* at 3.

⁴¹¹ *See supra* notes 90–91 and accompanying text.

⁴¹² *See, e.g.,* Forman, *The Future of 401(k) Plan Fees*, *supra* note 404, at 9–6.

remained in their defined contribution plans.⁴¹³ Better financial education could help encourage participants to keep their savings in those low-cost pension plans, and plan sponsors could also be encouraged to make it easier for participants to take partial distributions as needed, rather than lump sum distributions.⁴¹⁴ Pertinent here, the 2015 ERISA Advisory Council made suggestions for plan sponsor education and a model notice that employers could use to encourage plan participants to keep their retirement savings in their pension plans rather than rolling their retirement savings into IRAs or taking lump sum distributions.⁴¹⁵

3. Encourage Workers to Work Longer

The government could also encourage workers to remain in the workforce longer.⁴¹⁶ Working longer increases retirement savings and reduces the number of years that retirement savings need to cover, thereby increasing annual income when workers actually retire.⁴¹⁷ For example, because Social Security provides actuarial increases in benefits to those who

⁴¹³ Jean A. Young, *Retirement Distribution Decisions Among DC Participants—An update*, VANGUARD (2015), <https://institutional.vanguard.com/iam/pdf/CRRRDDCP.pdf?cbdForceDomain=false>.

⁴¹⁴ *Id.*

⁴¹⁵ U.S. DEP'T OF LABOR, ADVISORY COUNCIL ON EMP. WELFARE AND PENSION BENEFIT PLANS, *Model Notices and Plan Sponsor Education on Lifetime Plan Participation* (Nov. 2015), <https://www.dol.gov/sites/default/files/ebsa/about-ebsa/about-us/erisa-advisory-council/2015ACreport1.pdf>.

⁴¹⁶ Forman, *Supporting the Oldest Old: The Role of Social Insurance, Pensions, and Financial Products*, *supra* note 161, at 406–07; Alicia H. Munnell, Natalia Sergeevna Orlova & Anthony Webb, *How Important is Asset Allocation to Financial Security in Retirement?*, B.C. CTR. FOR RET. (Working Paper No. 2012-13, Apr. 2012), <http://crr.bc.edu/wp-content/uploads/2012/04/wp-2012-13.pdf>.

⁴¹⁷ *See, e.g.*, Jack VanDerhei & Craig Copeland, *The Impact of Deferring Retirement Age on Retirement Income Adequacy*, EMP. BENEFIT RES. INST. (Issue Brief No. 358, 2011), http://www.ebri.org/pdf/briefspdf/EBRI_IB_06-2011_No358_Defr-Ret.pdf; Joseph Quinn, Kevin Cahill & Michael Giandrea, *Early Retirement: The Dawn of a New Era?*14, TIAA-CREF INST. (Policy Brief, July 2011), http://www1.tiaa-cref.org/ucm/groups/content/@ap_ucm_p_inst/documents/document/tiaa02030420.pdf; Alicia H. Munnell, *How Much to Save for a Secure Retirement*, B.C. CTR. FOR RET. RES., (Issue in Brief No. 11-13, Nov. 2011), http://crr.bc.edu/wp-content/uploads/2011/11/IB_11-13-508.pdf; Barbara Butrica, Karen E. Smith & C. Eugene Steuerle, *Working for a Good Retirement*, URBAN INST. RET. PROJECT (Discussion Paper No. 06-03, 28 fig.2, 2006), http://www.urban.org/UploadedPDF/311333_good_retirement.pdf.

delay taking their benefits,⁴¹⁸ the government could encourage people to delay taking their benefits until they reach their full retirement age or, better still, until age 70.

For that matter, the government could increase all of the statutory ages associated with retirement.⁴¹⁹ For example, the 10 percent early distribution penalty on premature withdrawals applies only to distributions made before an individual reaches age 59½,⁴²⁰ and the early retirement age for Social Security is age 62.⁴²¹ It could make sense to increase both early retirement ages to 65. It could also make sense to increase both the normal retirement age for Social Security (currently age 66 but gradually increasing to age 67)⁴²² and the normal retirement age for pensions (typically age 65)⁴²³ to age 70. Finally, it could make sense to increase both the delayed retirement age for Social Security (currently age 70)⁴²⁴ and the required minimum distribution age for pensions (age 70½)⁴²⁵ to age 75 or beyond.⁴²⁶ In passing, however, policymakers need to bear in mind that some policies to raise retirement ages may have undesirable distributional consequences.⁴²⁷

⁴¹⁸ See *supra* notes 24–27 and accompanying text.

⁴¹⁹ See, e.g., Forman, *Supporting the Oldest Old: The Role of Social Insurance, Pensions, and Financial Products*, *supra* note 161, at 406–08; *Risky Business: Living Longer Without Income for Life*, *supra* note 2, at 33–34.

⁴²⁰ See *supra* note 100 and accompanying text.

⁴²¹ See *supra* note 16 and accompanying text.

⁴²² See *supra* note 13 and accompanying text.

⁴²³ ERISA generally defines “normal retirement age” as the earlier of the time specified in the plan or age 65. I.R.C. § 411(a)(8) (2014); ERISA § 3(24), 29 U.S.C. § 1002(24) (2008).

⁴²⁴ See *supra* note 25 and accompanying text.

⁴²⁵ See *supra* note 101 and accompanying text.

⁴²⁶ See also Richard L. Kaplan, *Reforming the Taxation of Retirement Income*, 32 VA. TAX REV. 327, 357 (2012); Jacob A. Mortenson, Heidi R. Schramm & Andrew Whitten, *The Effect of Required Minimum Distribution Rules on Withdrawals from Traditional Individual Retirement Accounts* (May 6, 2016), <http://ssrn.com/abstract=2764435> (finding that 52 percent of IRA owners subject to the required minimum distribution rules would take an IRA distribution less than their required minimum if they were unconstrained).

⁴²⁷ See *supra* Part IV.D. See also ANNE L. ALSTOTT, *A NEW DEAL FOR OLD AGE* 95–98 (2016) (suggesting that retirement age could be linked to lifetime income in a way that favors those workers with relatively lower lifetime earnings over those with relatively higher lifetime earnings); Henry Aaron, *Recent Social Security blogs—some corrections*, BROOKINGS (Apr. 15, 2016), <http://www.brookings.edu/research/opinions/2016/04/15-recent-social-security-blogssome-corrections-aaron> (explaining how raising the full benefit age for Social Security is simply an across-

The federal government could also amend the required minimum distribution rules to make it easier to use retirement savings to buy deferred income annuities.⁴²⁸ In that regard, new regulations from the IRS have already eased the required minimum distribution rules to allow plan participants to spend up to \$125,000 on deferred income annuities that are qualifying longevity annuity contracts (QLACs).⁴²⁹ Also, the Obama Administration recently called for legislation that would completely exempt an individual from the required minimum distribution rules if her tax-favored retirement plan accumulations do not exceed \$100,000.⁴³⁰ All in all, the minimum distribution rules could be reformed to prioritize lifetime income provision over Treasury revenue-collection.⁴³¹

4. Preserve Benefits until Retirement

Government policies could also be designed to get workers to preserve their retirement savings until retirement, for example, by discouraging premature pension withdrawals and loans.⁴³² While defined

the-board cut in benefits for all new claimants, regardless of their incomes or life expectancies); Peter Coy, *How to Raise the Retirement Age for People Who Want to Work*, BLOOMBERG (June 16, 2016), <http://www.bloomberg.com/news/articles/2016-06-16/how-to-raise-the-retirement-age-for-people-who-want-to-work> (discussing ways to take work capacity into account).

⁴²⁸ I.R.C. § 401(a)(9) (2014); Natalie Choate, *New! Longevity Insurance for IRAs*, MORNINGSTAR ADVISOR (Mar. 9, 2012), <http://www.morningstar.com/advisor/t/52769065/new-longevity-insurance-for-iras.htm>.

⁴²⁹ See *supra* notes 158–160 and accompanying text.

⁴³⁰ U.S. DEP'T OF THE TREASURY, *General Explanations of the Administration's Fiscal Year 2017 Revenue Proposals*, *supra* note 388, at 143. The author favors a much higher cap. Forman, *Supporting the Oldest Old: The Role of Social Insurance, Pensions, and Financial Products*, *supra* note 161, at 411–412.

⁴³¹ Mark J. Warshawsky, *Reforming Retirement Income: Annuitization, Combination Strategies, And Required Minimum Distributions*, GEORGE MASON U. MERCATUS CTR., (Dec. 2015), <http://mercatus.org/sites/default/files/WarshawskyCombination-Retirement.pdf>; Brown, *Income As the Outcome: Reframing The 401(k) Plan*, *supra* note 403; U.S. CHAMBER OF COMMERCE, *Private Retirement Benefits in the 21st Century: Achieving Retirement Security* 18 (2016), https://www.uschamber.com/sites/default/files/documents/files/uscc_achieving_retirement_security_0.pdf.

⁴³² See, e.g., Forman & Mackenzie, *Optimal Rules for Defined Contribution Plans: What Can We Learn from the U.S. and Australian Pension Systems?*, *supra* note 371, at 650; Orlova et al., *supra* note 333, at 3; Richard L. Kaplan, *Retirement*

benefit plans typically provide lifetime annuities for retirees and their spouses, defined contribution plans are leaky: they often allow participants to withdraw all or a portion of their individual accounts, and many plans allow participants to borrow against their accounts.⁴³³ All in all, a significant portion of these premature distributions and loans are dissipated before retirement.⁴³⁴ Accordingly, it could make sense to further limit or even prohibit premature distributions and loans from defined contribution plans and IRAs. Also, the process for rolling over defined contribution balances can be cumbersome and could be simplified.⁴³⁵

Also, plan sponsors who make annuity investments available within a plan do not always have good options to remove the annuity investment option from the plan when it is no longer suitable (which can happen, for example, when the plan changes its investment offerings or its record keeper).⁴³⁶ The Obama Administration recently recommended legislation that would allow plan participants to roll over any unauthorized lifetime

Funding and the Curious Evolution of Individual Retirement Accounts, 7 ELDER L.J. 283, 293–303 (1999).

⁴³³ See *supra* notes 236–241 (distributions), 57 (hardship distributions), and 56 (loans) and accompanying text.

⁴³⁴ See, e.g., Lucas, *Plug the Drain: 401(k) Leakage and the Impact on Retirement*, *supra* note 226; Copeland, *Lump-Sum Distributions at Job Change*, *supra* note 227; Hurd & Panis, *The Choice to Cash Out, Maintain, or Annuitize Pension Rights upon Job Change or Retirement*, *supra* note 59.

⁴³⁵ See, e.g., U.S. GOV'T ACCOUNTABILITY OFF., GAO-13-30, 401(K) PLANS: LABOR AND IRS COULD IMPROVE THE ROLLOVER PROCESS (2013), <http://www.gao.gov/assets/660/652881.pdf>; U.S. GOV'T ACCOUNTABILITY OFF., GAO-16-408, RETIREMENT SECURITY: LOW DEFINED CONTRIBUTION SAVINGS MAY POSE CHALLENGES, *supra* note 191, at 29–31 (discussing universal rollover and finding that eliminating cash-outs and instead rolling funds into IRAs or other retirement plans would increase average projected retirement annuities by 16 percent). The ERISA Advisory Council is looking at how to facilitate plan-to-plan transfers and account consolidations. U.S. DEP'T OF LABOR, ADVISORY COUNCIL ON EMP. WELFARE AND PENSION BENEFIT PLANS, *Participant Plan Transfers and Account Consolidation for the Advancement of Lifetime Plan Participation* (Issue Statement 2016), <https://www.dol.gov/ebsa/pdf/2016-participant-plan-transfers-and-account-consolidation-scope-statement.pdf>.

⁴³⁶ U.S. DEP'T OF THE TREASURY, *General Explanations of the Administration's Fiscal Year 2017 Revenue Proposals*, *supra* note 388, at 142; STAFF OF THE J. COMM. ON TAXATION, 114TH CONG., PRESENT LAW AND BACKGROUND RELATING TO TAX-FAVORED RETIREMENT SAVING AND CERTAIN RELATED LEGISLATIVE PROPOSALS, *supra* note 37, at 85–88.

income investments to an IRA or other retirement plan—and so preserve these assets within the tax-favored retirement system.⁴³⁷

5. Revise the Rules that Are Used to Calculate Lump Sum Distributions

The Treasury and the IRS could also revise the rules that are used to calculate lump sum distributions. As we have seen, when a plan sponsor offers to replace a lifetime pension benefit with a lump sum, the minimum lump sum that is offered must be an amount that is actuarially equivalent to the promised lifetime pension benefit.⁴³⁸ Basically, that means that the minimum lump sum must have a value equal to the present value of the participant's lifetime stream of pension benefits. Unfortunately, the applicable regulations permit the use of that actuarially-equivalent lump sum amount even though that amount is almost invariably *less* valuable than the promised lifetime pension benefit. In fact, that minimum lump sum amount would almost never be sufficient to buy an insurance annuity as generous as the promised lifetime pension benefit. As Part IV.C above showed, the typical retail lifetime annuity has a 12 percent “load” factor built in, and the payouts from actuarially fair annuities would be around 15 percent higher than what can actually be purchased in current retail annuity markets. Similarly, in its recent study of lump sum risk transfers, the U.S. Government Accountability Office estimated that if a 65-year-old female participant were to accept a lump sum offer and then use that lump sum to purchase a retail annuity, her monthly annuity benefit would be 24 percent smaller than her lifetime pension benefit would have been (also estimating a 17 percent reduction for 65-year-old males).⁴³⁹

⁴³⁷ U.S. DEP'T OF THE TREASURY, *General Explanations of the Administration's Fiscal Year 2017 Revenue Proposals*, *supra* note 388, at 142. *See also* Institutional Retirement Income Council, *In-Plan Guaranteed Lifetime Income: Debunking Portability Myths* (2016), http://iricouncil.org/docs/Debunking_Portability_Myths.pdf.

⁴³⁸ *See supra* notes 211–220 and accompanying text.

⁴³⁹ U.S. GOV'T ACCOUNTABILITY OFF., GAO-15-74, PRIVATE PENSIONS: PARTICIPANTS NEED BETTER INFORMATION WHEN OFFERED LUMP SUMS THAT REPLACE THEIR LIFETIME BENEFITS, *supra* note 268, at 25; *See also* Mark Miller, *Six Ways Pension Annuities Almost Always Beat a Lump Sum*, WEALTHMANAGEMENT.COM (Mar. 9, 2012), <http://wealthmanagement.com/data-amp-tools/six-ways-pension-annuities-almost-always-beat-lump-sum>; U.S. DEP'T OF LABOR, ADVISORY COUNCIL ON EMP. WELFARE AND PENSION BENEFIT PLANS, *Model Notices and Disclosures for Pension Risk Transfers*, *supra* note 324, at 17–

In essence, in making a lump sum distribution, the plan sponsor shifts risk to the participant but does *not* fully compensate her for taking on that risk. The plan sponsor saves money, but it is generally a bad economic deal for the participant. Arguably, the right *economic* answer is that the plan sponsor should pay a premium to participants who take lump sum distributions. For example, instead of computing the lump sum as an amount equal to 100 percent of the actuarial present value of the participant's lifetime pension benefit, perhaps, the plan sponsor should have to pay a premium of, say, 15 percent on top of that present value; that is, the plan sponsor could be required to pay a lump sum distribution equal to 115 percent of the present value of the participant's lifetime pension benefit.

At bottom, in the typical lump sum distribution offer, the interests of plan sponsors and participants are in direct conflict, and that raises some interesting issues. In our voluntary pension system, plan sponsors are relatively free to design pension plans to their liking. That is the nature of the settlor function.⁴⁴⁰ On the other hand, when a plan sponsor administers its plan it acts as a fiduciary and so must operate in the best interest of the participants (and beneficiaries).⁴⁴¹ In short, a plan sponsor's decision to offer lump sum distributions, as a matter of course—or as part of a pension risk transfer transaction, is a matter of plan design that is viewed as a settlor function rather than a fiduciary function, but when the plan sponsor implements lump sum distributions, it acts as a fiduciary.⁴⁴²

The first set of issues relates to the plan sponsor's ability to offer lump sum distributions. For example, as Part III.E.3.b above showed, amending a plan to offer participants a new lump sum benefit is pretty clearly a settlor function (not a fiduciary function). Accordingly, the plan sponsor is generally free to amend the plan to offer the lump sum distributions and is generally free to define the terms of that offer. Within certain regulatory limits the interest rate and the mortality table to be used in computing the lump sum will be identified in the plan amendment. As these selections involve the settlor function, a plan sponsor can select permissible interest

18 (showing estimates that if a 65-year-old male participant were to accept a lump sum offer and then use that lump sum to purchase a retail annuity, his monthly annuity benefit would be around 10 percent smaller than his lifetime pension benefit would have been [an \$897 per month annuity versus a \$1000 per month pension] and also estimating a 14 percent reduction for 65-year-old female [an \$861 per month annuity versus a \$1000 per month pension]).

⁴⁴⁰ See *supra* notes 294–295 and accompanying text.

⁴⁴¹ ERISA § 404, 29 U.S.C. § 1104 (2008); I.R.C. § 401(a) (2015).

⁴⁴² See *supra* notes 294–295 and accompanying text.

rates and mortality tables that are advantageous to it. Under the current rules, for example, a plan sponsor can gain a financial advantage for itself by selecting a so-called “lookback” interest rate from up to 17 months earlier—when that interest rate is higher (and so results in lower lump sums) than the rate that prevails at the time the lump sum offer is made.⁴⁴³ Similarly, until new mortality table regulations come into effect for 2017 or later,⁴⁴⁴ a plan sponsor can gain a financial advantage for itself by selecting the currently-required mortality table with its relatively shorter life expectancies (that result in fewer months of pension benefits and so lower lump sums).⁴⁴⁵

The second set of issues relates to the plan sponsor’s implementation of lump sum distributions. Here, the plan sponsor must act as a fiduciary. That makes it a real challenge for the plan sponsor, as its interests are economically adverse to the interests of its participants: the plan sponsor typically expects to save money by encouraging its plan participants to take lump sums that are almost invariably less valuable than the participants’ lifetime pension benefits.

The author believes that a plan sponsor breaches its fiduciary duties to its participants if it downplays the very real reductions in value that occur when participants elect to take lump sum distributions rather than retaining their lifetime pension benefits. Acting as a fiduciary, the plan sponsor should be fully forthcoming with all the information that the participants (and beneficiaries) need to make informed decisions. It will never be enough for a plan sponsor to offer an unblemished picture of the pension risk transfer options: the plan sponsor should reveal the naked truth about lump sums, warts and all. The government has ample authority to require that plan sponsors make full disclosures about how the proffered lump sums truly compare with the participants’ lifetime pension benefits.⁴⁴⁶

All in all, the author believes that the Treasury and the IRS should revise the relative value regulations that are used to compute lump sums.⁴⁴⁷ Plan sponsors could be required to use the most up-to-date mortality tables for lump sum calculations.⁴⁴⁸ Plan sponsors could also be required to take

⁴⁴³ See *supra* notes 298–299 and accompanying text.

⁴⁴⁴ See *supra* notes 218–220 and accompanying text.

⁴⁴⁵ As the I.R.C. § 411(d)(6) anti-cutback rule protects a participant’s accrued benefits, a plan sponsor can never amend its plan to offer a lump sum alternative that actually cuts benefits.

⁴⁴⁶ See, e.g., *supra* note 84 and accompanying text.

⁴⁴⁷ See also U.S. GOV’T ACCOUNTABILITY OFF., GAO-15-74, PRIVATE PENSIONS: PARTICIPANTS NEED BETTER INFORMATION WHEN OFFERED LUMP SUMS THAT REPLACE THEIR LIFETIME BENEFITS, *supra* note 268, at 51.

⁴⁴⁸ See, e.g., Noel Abkemeier, et al., *Risky Business: Living Longer Without*

into account the value of any subsidies or other supplements provided by the plan. For example, if the plan offers an enhanced early retirement subsidy, revised relative value regulations could require that that subsidy be taken into account when computing the amount of a lump sum distribution.⁴⁴⁹ Finally, the Treasury and the IRS might consider requiring plan sponsors to pay a premium (say 15 percent) on top of the actuarially-determined present value (although legislation might be needed before this requirement could be imposed).

At the very least, the relative value notices required by the IRS and any notices of plan benefits required by the PBGC or the U.S. Department of Labor could make plan sponsors clearly disclose the very real reductions in value that occur when a participant elects to take a lump sum in lieu of retaining her lifetime pension benefit. While the present actuarial valuation rules permit plan sponsors to offer lump sums that are based on out-of-date interest rates and mortality tables, the applicable notices could require the prominent disclosure of the “right” interest rates and mortality tables. The notices could also explain how hard it is to invest a lump sum to provide equivalent lifetime income and how difficult it is to use a lump sum to purchase a retail annuity that replicates the participants’ lifetime pension benefit. The model lump sum risk transfer notice recommended by the 2015 ERISA Advisory Council addresses these concerns, for example by noting that “[a]n annuity purchased in the insurance market will generally provide less income than your plan’s pension.”⁴⁵⁰

B. REFORM THE TAX TREATMENT OF ANNUITIES AND DEFERRED INCOME ANNUITIES

The current tax treatment of annuities has some features that encourage individuals to buy them and some features that do not. On the whole, the deferral of taxation on annuities until benefits are actually received is a very valuable tax benefit, especially when compared to, say, a regular bank account where the interest income is taxed on an annual basis

Income for Life: Legislative and Regulatory Issues, AM. ACAD. OF ACTUARIES (Oct. 2015), http://actuary.org/files/LegReg_IB_102215.pdf [hereinafter AM. ACAD. OF ACTUARIES].

⁴⁴⁹ *Id.* at 6–7.

⁴⁵⁰ U.S. DEP’T OF LABOR, ADVISORY COUNCIL ON EMP. WELFARE AND PENSION BENEFIT PLANS, *Model Notices and Disclosures for Pension Risk Transfers*, *supra* note 324, at 35.

at ordinary income tax rates.⁴⁵¹ As Table 2 above showed, the exclusion of investment income on annuity and life insurance was listed as a \$23.4 billion tax expenditure in the U.S. Government's *Fiscal Year 2017 Budget*, and over the years, including this "inside buildup" in taxable income has been a common tax-reform proposal.⁴⁵²

In that regard, under a comprehensive income tax (i.e., a theoretically pure income tax), individuals would pay tax on the sum of the wages, interest, dividends, and other forms of economic income that they earn.⁴⁵³ Portions of the premiums paid for annuities are invested and earn interest, dividends, and other types of investment income. That investment income—the inside buildup—is generally not taxable until the annuitant begins receiving annuity distributions.⁴⁵⁴ Under a comprehensive income tax, investors would be taxed on those investment earnings annually, just like investors in bank accounts, taxable bonds, and mutual funds, and it could make sense to extend comprehensive income tax treatment to annuities (and life insurance) by taxing the inside buildup in those policies. According to

⁴⁵¹ I.R.C. § 61(a)(4) (2015).

⁴⁵² See, e.g., CONG. BUDGET OFF., *Options for Reducing the Deficit: 2014 to 2023* 126 (2013), <https://www.cbo.gov/sites/default/files/cbofiles/attachments/44715-OptionsForReducingDeficit-3.pdf>; DAVID F. BRADFORD, *BLUEPRINTS FOR BASIC TAX REFORM* 178 (2d ed., revised 1984); CONG. RES. SERV., *Tax Expenditures: Compendium of Background Material on Individual Provisions*, S. Rep. No. 45, 112th Cong., 2d Sess. 321–27 (2012), <http://www.gpo.gov/fdsys/pkg/CPRT-112SPRT77698/pdf/CPRT-112SPRT77698.pdf> (discussing the exclusion of investment income on life insurance and annuity contracts); Jonathan Barry Forman, *Reconsidering the Tax Treatment of Pensions and Annuities*, 18(1) *CHAP. L. REV.* 221, 231–233 (2014). But see Michael A. Schuyler, *Tax Treatment of Inside Buildup In Life Insurance Products*, *INST. FOR RES. ON THE ECON. OF TAX'N* (1994), <http://iret.org/pub/FI-09.PDF> (arguing against taxing inside buildup).

⁴⁵³ See generally HENRY C. SIMONS, *PERSONAL INCOME TAXATION: THE DEFINITION OF INCOME AS A PROBLEM OF FISCAL POLICY* 50 (1938); Robert M. Haig, *The Concept of Income—Economic and Legal Aspects*, in *THE FEDERAL INCOME TAX 1*, 7 (Robert M. Haig, ed., 1921); see generally *COMPREHENSIVE INCOME TAXATION* (Joseph A. Pechman, ed., 1977); *WHAT SHOULD BE TAXED: INCOME OR EXPENDITURE?: A REPORT OF A CONFERENCE SPONSORED BY THE FUND FOR PUBLIC POLICY RESEARCH AND THE BROOKINGS INSTITUTION* (Joseph A. Pechman, ed., 1980); Henry Aaron, *What is a Comprehensive Tax Base Anyway?*, 22 *NAT'L TAX J.* 543 (1969); BRADFORD & THE U.S. TREASURY, *supra* note 452.

⁴⁵⁴ A similar deferral of tax occurs on investments in whole-life insurance policies. A whole-life insurance policy provides life insurance coverage throughout the insured's whole life, as opposed to term-life insurance which provides coverage for a specified period. CONG. BUDGET OFF., *supra* note 452, at 126.

the Joint Committee on Taxation, including the investment income from annuities (and life insurance) in taxable income would have raised \$24 billion in Fiscal Year 2015 and \$210 billion over ten years.⁴⁵⁵

Perhaps a better approach would be to continue the current exclusion for the inside buildup in annuities, but only for lifetime annuities. This approach—which was suggested by the President’s 2005 Advisory Panel on Federal Tax Reform—would continue to encourage annuities that provide lifetime income but discourage the use of annuities and variable annuities merely for tax avoidance.⁴⁵⁶

The federal government might also consider other ways the tax system could be used to encourage investors and plan participants to select lifetime annuities and deferred income annuities. As explained in Part II.D.2.c above, current law allows a life annuitant to recover a portion of each annuity payment tax-free but only until she recovers her investment in the contract—typically, as she reaches her life expectancy; thereafter, each annuity payment received is fully taxable. The current rule provides some balance, as it typically allows annuitants who die before they recover their annuity investment to deduct the unrecovered portion in the year they die. Still, if the federal government wants to encourage individuals to buy lifetime annuities and deferred income annuities, it could consider allowing individuals to keep excluding a portion of each annuity payment from income even if they live beyond their life expectancy. After all, it certainly seems odd that taxes increase on those who “live too long.”⁴⁵⁷ Alternatively, or, perhaps, in addition to extending the exclusion ratio for more years, the federal government might also allow individuals to deduct any unrecovered annuity investments even if they die before the annuity starting date. After all, it seems strange that only those individuals who live past the annuity starting date are allowed to deduct their unrecovered annuity investments; and that rule almost certainly discourages the purchase of deferred income annuities.⁴⁵⁸ All in all, the benefits from changing these tax rules to better encourage the purchase of lifetime annuities and deferred income annuities

⁴⁵⁵ CONG. BUDGET OFF., *supra* note 452, at 126. *See also* Table 2, *supra* (showing the Office of Management and Budget’s slightly different tax expenditure estimates: \$23 billion in Fiscal Year 2017 and \$371 billion over ten years).

⁴⁵⁶ The President’s Advisory Panel on Federal Tax Reform, *Simple, Fair, and Pro-Growth: Proposals to Fix America’s Tax System*, 123 (Nov. 2005), <https://www.treasury.gov/resource-center/tax-policy/Documents/Report-Fix-Tax-System-2005.pdf>.

⁴⁵⁷ *See supra* note 171 and accompanying text.

⁴⁵⁸ *See supra* notes 172–176 and accompanying text.

would probably outweigh the revenue losses that would result from those changes.

The federal government might even provide additional tax benefits for individuals who receive income from lifetime annuities and lifetime pensions, for example, by completely exempting lifetime income payments from income taxation or favoring them with a reduced tax rate.⁴⁵⁹ In that regard, investments always involve choices, and tax rates can influence those choices. Under current law, annuity (and pension) income is subject to ordinary income tax rates of up to 39.6 percent, but capital gains and dividends are typically taxed at just 0, 15, or 20 percent.⁴⁶⁰ Those preferential tax rates for capital gains and dividends can be very attractive, even to investors who would prefer the lifetime income that comes from investing in annuities (or pensions).⁴⁶¹ Accordingly, as long as there are preferential tax rates for capital gains and dividends, it might make sense to extend those preferential tax rates to the income that comes from lifetime annuities and lifetime pensions. Policymakers could, of course, target the benefit towards less affluent retirees by limiting the preferential rates to, say, no more than \$30,000 a year of annuity or pension income per retiree.

C. THE GOVERNMENT COULD MANDATE OR ENCOURAGE ANNUITIZATION

Since 2010, the IRS and the U.S. Department of Labor have made a concerted effort to promote lifetime income options for retirement plans.⁴⁶² For example, in 2012, the Treasury and the IRS released a package of proposed regulations and rulings intended to make it easier for pension plans to offer partial annuities, longevity annuities, and other lifetime income

⁴⁵⁹ See, e.g., Retirement Security Needs Lifetime Pay Act of 2009, H.R. 2748, 111th Cong. (2009) (a bill introduced by former Representative Earl Pomeroy [D-N.D.] to encourage guaranteed lifetime income payments by excluding from income a portion of such payments); Çebi, *supra* note 338, at 7; AM. ACAD. OF ACTUARIES, *supra* note 448, at 8.

⁴⁶⁰ See *supra* notes 120–121 and accompanying text.

⁴⁶¹ See, e.g., William J. Bernstein, *A Limited Case for Variable Annuities*, EFFICIENT FRONTIER, <http://www.efficientfrontier.com/ef/701/annuity.htm> (last visited July 27, 2016) (giving some numerical examples that show how investments in variable annuities compare with free-standing stock market investments over time).

⁴⁶² See, e.g., U.S. DEP'T OF LABOR, EMP. BENEFITS SECURITY ADMIN., *Lifetime Income Options for Participants and Beneficiaries in Retirement Plans* (2010), <http://www.dol.gov/ebsa/regs/cmt-1210-AB33.html>.

choices,⁴⁶³ and in 2014, the IRS promulgated final regulations that ease the minimum distribution requirements to allow plan participants to spend up to \$125,000 on qualified longevity annuity contracts (QLACs).⁴⁶⁴ This subpart discusses a variety of other ways that the government could promote annuitization. In that regard, however, policymakers need to bear in mind that some policies to mandate or encourage annuitization might have undesirable distributional consequences.⁴⁶⁵

1. The Government Could Mandate Annuitization

One approach would be for the government to mandate that retirees use at least a portion of their retirement savings to purchase annuities or similar lifetime income guarantees.⁴⁶⁶ Under this approach, participants in tax-favored plans and IRA holders could be required to annuitize at least a portion of their tax-favored retirement savings—unless they could show that they have adequate lifetime income streams from other sources.

2. The Government Could Require that Pension Plans Offer Annuities as an Investment and/or Distribution Option

Alternatively, the government might only want to encourage annuitization. For example, the government could require plan sponsors to include annuities or other lifetime income mechanisms in their investment options and/or in their distribution options.⁴⁶⁷ The government might also

⁴⁶³ See, e.g., *id.*; EXEC. OFF. OF THE PRESIDENT, COUNCIL OF ECON. ADVISORS, SUPPORTING RET. FOR AM. FAMILIES (2012), http://benefitslink.com/articles/CEA_report_2_2_2012.pdf.

⁴⁶⁴ See *supra* notes 158–160 and accompanying text.

⁴⁶⁵ See *supra* Part IV.D. See also Webb, *The United States Longevity Insurance Market*, in SECURING LIFELONG RETIREMENT INCOME: GLOBAL ANNUITY MARKETS AND POLICY, *supra* note 142, at 75–76 (noting that mandating annuitization could adversely affect a meaningful number of households).

⁴⁶⁶ See, e.g., MACKENZIE, *supra* note 117, at 191–200; Jeffrey R. Brown, *Automatic Lifetime Income as a Path to Retirement Income Security* (unpublished manuscript prepared for the American Council of Life Insurers, Aug. 7 2009), http://web.law.columbia.edu/sites/default/files/microsites/tax-policy/files/2009/Brown_Automatic%20Lifetime%20Income_With%20Cover.pdf, Perun, *supra* note 327.

⁴⁶⁷ See, e.g., U.S. GOV'T ACCOUNTABILITY OFF., *supra* note 51, at 38–39; Jeffrey R. Brown, *Understanding the Role of Annuities in Retirement Planning*, in

encourage pension plans to offer beneficiaries more flexibility, for example, by offering partial annuitization options and not just all-or-nothing annuitization choices.⁴⁶⁸ The government might even require plans to default participants into annuities or trial annuities, unless participants affirmatively elect otherwise.⁴⁶⁹

OVERCOMING THE SAVINGS SLUMP 178, 199–200 (Annamaria Lusardi, ed., 2008); Kathryn J. Kennedy, *How Can Lifetime Income Be Made a Desirable Retirement Plan Distribution Option?*, 2013 N.Y.U. REV. OF EMP. BENEFITS & EXEC. COMP. 1-1; AM. ACAD. OF ACTUARIES, *Risky Business: Living Longer Without Income for Life: Legislative and Regulatory Issues*, *supra* note 448, at 7; U.S. GOV'T ACCOUNTABILITY OFF., GAO-16-433, DOL COULD TAKE STEPS TO IMPROVE RETIREMENT INCOME OPTIONS FOR PLAN PARTICIPANTS (2016), <http://www.gao.gov/assets/680/678924.pdf>.

⁴⁶⁸ See, e.g., Beshears et al., *supra* note 383, at 17 (finding that “most consumers prefer partial annuitization of their retirement nest egg over either 0% or 100% annuitization”); INTERNAL REVENUE SERV., *Modifications to Minimum Present Value Requirements for Partial Annuity Distribution Options Under Defined Benefit Pension Plans* 81 Fed. Reg. 62,359 (Sept. 9, 2016) (recently issued regulations that make it easier for defined benefit plans to offer both a partial lump sum and a partial annuity).

⁴⁶⁹ See, e.g., U.S. GOV'T ACCOUNTABILITY OFF., *supra* note 51, at 39–40; MACKENZIE, *supra* note 117, at 200–203; J. Mark Iwry & John A. Turner, *Automatic Annuitization: New Behavioral Strategies for Expanding Lifetime Income*, BROOKINGS (Retirement Security Project Paper No. 2009-2, 2009), https://www.brookings.edu/wp-content/uploads/2016/06/07_annuitization_iwry.pdf (discussing various default strategies); William G. Gale, J. Mark Iwry, David C. John & Lina Walker, *Increasing Annuitization in 401(k) Plans with Automatic Trial Income*, BROOKINGS (Retirement Security Project, Paper No. 2008-2, 2008), https://www.brookings.edu/wp-content/uploads/2016/06/06_annuities_gale.pdf (recommending defaulting retirees into receiving at least 24 consecutive monthly payments from an annuity or similar lifetime income product); Çebi, *supra* note 338, at 7; John J. Kalamarides & Srinivas D. Reddy, *The Ease of Automation and Guaranteed Lifetime Income*, PRUDENTIAL FIN., INC. 7 (June 2016), <http://research.prudential.com/documents/rp/RSWP021-Ease-of-Automation.pdf> (“A majority of plan participants who understand guaranteed lifetime income solutions say being defaulted into them leads to better-than-average retirement outcomes.”); David Blanchett, *Default Participants in Defined Contribution Plans into Annuities: Are the Potential Benefits Worth the Costs?*, 4(1) J. OF RET. 54 (2016). Australia is also looking at having its superannuation funds default plan participants into a “comprehensive income product for retirement” (CIPR) option. See, e.g., Australian Government, The Treasury, *Financial System Inquiry Final Report* 91, 117 (Nov. 2014), http://fsi.gov.au/files/2014/12/FSI_Final_Report_Consolidated20141210.pdf.

3. The Government Could Sell or Guarantee Annuities

The federal government could even get into the market of selling annuities.⁴⁷⁰ As already mentioned, the Social Security system implicitly allows workers to buy actuarially fair lifetime annuities merely by delaying retirement beyond age 62,⁴⁷¹ but the government might also let individuals and couples buy a limited amount of explicit inflation-adjusted lifetime annuities—perhaps enough to keep them out of poverty throughout their retirement years.⁴⁷² Alternatively, the federal government could guarantee annuities sold by private companies.

4. The Government Could Make It Easier for Plan Sponsors to Offer Annuities and Deferred Income Annuities

As Parts III.B.2 and III.C.2 above explained, plan sponsors that offer annuities have fiduciary responsibilities with respect to the selection and monitoring of annuity providers. Plan sponsors can avoid those fiduciary duties if they instead only make lump sum distributions and leave it to the terminating employees to buy their own annuities directly (in after-tax dollars) or, alternatively, indirectly through a rollover IRA (using pre-tax dollars).⁴⁷³ The U.S. Department of Labor has a long way to go in overcoming plan sponsor concerns about offering in-plan annuities without fear of breaching their fiduciary duties.⁴⁷⁴ In general, it would be good to reduce these regulatory barriers.

⁴⁷⁰ See, e.g., Forman *supra* note 161 at 414–417 and sources cited therein; ELLIS ET AL. *supra* note 199, at 119.

⁴⁷¹ See *supra* notes 24–27 and accompanying text.

⁴⁷² In 2016, the poverty level for a single individual was \$11,880, and the poverty level for a married couple was \$16,020. U.S. DEP'T OF HEALTH AND HUM. SERVS, OFF. OF THE ASSISTANT SEC'Y FOR PLANNING AND EVALUATION, POVERTY GUIDELINES (2016), <https://aspe.hhs.gov/poverty-guidelines>.

⁴⁷³ See, e.g., *supra* note 235 and accompanying text.

⁴⁷⁴ See, e.g., Utkus, *supra* note 262 (“Concerns about barriers to in-plan annuities have led the Department of Labor to clarify its rules for in-plan annuity selection. So far, the rule clarification hasn’t changed employer sentiment.”); McGee, *supra* note 60, at 13; Brown, *supra* note 403; AM. ACAD. OF ACTUARIES, *supra* note 448, at 5–6; VOYA, *Legislative Update* (June 2015), <https://investments.voya.com/idc/groups/public/documents/retirement/132351.pdf>; Steve Vernon, *Foundations in Research for Regulatory Guidelines on the Design &*

In particular, it might make sense to let plan sponsors rely on insurance regulators and industry standards to oversee and monitor annuity providers. That is the way it works in many other countries,⁴⁷⁵ and it could probably work in the United States, as well. For example, the U.S. Department of Labor's Employee Benefits Security Administration (or alternatively, the U.S. Department of Treasury's Federal Insurance Office) could post a list of approved annuities and annuity providers that plan sponsors could use.⁴⁷⁶ Alternatively, the U.S. Department of Labor could at least host a website that would serve as a clearing house of information about annuity providers and annuity products.⁴⁷⁷

Also, better guidance on the process of selecting qualifying longevity annuity contracts (QLACs) and other deferred income annuities would increase their utilization.⁴⁷⁸ For that matter, it could make sense for the government to “jump-start” the market for deferred income annuities by offering them in the federal government's Thrift Savings defined contribution plan.⁴⁷⁹

Operation of Retirement Income Solutions in DC Plans, STANFORD CTR. ON LONGEVITY (Sept. 2014), <http://longevity3.stanford.edu/wp-content/uploads/2014/09/Foundations-for-Regulatory-Guidelines-2014-Final-.pdf>.

⁴⁷⁵ See *supra* notes 380-381 and accompanying text; Robert J. Toth, Jr. & Evan Giller, *Regulatory Recommendations for the Department of Labor to Facilitate Lifetime Income*, 3(4) J. OF RET. 28, 29-31 (2016), <http://www.ijournals.com/doi/pdfplus/10.3905/jor.2016.3.4.028>.

⁴⁷⁶ Insurers interested in having their annuity products on the “qualified” list could be required to formally apply for listing and meet certain solvency and consumer-protection standards. See also Abraham & Harris, *supra* note 153, at 22 (suggesting that the government find a way to “certify financial products—including longevity annuities—that meet established standards for reliability, cost, and quality”).

⁴⁷⁷ Toth & Giller, *supra* note 475, at 29-31.

⁴⁷⁸ Ed McCarthy, *Are Retirement Plan Sponsors Too Afraid of Longevity Annuities?*, WEALTHMANAGEMENT.COM (Feb. 10, 2016) <http://wealthmanagement.com/retirement-planning/are-retirement-plan-sponsors-too-afraid-longevity-annuities>.

⁴⁷⁹ Abraham & Harris, *supra* note 153, at 22.

5. The Government Could Promote Education about Lifetime Income Options

The government could promote lifetime income options both through its own educational efforts and also by making it easier for plan sponsors to provide financial education and retirement planning advice.

a. *Government Efforts*

At the very least, the government could promote better financial education about annuities and other lifetime income options.⁴⁸⁰ In that regard, one way to encourage retirees to choose annuities and other forms of lifetime income is to promote financial education that frames the retirement decision in terms of lifetime consumption rather than in investment-oriented language that simply encourages individuals to accumulate large lump sums.⁴⁸¹

Information about replacement rates would help workers better understand how to convert their account balances into lifetime income streams.⁴⁸² The U.S. Government Accountability Office recommends that the U.S. Department of Labor retirement planning tools should build in more flexibility so that users can better understand how account balances translate into replacement rates that meet their personal needs.⁴⁸³ The U.S. Department of Labor already hosts a *Lifetime Income Calculator* that can be used to estimate monthly pension benefits for a typical retiree.⁴⁸⁴ For

⁴⁸⁰ Cebi, *supra* note 338, at 7.

⁴⁸¹ Robert Gazzale, Sandy Mackenzie & Lina Walker, *Do Default and Longevity Annuities Improve Annuity Take-Up Rates? Results from an Experiment*, AARP PUB. POL'Y INST. (Research Report No. 2012-11, Oct. 2012), <https://www.tiaa-crefinstitute.org/public/pdf/institute/events/pdfs/Do%20Default%20Longevity%20Annuities%20Improve%20TakeUp%20Rates.pdf>; Beshears et al., *supra* note 383, at 12–13, 13–14; Jeffrey R. Brown, Jeffrey R. Kling, Sendhil Mullainathan & Marian V. Wrobel, *Why Don't People Insure Late-Life Consumption? A Framing Explanation of the Under-Annuity Puzzle*, 98(2) AM. ECON. REV. 304 (2008); Brown, *supra* note 403.

⁴⁸² U.S. GOVERNMENT ACCOUNTABILITY OFF., GAO-16-242, RETIREMENT SECURITY: BETTER INFORMATION ON INCOME REPLACEMENT RATES NEEDED TO HELP WORKERS PLAN FOR RETIREMENT, *supra* note 382.

⁴⁸³ *Id.* at 38.

⁴⁸⁴ *Lifetime Income Calculator*, U.S. DEP'T OF LAB., EMP. BENEFITS SEC. ADMIN., <http://www.dol.gov/ebsa/regs/lifetimeincomecalculator.html> (last visited July 22, 2016): The calculator uses the safe harbor assumptions described in the

example, for a 65-year-old participant retiring on July 22, 2016 with a current account balance of \$100,000, the calculator projects that she can expect to receive \$486 a month for the rest of her life (\$5832 per year = $12 \times \$486$ per month).⁴⁸⁵ According to the *Advanced Annuity Calculator* at Immediateannuities.com, a 65-year-old man buying a \$100,000 lifetime annuity on July 22, 2016 would receive \$531 per month for the rest of his life (\$6372 per year = $12 \times \$531$ per month), while a 65-year-old woman would receive \$498 per month for the rest of her life (\$5976 per year = $12 \times \$498$ per month).⁴⁸⁶

ANPRM [Advance notice of proposed rulemaking] for estimating future contributions, investment earnings, and inflation:

- Contributions continue to Retirement Age at the Current Annual Contribution amount increased by 3 percent per year.
- Investment returns are 7 percent per year (nominal).
- An inflation rate of 3 percent per year is used for discounting the projected account balance to today's dollars.

In converting the account balances into lifetime income streams, the calculator uses the safe harbor annuity conversion assumptions described in the ANPRM:

- A rate of interest equal to the 10-year constant maturity Treasury securities rate for the first business day of the last month of the period to which the statement relates (equal to 1.63% as of December 3, 2012 for statement periods ending December 31, 2012).
- The applicable mortality table under section 417(e)(3)(B) of the Internal Revenue Code in effect on the first day of the last month of the period to which the statement relates. This is a unisex table (i.e., the annuity values are the same for males and females).
- No insurance company load for expenses, profit, reserves, etc.

⁴⁸⁵ U.S. DEP'T OF LAB., EMP. BENEFITS SEC. ADMIN, *supra* note 484, click on "Go to the Calculator"; enter Retirement Age: 65; Current Account Balance: \$100,000; Current Annual Contribution: \$0; Years to Retirement: 0; Statement Date: enter today's date; and click on "Calculate," and get Lifetime Income/Month for Participant With No Survivor Benefit: \$486). The results also show the \$439 per month that the participant (and spouse) would receive under a joint and survivor annuity (and the \$220 [50 percent] that would be paid to the surviving spouse), assuming that the participant and the spouse are the same age. *Id*

⁴⁸⁶ *Advanced Annuity Calculator*, IMMEDIATEANNUITIES <https://www.immediateannuities.com/annuity-calculators/> (last visited July 22, 2016) (Male: enter My Age Today: 65; My Gender: Male; State of Residence: DC; Income Start Date: Immediately; \$ Investment: \$100,000; click on "Calculate," and get Estimated Monthly Income: \$582; Female: enter My Age Today: 65; My Gender: Female; State of Residence: DC; Income Start Date: Immediately; \$ Investment: \$100,000;

In addition to the *Lifetime Income Calculator*, the U.S. Department of Labor could provide (or endorse) more extensive calculators that could be used by participants to evaluate the choice between lifetime pension benefits and lump sum distributions. Both present-value-of-an-annuity and principal-sum-to-annuity calculators could be hosted. Ideally, these calculators would allow participants to use a variety of assumptions about life expectancy and rates of return, rather than just the fixed assumptions in the current *Lifetime Income Calculator*.⁴⁸⁷

The U.S. Department of Labor could also design (or endorse) an individualized *Life Expectancy Calculator* to help participants get a better idea how long they and their spouses can expect to live. To calculate life expectancy, these individualized calculators typically ask about an individual's age, education, work, smoking habits, exercise regime, and family health.⁴⁸⁸ At the very least, the U.S. Department of Labor could link to the very simple life expectancy calculator that the Social Security Administration hosts on its website.⁴⁸⁹ The U.S. Department of Labor could also prominently display or link to individual and joint life expectancy tables.⁴⁹⁰ In addition to providing life expectancy tables for the average

click on “Calculate,” and get Estimated Monthly Income: \$531). The Advanced Annuity Calculator can also be used to find payments for couples. For example, when a 65-year-old male is coupled with a 65-year-old female, the results show that the 65-year-old couple would get a joint life annuity providing Estimated Monthly Income of \$444 per month (\$5328 per year = 12 × \$444 per month). *See also Should I Buy an Income Annuity?*, CANNEX.COM, <http://www.cannex.com/public/antecvp01.pdf> (last visited Jan. 8, 2017); *What is My Return with an Income Annuity? (IRR)*, CANNEX.COM, https://www.cannex.com/usa/english/tool_irr_public.html (last visited Jan. 8, 2017).

⁴⁸⁷See U.S. DEP'T OF LAB., EMP. BENEFITS SEC. ADMIN *supra* note 484.

⁴⁸⁸See, e.g., Dean P. Foster, Choong Tze Chua & Lyle H. Ungar, *How Long Will you Live?*, WHARTON.UPENN.EDU, <http://gosset.wharton.upenn.edu/~foster/mortality/> (last visited July 22, 2016) (click on “Our longer version of the life calculator”).

⁴⁸⁹*Retirement & Survivors Benefits: Life Expectancy Calculator*, SOC. SEC. ADMIN., <http://www.ssa.gov/planners/benefitcalculators.html> (last visited July 22, 2016).

⁴⁹⁰See, e.g., SOC. SEC. ADMIN, *supra* note 132; Elizabeth Arias, *United States Life Tables, 2011*, 64(11) NAT'L VITAL STATS. REP. 1, 9 tbl.1 (2015), http://www.cdc.gov/nchs/data/nvsr/nvsr64/nvsr64_11.pdf; CTRS. FOR DISEASE CONTROL, *Life Tables*, http://www.cdc.gov/nchs/products/life_tables.htm (last updated Dec. 8, 2015); INTERNAL REVENUE SERV., *General Rule for Pensions and Annuities* 26 tbl.V (Ordinary Life Annuities, One Life), 27–42 tbl.VI (Ordinary Joint

population, it could make sense to provide life tables for individuals who are healthier than the average population.⁴⁹¹

b. *Plan Sponsors*

Plan sponsors are not required to provide retirement planning advice, and concerns about fiduciary liability often keep them from doing so.⁴⁹² Even when employers provide financial education and retirement planning advice, they may not spend much effort explaining annuities and other lifetime income options.⁴⁹³ The costs of providing such retirement planning advice may also be a problem, particularly for smaller employees. Somehow, the government could make it easier for plan sponsors to provide such financial education and retirement planning advice. In that regard, the U.S. Department of Labor is already considering changes that would require that the periodic benefit statements provided to defined contribution plan participants about their account balances also show how those account balances would be expressed as estimated streams of payments.⁴⁹⁴

Life and Last Survivor Annuities, Two Lives) (Publication No. 939, 2013), <http://www.irs.gov/pub/irs-pdf/p939.pdf>; Treas. Reg. § 1.72-9 tbls.V & VI

⁴⁹¹ See *supra* note 176.

⁴⁹² See, e.g., AM. ACAD. OF ACTUARIES, *supra* note 448, at 2; see also Transamerica Center for Retirement Studies, *The Current State of Retirement: A Compendium of Findings About American Retirees* 48 (Apr. 2016), https://www.transamericacenter.org/docs/default-source/retirees-survey/tcrs2016_sr_retiree_compendium.pdf (survey showing that more than 60 percent of most recent employers did little or nothing to help pre-retirees transition into retirement).

⁴⁹³ For example, a recent survey of 406 large employers found that just 26.8% of those who offered financial/retirement education said they discussed annuities with their employees and plan participants. INT'L FOUND. OF EMP. BENEFIT PLANS, *Financial Education for Today's Workforce: 2016 Survey Results* 20 ex.17 (2016), <https://www.ifebp.org/pdf/financial-education-2016-survey-results.pdf>.

⁴⁹⁴ U.S. DEP'T OF LAB., EMP. BENEFITS SEC. ADMIN., *Fact Sheet: Lifetime Income Illustration* (May 7, 2013), <http://www.dol.gov/ebsa/pdf/fsanprm.pdf>; Pension Benefits Statements, 78 Fed. Reg. 26,727 (May 8, 2013) (to be codified at 29 C.F.R. pt. 2520), <http://webapps.dol.gov/FederalRegister/PdfDisplay.aspx?DocId=26998> (Advance notice of proposed rulemaking issued under ERISA § 105, 29 U.S.C. § 1025 (2006)). See also U.S. GOV'T ACCOUNTABILITY OFF., *supra* note 374, at 21–23.

D. IMPROVE ANNUITY REGULATION AND MARKETS

1. Strengthen the Regulation of Annuities

As already explained in Part III.A above, annuities are generally regulated under state insurance laws, and all states have state-based guaranty funds that provide at least \$100,000 of protection for each annuitant in case the insurance company that sold the policy becomes insolvent. Unfortunately, the current state-by-state insurance regulatory system is antiquated, costly, and inefficient.⁴⁹⁵ One way to cut down on regulatory costs might be to allow insurance companies to avoid costly state-by-state regulation by instead electing an optional federal charter.⁴⁹⁶ Another approach would be to make the state-based guaranty funds that backstop annuities stronger. A more uniform standard, or even a federal guaranty fund, would be preferable to the current system.⁴⁹⁷ All in all, these kinds of improvements in annuity markets would make annuities more attractive to plan sponsors and to individual purchasers.⁴⁹⁸

2. Allow Annuity Providers to Advertise Their State Guarantees

A related problem with retail annuities in the United States is that state laws generally prevent insurance companies from mentioning their state-based guarantees in their sales material.⁴⁹⁹ That, too, could be changed. The no-advertising rule seems to be designed to limit the moral hazard among insurance companies that might occur if insurance companies took greater investment risks because they could rely on the state-based insurance guarantees.⁵⁰⁰ While we should be concerned about the solvency of insurance companies, allowing insurance companies to advertise their state-based

⁴⁹⁵ See, e.g., Pamela Perun, *Putting Annuities Back into Savings Plans*, in EMP. PENSIONS: POLICIES, PROBLEMS, AND POSSIBILITIES 143, 157 (Teresa Ghilarducci & Christian E. Weller, eds., 2007), <http://www.aspeninstitute.org/sites/default/files/content/images/PerunPuttingAnnuities%20BackintoSavingsPlans.pdf>.

⁴⁹⁶ *Id.* at 156–159 (citing numerous insurance industry association proposals).

⁴⁹⁷ *Id.* at 157–159.

⁴⁹⁸ *Id.* at 158 and sources cited in 158 n15.

⁴⁹⁹ AM. ACAD. OF ACTUARIES, *supra* note 448, at 5; Abraham & Harris, *supra* note 153, at 20 (also noting that Alabama and Michigan are two states that do not have a no-advertising rule).

⁵⁰⁰ AM. ACAD. OF ACTUARIES, *supra* note 448, at 5.

guarantees would increase consumer confidence in annuities and so encourage more individuals to buy them.⁵⁰¹ Moreover, competitive pricing of annuities would also improve, as consumers would feel less need to pay higher premiums to buy annuities from insurance companies with higher financial rankings.⁵⁰² In short, purchasers would get better prices for their annuities. In that regard, while the *Annuity Shopper* reports that the average monthly benefit for a \$100,000 immediate fixed annuity for a 65-year-old man in December 1, 2015 for a 65-year-old man was \$545 per month (\$6540 per year),⁵⁰³ policy quotes from the individual companies cited there ranged from \$528 per month to \$560 per month.⁵⁰⁴ Simple single-life annuities such as the one for a 65-year-old male are probably the most competitive annuity product offered by insurance companies, but there is even more price variation on some of the more complicated annuity products reported on in a typical issue of the *Annuity Shopper*, and, no doubt, we would see even more price variation if we also reviewed the annuity prices charged by those insurance companies that are not included in the *Annuity Shopper* surveys. As all similar annuities come with the same state-based guarantee, we should be concerned anytime a purchaser has to pay much more than it would cost to cover the cost of an actuarial fair annuity plus a small premium to cover an insurance company's risks and profits.

3. Broaden the Range of Permissible Lifetime Income Products

In addition to promoting annuities, it could make sense to broaden the range of permissible lifetime income products. One approach is to develop more products that pool risk among participants, as opposed to products that necessitate high premiums to compensate insurance companies for their guarantees and profits. In that regard, for example, TIAA's College Retirement Equities Fund (CREF) has been offering low-cost variable annuities that pool risk among participants for years.⁵⁰⁵ Participants choose

⁵⁰¹ See, e.g., Beshears et al., *supra* note 383, at 14.

⁵⁰² See, e.g., MOSHE MILEVSKY, LIFE ANNUITIES: AN OPTIMAL PRODUCT FOR RETIREMENT INCOME 27–30 (The Research Foundation of CFA Institute, 2013), <http://ssrn.com/abstract=2571379> (discussing the relationship between annuity pricing and insurance company credit rating).

⁵⁰³ See *supra* note 144 and accompanying text.

⁵⁰⁴ *Id.*

⁵⁰⁵ Poterba & Warshawsky, *supra* note 350, at 191–198 (discussing the history and development of individual annuities offered by TIAA); Forman & Sabin, *supra*

from various funds to invest in; and later on, they choose from among a variety of distribution options, including one-life and two-life annuities.⁵⁰⁶ When a retiree selects a lifetime annuity, the annuity payments depend on both the investment experience of the chosen accounts and the mortality experience of the other participants, but the way these annuities are designed, the mortality risk falls on the annuitants and is not guaranteed by TIAA.⁵⁰⁷

There are many other ideas for lifetime income products that could share longevity risk among participants.⁵⁰⁸ For example, so-called “defined-

note 126, at 798; Roman L. Weil & Lawrence Fisher, *TIAA/CREF: Who Gets What? An Analysis of Wealth Transfers in a Variable Annuity*, 47(1) J. OF BUS. 67 (1974), <http://www.jstor.org/stable/pdf/2352084.pdf>. See, e.g., TIAA GLOBAL ASSET MANAGEMENT, *supra* note 354.

⁵⁰⁶ Forman & Sabin, *supra* note 126, at 798

⁵⁰⁷ *Id.*

⁵⁰⁸ See, e.g., Catherine Donnelly, *Actuarial Fairness and Solidarity in Pooled Annuity Funds*, 45(1) ASTIN BULL. 49 (2015); Catherine Donnelly, Montserrat Guillén & Jens Perch Nielsen, *Bringing cost transparency to the life annuity market*, 56(1) INS.: MATHEMATICS AND ECON. 14 (May 2014); Raimond Maurer, Olivia S. Mitchell, Ralph Rogalla & Vasily Kartashov, *Lifecycle Portfolio Choice with Stochastic and Systematic Longevity Risk, and Variable Investment-Linked Deferred Annuities*, 80(3) J. OF RISK AND INS. 649 (2013), <http://online.library.wiley.com/doi/10.1111/j.1539-6975.2012.01502.x/epdf>; Raimond Maurer, Ralph Rogalla & Ivonne Siegelin, *Participating Payout Life Annuities: Lessons from Germany* 43(2) ASTIN BULL. 159 (2013) (noting that participating life annuities offer guaranteed minimum benefits for life and an additional non-guaranteed surplus based on investment return, mortality, and costs); Catherine Donnelly, Montserrat Guillén & Jens Perch Nielsen, *Exchanging uncertain mortality for a cost*, 52(1) INS.: MATHEMATICS AND ECON. 65 (Jan. 2013); Chao Qiao & Michael Sherris, *Managing Systematic Mortality Risk With Group Self-Pooling and Annuitization Schemes*, 80(4) J. OF RISK AND INS. 949 (2013), <http://onlinelibrary.wiley.com/doi/10.1111/j.1539-6975.2012.01483.x/epdf>; Robert L. Brown & Tyler Meredith, *Pooled Target-Benefit Pension Plans* (Institute for Research on Public Policy, Study No. 27, Mar. 2012), <http://irpp.org/wp-content/uploads/assets/research/faces-of-aging/new-research-article-2/IRPP-Study-no27.pdf>; Andreas Richter & Frederik Weber, *Mortality-Indexed Annuities: Managing Longevity Risk via Product Design*, 15(2) N. AM. ACTUARIAL J. 212 (2011); Michel Denuit, Steven Haberman & Arthur Renshaw, *Longevity-Indexed Life Annuities* 15(1) N. AM. ACTUARIAL J. 97 (2011); Roberto Rocha & Dimitri Vitas, *Designing the Payout Phase of Pension Systems: Policy Issues, Constraints and Options*, WORLD BANK (Policy Research Working Paper No. WPS5289, 2010), <http://documents.worldbank.org/curated/en/899971468339618157/pdf/WPS5289.pdf>; Michael Z. Stamos, *Optimal consumption and portfolio choice for pooled annuity funds*, 43(1) INS.: MATHEMATICS AND ECON. 56 (Aug. 2008); John Piggott, Emiliano A. Valdez &

ambition plans”—like those in operation in the Netherlands—offer a way to share risk among plan participants.⁵⁰⁹ Also, elsewhere, the author has suggested we could pool risk among participants with so-called “tontine annuities”⁵¹⁰ and “tontine pensions.”⁵¹¹ So-called “variable annuity pension plans” are another product that could help promote retirement income security.⁵¹² Another idea would be to modify ERISA to permit employers to offer longevity plans—supplemental defined benefit plans where participation begins at age 45 or later and benefits commence at age 75 or later.⁵¹³

E. OTHER IDEAS

At some point the government also needs to solve the underfunding problems of both Social Security and the PBGC.⁵¹⁴

Bettina Detzel, *The Simple Analytics of a Pooled Annuity Fund*, 72(3) J. OF RISK AND INS. 497 (2005).

⁵⁰⁹ See, e.g., Niels Kortleve, *The “Defined Ambition” Pension Plan: A Dutch Interpretation*, 6(1) ROTMAN INT’L J. OF PENSION MGMT. (2013), http://www.rijpm.com/admin/article_files/2-Kortleve_The_Defined_Ambition_F2.pdf; Bart van Riel & Eduard Ponds, *Sharing Risk: The Netherlands’ New Approach to Pensions*, B.C. CTR. FOR RET. RES. (Issue in Brief No. 7-5, Apr. 2007), http://crr.bc.edu/wp-content/uploads/2007/04/ib_2007-5-508.pdf; A. Lans Bovenberg, Roel Mehlkopf & Theo Nijman, *The Promise of Defined Ambition Plans: Lessons for the United States*, REIMAGINING PENSIONS: THE NEXT 40 YEARS 215–246 (Olivia S. Mitchell & Richard C. Shea, eds. 2016); John A. Turner, *Hybrid Pensions: Risk Sharing Arrangements for Pension Plan Sponsors and Participants* (Feb. 2014), <https://www.soa.org/files/research/projects/research-2014-hybrid-risk-sharing.pdf>; Martin Bauer, *supra* note 130, at 31.

⁵¹⁰ See, e.g., Forman & Sabin, *supra* note 126, at 790–801.

⁵¹¹ See, e.g., *id.*, at 802–804.

⁵¹² Grant Camp, Kelly S. Coffing & Ladd E. Preppernau, *Making the case for variable annuity pension plans (VAPPs)*, MILLIMAN (Oct. 7, 2014), <http://us.milliman.com/basic-vapp-benefits/> (“A VAPP is a defined benefit (DB) pension plan where the benefits adjust each year based on the return of the plan’s assets, resulting in stable funding requirements.”).

⁵¹³ William Most & Zorast Wadia, *Longevity Plans: An Answer to the Decline of the Defined Benefit Plan*, 28(1) BENEFITS L. J. 23 (2015), <http://www.milliman.com/uploadedFiles/insight/2015/longevity-plans.pdf>.

⁵¹⁴ AM. ACAD. OF ACTUARIES, *supra* note 448, at 10–12.

VI. CONCLUSION

Pensions, annuities, and similar lifetime income products provide the best way to protect against longevity risk. Over the years, the responsibility for creating such secure retirement income streams has shifted from employers to individuals. This Article showed how changes in the U.S. laws and regulations governing pensions and annuities could help promote secure, lifetime income policies. More specifically, this Article showed how the laws governing annuities could be changed to make voluntary annuitization more attractive and how the laws regulating pensions could be changed to incentivize pension plan sponsors to offer more annuity options and to encourage employees to elect those options.

FUNDING OF PUBLIC SECTOR PENSION PLANS: WHAT CAN BE LEARNED FROM THE PRIVATE SECTOR?

ISRAEL GOLDOWITZ¹

Public pensions can be poorly funded, and, if recent events are any guide, benefit promises may be impaired in municipal bankruptcies. Experience with private-sector pension plans suggests that responsible funding is the best protection against default risk.

Studebaker's default on promised pensions inspired the 1974 federal pension reform act, ERISA. The company's pension plan was substantially underfunded when the company failed, despite periodic contributions under pre-ERISA standards. The plan's assets first paid retirees' benefits, leaving 7,000 younger workers with little to nothing in retirement. ERISA addressed this default risk through funding rules and PBGC insurance.

ERISA's minimum funding rules have not prevented pension plan failure. To the contrary, the PBGC and plan participants have absorbed some large losses. However, the funding rules remain the primary protection against default risk.

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I thank Amy Monahan, Professor at the University of Minnesota Law School, for the opportunity to present this concept at the American Law Institute's 2015 conference, *The Law and Public Pensions*, and Brendan Maher, Professor at the University of Connecticut Law School, for the opportunity to present at the Fifth Annual National Benefits & Social Insurance Conference in 2016. Professor Monahan's work is an important starting point for anyone who wants to understand the issues that affect public pensions. *E.g.*, Amy B. Monahan, *State Fiscal Constitutions and the Law and Politics of Public Pensions*, 2015 U. ILL. L. REV., 117 (2015); Thomas J. Fitzpatrick IV & Amy B. Monahan, *Who's Afraid of Good Governance? State Fiscal Crises, Public Pension Underfunding, and the Resistance to Governance Reform*, 66 FLA. L. REV. 1317 (2014). Natalya Shnitser, Assistant Professor at Boston College Law School, has done important empirical work in this area. Natalya Shnitser, *Funding Discipline for U.S. Public Pension Plans: An Empirical Analysis of Institutional Design*, 100 IOWA L. REV. 663 (2015).

I thank Sam Alberts, James Armbruster, Christopher Bone, Julie Cameron, Charles Finke, Amy Monahan, Kathryn Moore, James O'Neill, Bruce Perlin, Lawrence Rausch, Sanford Rich, Natalya Shnitser, John Turner, and Andrea Wong for their critical reading and helpful comments, and Michelle Li for her assistance with citations. Any errors are mine.

Among the strengths of ERISA's funding rules are mandatory amortization of unfunded liabilities, constraints on actuarial methods and assumptions, a variety of enforcement tools, and payment restrictions for poorly funded plans. ERISA also has robust reporting and disclosure requirements, which can help promote funding discipline.

Congress has amended ERISA's funding rules many times since 1974, as it addresses competing social and federal revenue-raising goals. Though generally sound, some changes have been ill-timed or made for the wrong reasons.

This article's thesis is that the experience under ERISA, both positive and negative, has important lessons for public plans. The article first provides a brief history of legal developments up to ERISA's enactment. It then describes ERISA's minimum standards, which include vesting and benefit accrual rules, funding standards, fiduciary standards, reporting and disclosure, and benefit insurance, but which generally do not apply to public plans. It then surveys ERISA's funding rules for both single-employer and multiemployer plans, and provides a history of those rules, showing how Congress has generally tightened the rules, though it has sometimes relaxed them. Next, it surveys other controls on funding, such as reporting and disclosure, accounting rules, and actuarial standards. Finally, it sets forth conclusions that may be of use to law reformers, among them the need for funding rules, conservative actuarial assumptions, actuarial independence, enforcement tools, transparency, and a balance between funding and benefit promises.

I. INTRODUCTION

In my tenure with the Pension Benefit Guaranty Corporation ("PBGC"), I have often seen pension plans fail that might have survived if funding rules had been stronger. Among them are plans in the steel and airline industries that were underfunded by billions of dollars.²

² PBGC is the federal agency charged with insuring private-sector defined benefit pension plans. 29 U.S.C. §1302 (2012). PBGC was established by the Employee Retirement Income Security Act of 1974, 29 U.S.C. §1001-1461. In carrying out its statutory mission, PBGC devotes much of its day-to-day attention to financially troubled sponsors of underfunded plans. For an overview, see Israel Goldowitz, Garth Wilson, Erin Kim, & Kirsten Bender, *The PBGC Wins a Case Whenever the Debtor Keeps Its Pension Plan*, 16 MARQ. BENEFITS & SOC. WELFARE

Corporate sponsors of PBGC-insured defined benefit plans have struggled with a number of adverse trends. Among them globalization of manufacturing and trade, industry obsolescence, and volatility in financial markets, and pension cost increases due to improvements in life expectancy. The decline in private sector unionization and the growth in defined contribution plans have also contributed to the steady decline in private defined benefit plans. As a result, fewer workers in the defined benefit system are supporting more retirees for longer periods. That puts an increasing burden on labor costs and, in turn, the cost of goods and services. The same pay package supports retiree healthcare in many cases.³

Some of these trends affect defined benefit pension plans for state and local employees. So the private-sector experience may be useful to those considering funding rules for public plans.

Public plans cover about 15 million employees and 10 million retirees and surviving dependents. Based on reported data and plan-specific actuarial assumptions, public plans are underfunded by more than \$1 trillion. They are 73% funded on average, and plans in Illinois, Connecticut and Kentucky less than 50% funded. The unfunded liabilities represent an average taxpayer burden of about \$3,000 per capita, with Illinois, Connecticut, and Ohio at about \$7,000.⁴

L. REV. 257 (2015), <http://scholarship.law.marquette.edu/cgi/viewcontent.cgi?article=1005&context=benefits>.

³ For another synthesis, see Ilana Boivie, NAT'L INST. ON RET. SEC., *Who Killed the Private Sector DB Plan?* (March 2011), http://www.nirsonline.org/storage/nirs/documents/Who%20Killed%20DBs%20final_-_who_killed_the_private_sector_db_plan.pdf.

⁴ Alaska leads the nation at \$11,000 per capita and Puerto Rico is close behind at \$10,000. Keith Brainard & Alex Brown, NAT'L ASSOC. OF STATE RET. ADMIN., *Public Fund Survey* ("NASRA Survey") and *id.*, APPENDIX B (Mar. 2016), <http://www.nasra.org/publicfundsurvey>; *Standard and Poor, Ratings Direct, U.S. State Pension Funding: Strong Investment Returns Could Life Funded Rations, But Longer-Term Challenges Remain* (Jun. 24, 2014), <http://www.nasra.org/Files/Topical%20Reports/Credit%20Effects/sandpstate1406.pdf>. Data are as of 2014. For accounting and funding purposes, future benefits are discounted to present value. The higher the assumed interest rate, the lower the present value. Dan M. McGill, Kyle N. Brown, John J. Haley, Sylvester J. Schieber & Mark J. Warshawsky, *Fundamentals of Private Pensions* 207-09 (9th ed. 2010). The NASRA Survey notes: "Even a small change in a plan's investment return assumption can impose a disproportionate impact on a plan's funding level and cost. For most of the Public Fund Survey's measurement period, the median investment return assumption used by public pension plans was 8.0 percent. Since 2009, a majority of plans have reduced their assumed investment return, resulting in a

In the past decade, pension obligations have been a factor in several municipal bankruptcies. Central Falls, Rhode Island, for example, negotiated a benefit reduction that in some cases exceeded 40%.⁵ Detroit negotiated a 4.5% benefit reduction, along with other benefit concessions, to resolve litigation with bondholders and present a viable plan of adjustment of its debts.⁶ Like many jurisdictions, Detroit had used aggressive interest rate assumptions to value benefit liabilities, masking the problem. Detroit had also depleted plan assets by paying a “13th check” during flush times and overstating the earnings transferred to commonly managed annuity accounts.⁷ Stockton, California, sought to withdraw from the California Public Employees Retirement System (“CalPERS”), but eventually decided against it.⁸

reduction to the median return assumption to 7.75 percent.” *Id.*, Figure N. “Asset smoothing,” i.e., averaging of returns, can also have a significant effect. See Mary Williams Walsh & Michael Cooper, *New York Gets Sobering Look at Its Pensions*, N.Y. TIMES (Aug. 20, 2006), <http://www.nytimes.com/2006/08/20/nyregion/20pension.html>.

⁵ Mary Williams Walsh, *Cuts for the Already Retired*, N.Y. TIMES (Dec. 19, 2011), <http://www.nytimes.com/2011/12/20/business/pension-deal-in-rhode-island-could-set-a-trend.html>. W. Zachary Malinowski, *Chafee Signs Law Giving Retired Central Falls Police, Firefighters Pension Supplement*, PROVIDENCE J. (Aug. 27, 2014), <http://www.providencejournal.com/article/20140827/News/308279896> (noting that the state later enacted legislation to restore up to 75% of the original amounts).

⁶ Susan Tompor, *Detroit Retirees to See Pension Cuts Starting Monday*, DETROIT FREE PRESS (Mar. 2, 2015), <http://www.freep.com/story/money/personal-finance/susan-tompor/2015/02/27/detroit-orr-pension-checks-cuts/24144513>. INTERNAL REVENUE SERV., *Internal Revenue Manual*, § 7.11.6.6.11 (Sept. 18, 2015), https://www.irs.gov/irm/part7/irm_07-011-006.html (noting in the private sector, if a plan “is amended on a regular basis to provide for thirteenth checks..., the series of amendments may give rise to an expectation of such payments and be subject to protection as an accrued benefit...”).

⁷ NATHAN BOMEY, *DETROIT RESURRECTED: TO BANKRUPTCY AND BACK* 52-57, 157-61 (W.W. Norton & Co. 2016).

⁸ Marc Lifsher and Melody Peterson, *Judge Approves Stockton Bankruptcy Plan; Worker Pensions Safe*, L.A. TIMES (Oct. 30, 2014), <http://www.latimes.com/business/la-fi-stockton-pension-court-ruling-cuts-20141029-story.html>; *In re City of Stockton, California*, 526 B.R. 35 (Bankr. E.D. Cal. 2015) (city authorized to reject its contract with CalPERS and to avoid a statutory “termination lien” for pension underfunding under the Bankruptcy Code, which preempts contrary state law); *Id.* (noting CalPERS is apparently an “agent” rather than “cost-sharing multiple-employer plan,” with common administration of separate plans for

Outside bankruptcy, courts are generally more protective of public employees' pension benefits. For example, the Illinois Supreme Court recently held that Chicago cannot reduce cost-of-living adjustments despite requiring increased contributions and providing administrative and judicial remedies, thereby putting pensions on a sounder financial footing for a greater "net benefit." "[M]embers of the Funds already have a legally enforceable right to receive the benefits they have been promised" under the State Constitution, the Court held. "By offering a purported 'offsetting benefit' of actuarially sound funding and solvency in the Funds, the legislation merely offers participants in those funds what is already guaranteed to them—payment of the pension benefits in place when they joined the fund."⁹

Pension funding issues, of course, exist in a larger context of budget politics.¹⁰ To avoid statutory borrowing limits, Detroit set up remote entities to finance pension debt, collateralized the debt with casino tax revenues, and tacked on default insurance and interest-rate swaps.¹¹ The Chicago "net benefit" proposal was designed to avoid a property tax increase.¹² New Jersey's governor declined to follow a law that required inclusion of an

participating employers rather than a single risk pool); see Shnitser, *supra* note 1, at 688-89.

⁹ Jones v. Mun. Employees' Annuity & Benefit Fund of Chicago, 50 N.E.3d 596, 607 (Ill. 2016) (internal quotations omitted).

¹⁰ See STATE BUDGET CRISIS TASK FORCE, Full Report (2012), <http://www.statebudgetcrisis.org>. For an influential report focused on public pensions, see Donald J. Boyd & Pieter J. Kiernan, *Strengthening the Security of Public Sector Defined Benefit Plans*, THE NELSON A. ROCKEFELLER INST. OF GOV'T (St. U. of N.Y. ed., 2014), http://www.rockinst.org/pdf/government_finance/2014-01-Blinken_Report_One.pdf.

¹¹ The arrangement was undone in a bankruptcy settlement. Bomey, *supra* note 7, at 23-30, 92-112.

¹² Monica Davey and Mary Williams Walsh, *Pensions and Politics Fuel Crisis in Illinois*, N.Y. TIMES (May 25, 2015), <http://www.nytimes.com/2015/05/26/us/politics/illinois-pension-crisis.html>. Chicago continues to struggle, with a new valuation more than doubling the shortfall of its Municipal Employees' Annuity and Benefit Fund, Elizabeth Campbell, *Chicago's Pension-Fund Woes Just Became \$11.5 Billion Bigger*, BLOOMBERG (May 19, 2015), <http://www.bloomberg.com/news/articles/2016-05-19/chicago-s-pension-fund-troubles-just-became-11-5-billion-bigger>, and the legislature overriding a veto of a funding relief bill for the uniformed services plan. Elizabeth Campbell, *Illinois Lawmakers Override Veto of Chicago Pension Break*, BLOOMBERG (May 30, 2016), <http://www.bloomberg.com/news/articles/2016-05-30/illinois-senate-moves-to-override-veto-of-chicago-pension-break>.

actuarially determined “minimum required contribution” as a line item in annual appropriation acts and conferred a contract right on plan members to that contribution. The State Supreme Court agreed—“The Debt Limitation Clause of the State Constitution interdicts the creation . . . of a legally binding enforceable contract compelling multi-year financial payments in the sizable amounts” at issue.¹³

Cities have sold or pledged assets to fund pension costs. Detroit’s “grand bargain” included a purchase of the Detroit Institute of Art’s collection by national and local charitable foundations.¹⁴ Chicago and other cities have pledged future parking meter revenues.¹⁵ And Scranton, Pennsylvania, recently monetized its sewer system in part to pay down its pension shortfall.¹⁶

Pensions, in short, represent a major challenge for state and municipal finance.¹⁷ The concern extends to U.S. territories. In June 2016, Congress enacted the Puerto Rico Oversight, Management, and Economic

¹³ *Burgos v. State of New Jersey*, 118 A.3d 270, 274-75 (N.J. 2015). Later, condemning “accounting gimmickry,” the governor vetoed a bill calling for quarterly and supplemental pension contributions. Christopher Baxter, *Christie Vetoes Quarterly N.J. Pension Payments Bill, \$300M 'Pre-payment'*, NJ.COM (Aug. 10, 2015), http://www.nj.com/politics/index.ssf/2015/08/christie_vetoes_quarterly_nj_pension_payments_bill.html.

¹⁴ Jordan Weissman, *Detroit Exits Bankruptcy, Thanks to Its Art Museum*, SLATE (Nov. 7, 2014), http://www.slate.com/blogs/moneybox/2014/11/07/detroit_exits_bankruptcy_city_s_pensions_saved_in_part_thanks_to_detroit.html. Some doubt that this could be a template for other cities. Michael J. Bologna, *Would Detroit's 'Grand Bargain' Work in Chicago?*, BLOOMBERGBNA (May 6, 2016), <http://www.bna.com/detroits-grand-bargain-n57982070754/>. The bargain was upheld under the doctrine of equitable mootness—which prevents appellate courts from “unscrambling complex bankruptcy reorganizations.” *Ochadlus v City of Detroit* (In re City of Detroit), 838 F.3d 792 (6th Cir, 2016) (citations omitted).

¹⁵ Donald Cohen, *Cities Need to Weigh Costs of Private Partnerships*, N.Y. TIMES, (Jul. 23, 2013), <http://dealbook.nytimes.com/2013/07/23/cities-need-to-weigh-costs-of-private-partnerships/>.

¹⁶ Terrie Morgan-Besecker, *Sewer Sale Could Save Scranton Pensions*, SCRANTON TIMES-TRIB. (Dec. 10, 2015), <http://thetimes-tribune.com/news/sewer-sale-could-save-scranton-pensions-1.1981682>.

¹⁷ See generally, James E. Spiotto, *How Municipalities in Financial Distress Should Deal with Unfunded Pension Obligations and Appropriate Funding of Essential Services*, 50 WILLAMETTE L. REV. 515 (2014); Alicia H. Munnell & Jean-Pierre Aubry, *Will Pensions and OPEBs Break State and Local Budgets?*, CTR. FOR RETIREMENT RES. AT B.C. (Oct. 2016), http://crr.bc.edu/wp-content/uploads/2016/10/slp_51-1.pdf.

Stability Act (“PROMESA”), establishing an Oversight Board to restructure the island’s \$72 billion in debt and balance its budget. PROMESA requires an actuarial study of territorial pensions, but not a compromise of pensions as part of a restructuring plan.¹⁸ Even the pension plan for Marianas Island employees briefly found shelter in bankruptcy until the case was dismissed on jurisdictional grounds.¹⁹

To be sure, many public plans are reasonably well funded, at least under stated assumptions.²⁰ In some cases, they survived a larger financial crisis. In 1976, New York State imposed a Financial Control Board with a majority of members appointed by the Governor as a condition of rescuing New York City’s finances.²¹ The Board remains in place and retains certain

¹⁸ Puerto Rico Oversight, Management, and Economic Stability Act, S. 2328, 114th Cong. § 211 (2016) (noting PROMESA authorizes the Oversight Board to conduct an actuarial analysis of any underfunded territorial pension plan to aid “in evaluating the fiscal and economic impact of the pension cash flows... [such an analysis would include] (1) an actuarial study of the pension liabilities and funding strategy that includes a forward looking projection of payments of at least 30 years of benefit payments and funding strategy to cover such payments; (2) sources of funding to cover such payments; (3) a review of the existing benefits and their sustainability; and (4) a review of the system’s legal structure and operational arrangements, and any other studies of the pension system the Oversight Board shall deem necessary.”) Peter Roff, *A Bad Bailout for Puerto Rico*, U.S. NEWS & WORLD REP. (May 26, 2016), <http://www.usnews.com/opinion/articles/2016-05-26/house-bill-promesa-that-grants-bailout-to-puerto-rico-rips-off-bondholders> (“Puerto Rico’s general obligation bonds . . . would [] take a back seat to Puerto Rico’s almost totally underfunded \$46 billion public pension system”). Puerto Rico’s pension system is described in Nick Brown, *Puerto Rico’s Other Crisis: Impoverished Pensions*, REUTERS (Apr. 7, 2016), <http://www.reuters.com/investigates/special-report/usa-puertorico-pensions>. A recent audit indicates that Puerto Rico’s Employees’ Retirement System, with a reported \$30 billion in liabilities, will run out of money within a year. Michelle Kaske, *Puerto Rico Pension Risks Insolvency Next Year, Audit Says*, BLOOMBERG (Jun. 3, 2016), <http://www.bloomberg.com/news/articles/2016-06-02/puerto-rico-pension-plan-risks-insolvency-next-year-audit-says>.

¹⁹ Caitlin Kenney, *Judge Says Pension Fund Can’t Seek Bankruptcy Protection*, NPR (Jun. 5, 2012), <http://www.npr.org/sections/money/2012/06/05/154302347/judge-says-pension-fund-cant-seek-bankruptcy-protection>.

²⁰ Brainard & Brown, *supra* note 4.

²¹ CONG. BUDGET OFF., *The Causes of New York City’s Fiscal Crisis 1975*, 90 POL. SCI. Q. 659 (Winter 1975-76); Roger Dunstan, CAL. RES. BUREAU, CAL. STATE LIBR., *Overview of New York City’s Fiscal Crisis* (1995), <http://www.library.ca.gov/crb/95/notes/v3n1.pdf>. As part of the compromise, the City teachers’ pension fund bought bonds of the Municipal Assistance Corporation,

oversight duties.²² New York City's pensions have respectable funding ratios, though hardly strong ones.²³ As part of the federal rescue of the District of Columbia's finances in 1997, Congress had the federal government takeover \$4.8 billion in unfunded pension liability for DC police, firefighters, teachers, and judges; froze the plans; adopted an amortization schedule; and authorized replacement plans. The new plans were required to be funded under standards borrowed from ERISA as then in effect. These plans have strong funding ratios.²⁴

II. OVERVIEW OF FEDERAL PENSION LAW

ERISA governs private-sector employee benefit plans.²⁵ ERISA sets minimum standards for participation, vesting, benefit accrual, funding, fiduciary conduct, and reporting and disclosure. ERISA also established PBGC to insure benefits under failed defined benefit plans.²⁶

which was formed to provide the City with emergency financing. Eric Jaffe, CITYLAB, *The Time the Teachers' Union Saved New York from Bankruptcy* (July 24, 2013), <http://www.citylab.com/work/2013/07/time-teachers-union-save-new-york-city-bankruptcy/6306>.

²² STATE OF N.Y., FIN. CONTROL BD., MISSION STATEMENT, <http://www.fcb.state.ny.us> ("During sunset, the Control Board must review the four-year financial plan at least quarterly, and must notify the City if a plan or modification to the financial plan does not conform to the Act's standards. In addition, the Control Board must make a determination annually whether a new control period . . . should be declared").

²³ New York City's two largest pension plans have funding ratios of 58% and 70%. The statewide plans have ratios greater than 90 percent. NASRA, PUBLIC FUND SURVEY, APPENDIX B, *supra* note 4. The State's budget process can obscure the facts, however, and pension funding is no exception. RICHARD RAVITCH, SO MUCH TO DO: A FULL LIFE OF BUSINESS, POLITICS, AND CONFRONTING FISCAL CRISES 215-16 (2014) (contribution of promissory notes under the guise of "pension smoothing").

²⁴ Balanced Budget Act of 1997, Pub. L. No. 105-33, §§11001-11087, 111 Stat. 251, 715-31 (1997). See EDWIN C. HUSTEAD, PENSIONS IN THE PUBLIC SECTOR 354-362 (Olivia S. Mitchell and Edwin C. Husted, eds. 2001). Those plans now have 89-percent and 107-percent funding ratios. NASRA, *supra* note 4.

²⁵ 29 U.S.C. §§ 1001-1453 (2014). ERISA exempts governmental plans. 26 U.S.C. § 414(d) (2015); 29 U.S.C. §§ 1003(b)(1) (2002), 1321(b)(2) (2008).

²⁶ 29 U.S.C. §§ 1301-1453. A defined benefit plan is one that promises a benefit based on a formula, typically a percentage of final pay times years of service. 29 USC § 1002(35) (2008). Because the benefit is due regardless of the plan's funding

The House Ways and Means Committee, one of the committees of jurisdiction, saw responsible funding as the main protection for vested benefits under such plans— “Without adequate funding, a promise of a pension may be illusory and empty.” Moreover, “[t]o create a plan termination insurance program without appropriate funding standards would permit those who present the greatest risk in terms of exposure to benefit at the expense of employers who have developed conscientious funding programs.”²⁷

A. HISTORY OF PENSION REGULATION

Pensions were originally a workforce management tool.²⁸ A trained workforce is a valuable asset. But pay increases as worker’s advance, and workers wear out as they age, especially in industrial jobs. So at some point, it makes sense to replace older workers. By giving older workers an incentive to retire and new hires an incentive to stay, pensions help to manage turnover.

The first pensions were for the military. Private pensions were first introduced by steel companies, railroads, and public utilities in the late 19th Century. Pensions for federal civilian employees and state and local employees are mainly a 20th Century development.²⁹

State courts initially saw pensions as gratuities, and unenforceable.³⁰ A few courts saw a pension promise as an offer of a unilateral contract—promise for performance—to a class of persons. For example, if an employer promises anyone who works 20 years and reaches age 65 a pension of one-

status, investment risk is on the employer. *See, e.g.*, *Hughes Aircraft Co. v. Jacobson*, 525 U.S. 432, 439-40 (1999).

²⁷ H.R. REP. NO. 93-533 at 7, 14 (1973), *reprinted in* 1974 U.S.C.C.A.N. 4639, 4645, 4652.

²⁸ LAWRENCE A. FROLIK & KATHRYN L. MOORE, *LAW OF EMPLOYEE PENSION AND WELFARE BENEFITS* 7 (3d ed. 2012) (citing MERTON C. BERNSTEIN, *THE FUTURE OF PRIVATE PENSIONS* 10 (1964)).

²⁹ ROBERT L. CLARK, LEE A. CRAIG, & JACK W. WILSON, *PENSION RESEARCH COUNCIL, A HISTORY OF PUBLIC SECTOR PENSIONS IN THE UNITED STATES* (U. Penn. Press ed. 2003), <http://www.pensionresearchcouncil.org/publications/pdf/0-8122-3714-5-1.pdf>; JEFFREY LEWIS, MYRON D. RUMELT, & IVELISSE BERIO LEBEAU, *EMPLOYEE BENEFITS LAW 1-1* (3d ed. 2012); David Gregory, *The Scope of ERISA Preemption of State Law: A Study of Effective Federalism*, 48 U. PITT. L. REV. 427, 438 (1987).

³⁰ *E.g.*, *McNevin v. Solvay Process Co.*, 32 A.D. 610 (N.Y. App. Div. 1898), *aff’d per curiam*, 60 N.E. 1115 (N.Y. 1901), cited in Gregory, *supra* note 29.

third of her final pay for life, any member of the class who meets these conditions would have a contractual right to a pension.³¹

A worker rights theory mainly emerged in other forums. For example, the Internal Revenue Service (“IRS”) developed a theory of vesting in plan assets when a plan terminates (or when a major downsizing can be considered a termination for affected employees).³² The IRS administers the rules that allow pension plans to be tax-qualified. Employer contributions to a qualified plan are tax deductible, the plan’s earnings are not taxed, and employees are taxed only on their distributions.³³ No employer wants its plan to be disqualified, given the substantial tax benefits at stake.

The Labor-Management Relations Act, 1947 (“LMRA”), altered the balance of power between management and labor, and included pension provisions. Some unions had negotiated pension and health benefit plans funded by employers. Congress required that the money be held in trust, that contributions be governed by a written agreement, and that the trust be administered by equal numbers of employer and union appointees.³⁴ In light of these requirements, some courts held that if the trustees changed the eligibility rules and did so arbitrarily, they could be compelled to honor the prior rules.³⁵

³¹ See *Wickstrom v. Vern E. Alden Co.*, 240 N.E. 2d 401 (Ill. App. Ct. 1968) (early retirement offer), cited in 1-3 Corbin on Contracts § 3.16 (2006). An example well-known to lawyers is *Carlill v. Carbolic Smoke Ball Company*, 1 QB 256 (1893). A vendor put an ad in a newspaper saying that anyone who bought this contraption and inhaled its vapors and still contracted the flu would be paid 100 pounds. The court held that this was an offer to a class and that any member of the class who met the conditions had accepted the offer and held an enforceable right to payment.

³² Isidore Goodman, *Developing Pension and Profit-Sharing Requisites*, 13 SANTA CLARA L. REV. 1, 20-21 (1972). See *In re Gulf Pension Litig.*, 764 F. Supp. 1149 (S.D. Tex. 1991). See also Lewis, *supra* note 29, at 1-5 (Tax Code’s “exclusive benefit” rule was designed to curb deductions for amounts subject to recapture by revocation of pension trust, but also to encourage formation of trusts on which employees can rely for retirement income); 26 U.S.C. § 411(d)(3) (2014).

³³ 29 U.S.C. §§ 401(a), 402(a), 501(a).

³⁴ As trustees, those appointees serve as fiduciaries, not collective bargaining representatives. *NLRB v. Amax Coal Co.*, 453 U.S. 322 (1981).

³⁵ See *Danti v. Lewis*, 312 F.2d 345, 348 n.3 (D.C. Cir. 1962) (“[the] authorities are divided as to whether an applicant for a pension has a contractual interest in the Fund as a third party beneficiary to the Wage Agreement, or whether his interest is merely equitable and conditioned on meeting the eligibility requirements reasonably established by the Trustees. Since our view of the present case does not require a determination of this controversy, we express no opinion on it.”).

In 1948, the National Labor Relations Board held that pensions are among the terms and conditions of employment, and, as such, a mandatory subject of collective bargaining.³⁶ In 1958, Congress enacted the Welfare and Pension Plans Disclosure Act,³⁷ which required all employee benefit plans to file an annual report with the Department of Labor. But there was no comprehensive federal law until ERISA.

B. ERISA'S MINIMUM STANDARDS

ERISA's minimum standards codify an understanding that pensions are deferred compensation for services rendered.³⁸ Among its key features, ERISA:

- requires that employees be allowed to participate in a plan after a minimal length of service;
- requires that benefits vest within a reasonable period, so employees do not forfeit their rights if they go to work elsewhere, become disabled, or retire early;
- requires that a surviving spouse receive a benefit, to protect non-working spouses;
- provides that accrued benefits generally cannot be reduced;
- requires that defined benefit plans be advance funded;
- imposes minimum standards of prudence and loyalty on plan fiduciaries, and prohibits self-dealing;
- requires annual financial reporting, and plain-English disclosure of plan terms;
- provides for federal insurance of defined benefit pension plans if they terminate (single-employer plans) or become insolvent (multiemployer plans);
- authorizes the Labor Department and plan participants to enforce the minimum standards;

³⁶ *Inland Steel Co. v. NLRB*, 170 F.2d 247 (7th Cir. 1948) (noting that a failure to bargain in good faith on the terms and condition of employment is an unfair labor practice). 29 U.S.C. § 158(a)(5); *NLRB v. Katz*, 369 U.S. 736 (1962).

³⁷ Welfare and Pensions Plans Disclosure Act, Pub. L. No. 85-836, 72 Stat. 997 (1958).

³⁸ 29 U.S.C. §§ 1001(a), 1001(b) (“...the continued well-being and security of millions of employees and their dependents are directly affected by [employee benefit] plans... [ERISA’s declared policy is to] protect interstate commerce and the interests of participants in employee benefit plans and their beneficiaries . . .”).

- broadly preempts State law as it relates to employee benefit plans; and
- opens the federal courts to benefit claims.³⁹

Like all legislation, however, ERISA represents a compromise. In the first place, ERISA does not require an employer to have a plan. Nor did Congress want to deter employers from establishing or continuing plans by making them too expensive.⁴⁰ Thus, for instance, ERISA does not require immediate vesting.⁴¹ Most important for our purpose, ERISA does not require that benefits be fully funded. Rather, it allows a funding shortfall to be amortized over a period of years.⁴²

ERISA's minimum standards are found in the Labor title of the U.S. Code (Title 29) as positive law. Thus, for example, the vesting and anti-cutback rules are enforceable in court.⁴³ The minimum standards are also found in the Internal Revenue Code (Title 26), mainly as conditions of tax qualification. To enjoy favorable tax treatment, an employer must (for example) ensure that its plan meets the vesting and anti-cutback

³⁹ 29 U.S.C. §§ 1021-25, 1052-55, 1082-85(a), 1102-11, 1114(a), 1132, 1301-1453.

⁴⁰ See H.R. REP. NO. 93-533 *supra* note 27, at 9 (“The Committee believes that the legislative approach of establishing minimum standards and safeguards for private pensions is not only consistent with retention of the freedom of decision-making vital to pension plans, but in furtherance of the growth and development of the private pension system.”).

⁴¹ Compare 29 U.S.C. § 1053(a) (1976) (permitting employers to use ten-year “cliff” vesting under defined benefit plans; an employee was not vested at all until after ten years of participation, and then became 100% vested) with 29 U.S.C. § 1053(a) (2000) (mandating five-year cliff vesting).

⁴² See *infra* p.16 (noting ERISA initially provided for a series of charges and credits to a “funding standard account,” each to be amortized over a period that in some cases was as long as 30 years. Under current law, there is a single “shortfall,” generally amortized over seven years.) See James Wooten, “*The Most Glorious Story of Failure in the Business*”: *The Studebaker-Packard Corporation and the Origins of ERISA*, 49 BUFF. L. REV. 683, 700-01 (2001) (noting Pension plans generally begin life with a significant unfunded past service liability, as they usually grant credit for service with the employer before it established the plan. Otherwise, at least in a unionized workplace, senior employees might prefer to forgo pensions in favor of larger paychecks.); Malcolm Gladwell, *The Risk Pool*, THE NEW YORKER (Aug. 28, 2006), <http://www.newyorker.com/magazine/2006/08/28/the-risk-pool>.

⁴³ E.g., *Cent. Laborers Pension Fund v. Heinz*, 541 U.S. 739 (2004).

requirements.⁴⁴ By Executive Order, President Carter allocated primary authority between the Department of Labor and the Department of Treasury/Internal Revenue Service. Treasury/IRS has primary authority over the funding rules.⁴⁵

Because qualified plans are tax advantaged, Congress has historically used the qualification rules to promote broader pension coverage and other pension policy goals. For example, the Tax Code nondiscrimination rules, introduced by the Revenue Act of 1942, are designed to ensure that rank-and-file workers get some of the benefits that top management does.⁴⁶ But fiscal concerns have also led Congress to adjust the funding rules to reduce deductible contributions, so as to raise revenue or permit a spending bill to “erore” well.⁴⁷

C. PENSION INSURANCE UNDER ERISA

The rallying cry for pension reform was the failure of the Studebaker Company. The automaker was unable to compete with GM, Ford and Chrysler, and it was forced to liquidate in 1963. Studebaker had a defined benefit plan with a formula similar to the ones at the Big Three. As was

⁴⁴ 26 U.S.C. § 4971 (2014) (noting the funding rules, however, are not conditions of tax qualification. The IRS enforces funding by assessing excise taxes, 10% of the annual shortfall, and 100% if the shortfall is not made up.); 26 U.S.C. § 430(k) (2015) (noting PBGC also enforces the funding rules by perfecting and enforcing liens when contributions of more than \$1 million are delinquent).

⁴⁵ Reorganization Plan No. 4 of 1978, *reprinted* in 43 Fed. Reg. 47,713 (Oct. 17, 1978); *See Panel 3: Negotiating the Agency Peace Treaty: Reorganization Plan No. 4*, 6 DREXEL L. REV. 319-39 (Spring 2014). (For a discussion of the administration of ERISA in its infancy).

⁴⁶ Another purpose of the nondiscrimination rules, though, was to prevent tax evasion by firms seeking to shelter executives' compensation. The 1942 nondiscrimination provision was “particularly anemic.” Not surprisingly, the main purpose of the bill was to “extract the maximum contribution from taxpayers . . . during the austere and expensive years of the Second World War.” *See* Madeline Sexton Lewis, *The Legislative History of the Nondiscrimination Provision of Qualified Retirement Plans*, 2014-7 N.Y.U. REV. EMP. BENEFITS § 7.03 & 7.04 (2015) (Alvin D. Lurie ed., 2015).

⁴⁷ *See* Alan Cole, *The Highway Bill "Pension Gimmick": A Primer*, The Tax Policy Blog (Jul 15, 2014), <http://taxfoundation.org/blog/highway-bill-pension-gimmick-primer>; *See generally*, Lewis, *supra* note 30, at 1-12 (in the 1980s and early 1990s, “retirement income policy took a back seat to revenue-driven exigencies of budget deficit politics,” and it was not until the economic boom of the mid-1990s that Congress would refocus on retirement income policy.)

common, the plan document provided that plan assets would first be allocated to the benefits of retirees. Retirees' benefits were fully funded, but 4,000 vested employees between ages 40 and 60 got only 15% of what they were promised. Two thousand nine hundred under age forty got nothing.⁴⁸ That squarely presented the problem of default risk.⁴⁹

Federal insurance became the solution. Originally deemed "reinsurance," pension insurance was the brainchild of the United Auto Workers.⁵⁰ PBGC was largely modeled on the Federal Deposit Insurance Corporation.⁵¹ Thus, for example, pension insurance is mandatory for covered plans.⁵² And there are limits that serve as a form of co-insurance.⁵³

PBGC guarantees benefits under single-employer plans and (since 1980 amendments) multiemployer plans.⁵⁴ The insurable event for a single-

⁴⁸ Wooten, *supra* note 42, at 731.

⁴⁹ *Id.*

⁵⁰ Wooten, *supra* note 42, at 716-17. On reinsurance generally, see Marcus A. Mendoza, *Reinsurance as Governance: Governmental Risk Management Pools as a Case Study in the Governance Role Played by Reinsurance Institutions*, 21 CONN. INS. L. J. 53 (2014).

⁵¹ 120 CONG. REC. S29950 (daily ed. Aug. 22, 1974) (statement of Sen. Bentsen).

⁵² 29 U.S.C. § 1306(a), (c) (2016).

⁵³ Richard A. Ippolito, *The Economics of Pension Insurance* 21-24, 37-38 (1989) (One might loosely analogize PBGC to financial guarantee, or monoline, insurance. Monoline insurers typically backstop municipal bonds or mortgage obligations). See J.M. Pimbley, *Bond Insurers*, 22 J. OF APPLIED FIN. 35 (Spring/Summer 2012), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2689888; Sebastian Schich, *Challenges Related to Financial Guarantee Insurance*, 2008 FIN. MARKET TRENDS 81 (Jun. 2008) (State laws confine them to that line of business, hence the term "monoline." Like a monoline insurer, PBGC insures against a third party's default. And because the third-party obligations are homogeneous, the risk is not diversified. Telephone conversation with Christopher Anderson, Principal, Anderson Insights, Inc. (May 9, 2016).

⁵⁴ For single-employer plans, the maximum guaranteed amount is about \$60,000 per year at age 65. For multiemployer plans, the guarantee is much lower. The maximum is a function of the participant's service and the benefit accrual rate under the plan, e.g., about \$13,000 per year with 30 years of service, \$8,600 per year with 20 years of service, and so on. The guaranty of benefit increases is phased in over five years for single-employer plans, but benefit increases under multiemployer plans are not guaranteed at all if they are less than five-years old. Premiums for single-employer plans are \$64 per participant per year, plus \$30 per \$1,000 of unfunded vested benefits, with scheduled increases to \$80 and \$41, respectively, by 2019. For multiemployer plans, premiums are \$27 per participant per year. The

employer plan is plan termination.⁵⁵ A plan sponsor can terminate an underfunded single-employer plan only if it demonstrates financial distress—liquidation in bankruptcy or inability to reorganize in bankruptcy or to continue in business unless it sheds its pension plan. PBGC can initiate termination if a plan fails ERISA’s minimum funding standard, if it will be unable to pay benefits when due, or if PBGC’s long-run loss may increase unreasonably if the plan is not terminated (for instance, if the sale of a profitable subsidiary would lessen the employer’s ability to fund the plan).⁵⁶

On termination of an underfunded plan, PBGC becomes trustee, taking over the plan’s assets and its obligations. When a plan terminates, the employer is liable to PBGC for the difference between the plan’s benefit liabilities and its assets.⁵⁷ Employer liability is meant to keep plan sponsors from promising benefits they cannot afford, thereby shifting the financial burden to the insurance program and to other sponsors whose premiums support the program.⁵⁸ A PBGC regulation provides that liabilities are valued using surveys of closeout annuity prices. The regulation uses a constant mortality factor, so the higher the surveyed price the lower the interest factor.⁵⁹ The employer is also liable to the agency for any unpaid contributions, and for an exit fee known as a termination premium.⁶⁰ PBGC has taken in more than 4,000 single-employer plans, and its single-employer insurance fund has a \$24 billion deficit.⁶¹

premium rates are indexed for inflation. 29 U.S.C §§ 1306, 1322, 1322A. PBGC is financed by premiums, assets of terminated plans, recovery on claims, and investment earnings. 2015 PBGC ANN. REP. 10, <http://www.pbgc.gov/Documents/2015-annual-report.pdf>.

⁵⁵ 29 U.S.C. § 1361 (2016).

⁵⁶ 29 U.S.C. §§ 1341(c), 1342(a) (2016). ERISA makes all 80% commonly owned corporations or unincorporated businesses (a “controlled group”) jointly and severally liable for pension contributions. 26 U.S.C. §§ 412(b)(2), 414(b), (c), 26 C.F.R. §§ 1.414(b)(1), 1.414(c)-1-(c)-5 (2016). The controlled group is also liable to PBGC for the obligations described in nn. 59, 62, and to multiemployer plans for those described in nn. 67-68, post. 29 U.S.C. §§ 1301(a)(14), 1301(b)(1), 1362(a), 29 C.F.R. § 4001.2 (2016).

⁵⁷ 29 U.S.C. §§ 1301(a)(18), 1362(c) (2016).

⁵⁸ S. REP. NO 93-383, at 87 (1973), *reprinted in* 1974 U.S.C.C.A.N. 4971.

⁵⁹ 29 C.F.R. §§ 4044.41-.75 (2016); 70 Fed. Reg. 72,205 (Dec. 2, 2005) (*codified as* 29 C.F.R. pt. 4044).

⁶⁰ 29 U.S.C. §§ 1306(a)(7), 1362(b) (2016).

⁶¹ 2015 PBGC ANN REP., *supra* note 54, at 23. PBGC is not backed by the full faith and credit of the United States. *See id.* at 10.

Multiemployer plans can terminate, by mass withdrawal or by plan amendment.⁶² The insurable event, however, is insolvency, the inability to pay benefits in a given year.⁶³ PBGC doesn't become trustee of multiemployer plans, but provides them with financial assistance to pay benefits at the guaranteed level.⁶⁴

Multiemployer plans spread the risk of business failure. When an employer withdraws, by going non-union or ceasing business, it incurs withdrawal liability for its share of the plan's unfunded vested benefits.⁶⁵ It pays that liability in installments designed to approximate its contributions at their highest point.⁶⁶ Withdrawal liability is meant to slow the "vicious downward spiral" when employers start to abandon a troubled plan. It does that by neutralizing incentives to withdraw, shoring up plans affected by withdrawals, and keeping faith with remaining employers.⁶⁷ Nevertheless, PBGC provides financial assistance to more than 50 insolvent plans, and its multiemployer insurance fund has a \$52 billion deficit.⁶⁸

D. EXEMPTION OF PUBLIC PLANS FROM ERISA

Congress exempted state and local plans from ERISA's vesting, funding, and insurance regimes. Congress had several reasons including:

- public plans' vesting provisions were then more generous than those of private plans;
- "the ability of the governmental entities to fulfill their obligations to employees through their taxing powers was an adequate substitute for both minimum funding standards and plan termination insurance"⁶⁹; and

⁶² 29 U.S.C. § 1341A (2016).

⁶³ 29 U.S.C. § 1426 (2016).

⁶⁴ 29 U.S.C. § 1322A, 1431 (2016).

⁶⁵ 29 U.S.C. § 1381 (2016).

⁶⁶ 29 U.S.C. § 1399(c)(1) (2016).

⁶⁷ On the characteristics of multiemployer plans and withdrawal liability, *See* Jayne E. Zanglein et al., *Erisa Litigation* 1393-95, 1407-13 (5th ed. 2014 and 2015 Supp.).

⁶⁸ 2015 PBGC ANN REP., *supra* note 54, at 3, 23.

⁶⁹ *Rose v. Long Island R. Pension Plan*, 828 F.2d 910, 914 (2d Cir. 1987) (internal quotations and citations omitted).

- “imposition of the minimum funding and other standards would entail unacceptable cost implications to governmental entities.”⁷⁰

Congress also did not want to intrude on areas of state concerns. For example, the House Committee on Education and Labor report stated:

There are literally thousands of public employee retirement systems operated by towns, counties, authorities and cities in addition to the state and Federal plans. Eligibility, vesting, and funding provisions are at least as diverse as those in the private sector with the added uniqueness added by the legislative process. For this reason the Committee is convinced that additional data and study is necessary before any attempt is made to address the issues of vesting and funding with respect to public plans.⁷¹

On the other hand, some were concerned that public pensions were so generous that it was unlikely that adequate taxes would be allocated to them. Congressman John Erlenborn of Illinois, for example, noted that lawsuits in Philadelphia, Detroit, and Illinois were seeking to compel funding in amounts that ranged from \$18 million to \$1.7 billion.⁷²

Congress commissioned a study to determine "the necessity for Federal legislation and standards with respect to such plans."⁷³ In 1978, the House Committee on Education and Labor issued a Pension Task Force Report on Public Employee Retirement Systems. The Report found that plan members, government officials, and the general public were kept in the dark about the true costs of public pensions, and that there was compelling need

⁷⁰ *Id.*

⁷¹ *Id.*; See also *Younger v. Harris*, 401 U.S. 37, 44 (1971) (Three years earlier, the Supreme Court had emphasized “Our Federalism,” a “system in which there is sensitivity to the legitimate interests of both State and National Governments.”); *National League of Cities v. Usery*, 426 U.S. 833 (1976), *overruled*, *Garcia v. San Antonio Metropolitan Transit Authority*, 469 U.S. 528 (1985) (The Court held that the Tenth Amendment prevents the national government from imposing minimum wages on local government employees based on the reach of the Commerce Clause); See generally Heather K. Gerken, *Our Federalism(s)*, 53 WM. & MARY L. REV. 1549 (2012) (Federalism enjoyed another revival in the last decade).

⁷² H.R. REP. NO. 93-533, at 43 (1974), *reprinted in* 1974 U.S.C.C.A.N. 4667-68.

⁷³ 29 U.S.C. § 1231(a)(3) (2016).

for uniform actuarial measures to assess their funding requirements. The Report also found serious deficiencies in reporting and disclosure, and a need for fiduciary standards.⁷⁴

Bills were regularly introduced after ERISA was passed to establish minimum reporting, disclosure, and fiduciary standards for public plans. Initially dubbed “PERISA,” later versions were called “PEPPRA”—the Public Employee Pension Plan Reporting and Accountability Act—to reflect their more limited scope.⁷⁵ No such bill was ever enacted.

III. FEDERAL MINIMUM FUNDING STANDARDS

ERISA and the Internal Revenue Code set minimum funding standards for defined benefit plans. The initial standards were a significant improvement on pre-ERISA law. The standards were strengthened over two decades, including limits on actuarial discretion, shorter amortization periods, better enforcement tools, and stricter rules for poorly funded plans. More recently, some of the standards were relaxed.

A. SINGLE-EMPLOYER PLANS

A plan sponsor must make an annual contribution. To determine the annual contribution, the plan actuary will first calculate the “funding target,” or the present value of plan benefits at the beginning of the year. From the funding target, she will subtract the value of plan assets, to derive the “shortfall.” Next, she will set up a schedule to amortize the shortfall over seven years, netting out unamortized charges from prior years, to derive the “shortfall amortization charge.” The actuary will also calculate “normal cost,” or the present value of benefits expected to be earned in the year plus an estimate of expenses in the year.⁷⁶ Finally, the actuary will add the shortfall amortization charge and normal cost. The sum is the year’s required contribution.

⁷⁴ COMM. ON EDUC. & LAB. 95th Cong., *Pension Task Force Report on Public Employee Retirement Systems* (Comm. Print 1987).

⁷⁵ *Pub. Employee Pension Benefit Plans: J. Hearings Before the Subcomm. on Oversight of the Comm. on Ways & Means & Subcomm. on Labor-Mgmt. Relations of the Comm. on Educ. & Labor*, 98th Cong., (Nov. 15, 1983) at 2.

⁷⁶ 26 U.S.C. § 430(a)-(c). See 29 U.S.C. §§ 1133-1135; Lynn A. Cook & James E. Holland, Jr., 371-6TH U.S. INCOME: EMPLOYEE PLANS—DEDUCTIONS, CONTRIBUTIONS AND FUNDING, TAX MGMT. PORT. at A-113-75 (2015).

As noted, the lower the interest assumption, the higher the present value, and thus the greater the potential shortfall.⁷⁷ The interest assumption is based on an average of yields on high-quality corporate bonds, using a yield curve (or segments of the curve) to fit maturity to expected benefit payments. Mortality is to be prescribed by the Treasury Department at least once every ten years.⁷⁸ Mortality is currently based on the RP-2000 table (with improvements).⁷⁹

Contributions are generally due in quarterly installments, 15 days after the close of the quarter. Any deficiency must be paid off in a “catch-up payment” no later than 8-1/2 months after the close of the year. For instance, contributions for the 2016 year are due April 15, July 15, and October 15, 2016, and January 15, 2017, with the catch-up payment due September 15, 2017.⁸⁰

A sponsor may elect to create a prefunding balance if it contributes more than the minimum required. It may then apply the prefunding balance in lieu of cash contributions.⁸¹

A sponsor experiencing temporary substantial business hardship may apply to IRS for a waiver of the year’s contribution. The waived amount then becomes an additional amortization charge in the next five years. IRS may require that security be given to the plan, enforceable by PBGC.⁸²

Poorly funded plans are subject to greater discipline. A liquidity shortfall contribution is required to the extent a plan’s liquid assets do not equal three times its annual disbursements.⁸³ Additional funding is required if a plan is “at risk,” less than 80% funded. At-risk plans cannot increase benefits; they must assume that employees will retire as early as possible and take benefits in the most expensive form; and their funding is subject to a 4% “load” or surcharge. A pre-funding balance cannot be used instead of cash contributions if the plan is at risk.⁸⁴

Payment of shutdown benefits or other unpredictable contingent event benefits is prohibited to the extent a plan is less than 60% funded, as is payment of lump sums or purchase of annuities to the extent a plan is less than 60% funded (100% funded if the sponsor is in bankruptcy). Benefit

⁷⁷ McGill, *supra* note 4, at 207-09.

⁷⁸ 26 U.S.C. § 430(h)(2), (3) (2016).

⁷⁹ Cook & Holland, *supra* note 75, at A-122.

⁸⁰ 26 U.S.C. § 430(j) (2016).

⁸¹ 26 U.S.C. § 430(f)(3) (2016).

⁸² 26 U.S.C §§ 412(c), 430(a)(1)(c), (e) (2016).

⁸³ 26 U.S.C. § 430(j)(4) (2016).

⁸⁴ 26 U.S.C § 430(i) (2016).

accruals must cease to the extent the plan remains less than 60% funded. Partial restrictions apply if the plan is between 60% and 80% funded.⁸⁵

If the annual contribution is not made by the catch-up date, an “accumulated funding deficiency” results, and an excise tax of 10% of the deficiency is imposed. The tax increases to 100% if the deficiency is not timely corrected.⁸⁶

A plan fiduciary, a participant or beneficiary, or the Secretary of Labor can bring suit to enforce the minimum funding standards.⁸⁷ Case law and Labor Department guidance require a fiduciary to pursue full collection unless it would result in hardship and reduced collection.⁸⁸

PBGC also enforces the minimum funding requirements. If the unpaid balance exceeds one million dollars, a lien arises in favor of the plan on all property of the controlled group. PBGC has sole authority to perfect and enforce this lien.⁸⁹

⁸⁵ 26 U.S.C. § 436 (2016).

⁸⁶ 26 U.S.C. § 4971 (2012).

⁸⁷ 29 U.S.C. § 1132(a)(3), (5) (2012).

⁸⁸ In *McMahon v. McDowell*, 794 F.2d 100 (3d Cir. 1986), the employer obtained a funding waiver based on the required showing of temporary substantial business hardship, and later filed bankruptcy and terminated the pension plan. Former employees sued plan fiduciaries for failing to seek contributions. In affirming a grant of summary judgment for the fiduciaries, the court said, “whenever an employer seeks to avoid making its pension plan payments, whether pursuant to [a funding waiver] or in any other manner, trustees have a duty to investigate the relevant facts, to explore alternative courses of action and, if in the best interests of the plan participants, to bring suit against the employer.” But “[i]t normally will be reasonable,” the court continued, “for plan fiduciaries to refrain from action which might send the employer into bankruptcy or lead to the termination of the plan.” *Id.* at 112. A fiduciary’s compromising a claim for delinquent contributions or giving extended payment terms would ordinarily be a prohibited transaction under 29 U.S.C. § 1106(a)(1) (2012). The Labor Department’s Prohibited Transaction Exemption 76-1 permits trustees of a multiemployer plan to do so only if they make “systematic, reasonable, and diligent efforts” to collect delinquent contributions and only if they can demonstrate that the arrangement in a given case is reasonable and likely to maximize the net collection. Employee Benefit Plan, 41 Fed. Reg. 12,740 (March 26, 1976).

⁸⁹ 26 U.S.C. § 430(k) (2012). The lien has the status of a federal tax lien. Thus, for example, it may become senior to advances under a revolving credit arrangement after 45 days or notice to the lender, whichever occurs first. 26 U.S.C. § 6323 (2012), *incorporated by reference in* 26 U.S.C. § 430(k)(4)(C) (2012) and 29 U.S.C. § 1368(c)(1) (2012).

B. MULTIEMPLOYER PLANS

Contributions are set by collective bargaining agreements, usually at an hourly rate. The hourly rate is calibrated so that, when multiplied by an estimate of hours to be worked, contributions will meet the statutory minimum.

The minimum is set by a “funding standard account,” to which specified charges and credits are made each year. If the total charges to the funding standard account are greater than the total credits (including contributions), there is a funding deficiency. In computing the charges and credits, the plan’s actuary must use assumptions that are individually reasonable and that in combination represent her best estimate of future experience.⁹⁰

A funding waiver can be granted if 10% of the employers would otherwise suffer substantial business hardship, with the waived amount amortized over 15 years. A plan can also seek an extension of the amortization period from 15 to 20 years if it has adopted a funding improvement plan (see below), or to 25 years if necessary to avoid plan termination or a substantial benefit curtailment.⁹¹

The trustees of a multiemployer plan can bring suit to collect unpaid contributions. ERISA provides for a simple collection suit with virtually no defenses, and adds interest, liquidated damages, and attorney fees to the judgment.⁹²

Multiemployer plans in endangered or critical status (less than 80% or 65% funded, respectively) must also adopt funding improvement plans (FIP) or rehabilitation plans (RP). An endangered or “yellow zone” plan’s FIP must project a one-third funding improvement over ten years. The FIP typically contains a negotiated schedule of contribution increases and a

⁹⁰ 26 U.S.C. § 431(a), (c)(3) (2012).

⁹¹ 26 U.S.C. §§ 412(c), 431(d) (2012).

⁹² 29 U.S.C. §§ 1132(g)(2), 1145 (2012). A third-party beneficiary is ordinarily subject to the same defenses as the obligee, but, as a matter of federal labor law, union misconduct is no defense to a multiemployer plan’s collection suit. *Lewis v. Benedict Coal Corp.*, 361 U.S. 459 (1960). By declaring that “[e]very employer who is obligated to make contributions to a multiemployer plan under the terms of the plan or under the terms of a collectively bargained agreement shall, to the extent not inconsistent with law, make such contributions,” 29 U.S.C. § 1145 (2012), Congress invalidated other defenses that make the contract merely voidable and not void. An example is fraud in the inducement, as distinct from fraud in factum. *Sw. Adm’rs, Inc. v. Rozay’s Transfer*, 791 F.2d 769 (9th Cir. 1986).

default schedule if no agreement is reached. The default schedule typically requires decreases in benefit accruals as well.⁹³

A critical or “red zone” plan’s RP must project emergence from the red zone in ten years. Red zone plans generally may suspend early retirement subsidies and other ancillary benefits not in pay status and restrict lump sums, in addition to reducing future accruals. If emergence is not possible, a red zone plan must at least take reasonable measures to forestall insolvency.⁹⁴

Under the Multiemployer Plan Reform Act of 2014,⁹⁵ there is a new category, “critical and declining.” A plan that is projected to be insolvent within 20 years (fifteen years if its ratio of inactive to active participants is less than two to one) may permanently reduce benefits, even those in pay status, except for people who are older than 80 or are disabled. The reductions must be approved by the Treasury Department, in consultation with the Labor Department and PBGC, and the plan may not reduce benefits below 110% of the PBGC guaranteed level.⁹⁶ MPRA also authorizes PBGC to partition such a plan to reduce its own expected loss and maintain plan solvency. In that event, the partitioned plan pays guaranteed benefits from PBGC financial assistance.⁹⁷

⁹³ 26 U.S.C. § 432(c) (2012).

⁹⁴ 26 U.S.C. § 432(e) (2012).

⁹⁵ Consolidated and Further Continuing Appropriations Act, 2015, Pub. L. No. 113-235, 128 Stat. 2130, 2773-822 (2014).

⁹⁶ 26 U.S.C. § 432(b) & (e) (2014). In the first major test of these rules, *Central States, Southeast and Southwest Areas Pension Plan*, the Treasury Department denied a benefit reduction application, finding that earnings and entry-age assumptions were not reasonable, and that the proposed reductions were not reasonably estimated to prevent insolvency. Letter from Kenneth R. Feinberg, Special Master, Dep’t of the Treasury, to Gary Ford, Esq., Principal, Groom Law Group, Thomas C. Nyhan, Exe. Director & the Bd. of Trs., Cent. States, Se. & Sw. Areas Pension Plan (May 6, 2016), <https://www.treasury.gov/services/Responses2/Central%20States%20Notification%20Letter.pdf>.

⁹⁷ 29 U.S.C. § 1413 (2012). In *Road Carriers Local 707 Pension Plan*, PBGC denied a partition application, finding that employment and contribution projections were unduly optimistic, and that there was insufficient evidence to reasonably expect that the Plan would remain solvent following partition. Letter from PBGC to Kevin McCaffrey, Interim Fund Manager & Bd. of Trs., Road Carriers Local 707 Welfare & Pension Funds (June 2016), <http://www.pbgc.gov/documents/PBGC-Letter-June-2016.pdf>.

C. HISTORY OF ERISA'S FUNDING RULES

1. ERISA's Reforms

Before ERISA, the Internal Revenue Code required that an employer contribute only normal cost plus interest on unfunded accrued liability.⁹⁸ Thus, the unfunded liability might never be amortized. It was a recognized "best practice" to amortize past service liability over 30 years, but even that did not prevent the Studebaker disaster.⁹⁹

The ERISA rules were a considerable improvement. ERISA required plans to maintain a funding standard account, to which charges and credits were added each year. Among those charges were amortization of past service liability (generally over 30 years), losses from change in actuarial assumptions (20 years), and experience losses (15 years). For multiemployer plans, losses from both changes in assumptions and experience were amortized over 15 years. Credits included gains from changes in assumptions or experience, and they were similarly amortized.¹⁰⁰

If the sum of charges and credits was a net charge, or "accumulated funding deficiency," there was a contribution due that year. Conversely, if there was a "credit balance," it could be used in future years in lieu of cash contributions.¹⁰¹

Contributions were subject to the full funding limit, generally the difference between the present value of accrued benefits projected for salary increases and the lesser of market or actuarial value of assets. They were also subject to the deductible limit, which involved a more complex calculation, but was capped at the full funding limit.¹⁰²

There were six approved funding methods.¹⁰³ A funding method identifies gains and losses each year and amortizes them (as in the unit credit method), or spreads gains and losses by rolling them into normal cost (as in the frozen initial liability method). The methods differ in how much they backload funding costs.¹⁰⁴

⁹⁸ Steven Sass, *ERISA'S Treatment of Default and Forfeiture Risk in Defined Benefit Pension Plans: Reflections From ERISA at 40: What Were They Thinking?*, 6 DREXEL L. REV. 495, 496 (2014).

⁹⁹ *Id.* at 496-97.

¹⁰⁰ 26 U.S.C. § 412(b) (1976).

¹⁰¹ 26 U.S.C. § 412(a) (2012).

¹⁰² 26 U.S.C. §§ 404(a)(1), 412(c)(6) (2014).

¹⁰³ 26 U.S.C. § 412(c)(3) (2012); 29 U.S.C. § 1002(3) (2012).

¹⁰⁴ McGill, *supra* note 4, at 647-51; SOC'Y OF ACTUARIES, WHICH PENSION FUNDING METHOD IS RIGHT FOR YOU? 21-23 (No. 1, Session 54PD (Vol. 23 1997)),

Assumptions and methods had to be reasonable in the aggregate and represent the actuary's best estimate of anticipated experience.¹⁰⁵ This gave the actuary considerable discretion. For example, conservative assumptions could be offset by anti-conservative ones, and asset values could be "smoothed" (gains and losses averaged) over five years, to dampen volatility.¹⁰⁶ The legislative history made clear that these choices were for the actuary, and that the actuary was to exercise independent judgment.¹⁰⁷

<https://www.soa.org/Library/Proceedings/Record-Of-The-Society-Of-Actuaries/1990-99/1997/January/rsa97v23n154pd.aspx>.

¹⁰⁵ 26 U.S.C. § 412(c)(3) (2012).

¹⁰⁶ 26 C.F.R. § 1.412(c)(2)-1(b) (2016). In some cases, the IRS challenged assumptions on grounds that they were overly conservative and led to improperly large deductions for contributions. The courts generally deferred to the actuaries' judgments, emphasizing that assumptions needed only to be reasonable in the aggregate, not individually. *Rhoades, McKee & Boer v. United States*, 43 F.3d 1071 (6th Cir. 1995); *Wachtell, Lipton, Rosen & Katz v. Comm'r*, 26 F.3d 291 (2d Cir. 1994); *Vinson & Elkins v. Comm'r*, 7 F.3d 1235 (5th Cir. 1993).

¹⁰⁷ ERISA "requires that, for purposes of the minimum funding standard, all plan costs, liabilities, rates of interest, and other factors under the plan are to be determined on the basis of actuarial assumptions and methods which, in the aggregate, are reasonable. Actuarial assumptions are to take into account the experience of the plan and reasonable expectations. These assumptions are expected to take into consideration past experience as well as other relevant factors. In addition . . . the actuarial assumptions in combination are to offer the actuary's best estimate of anticipated experience under the plan." H.R. REP. NO. 93-1280, at 284-85 (1974), *reprinted in* 1974 U.S.C.C.A.N. 5038, 5065. Moreover, actuarial assumptions must be "independently determined by an actuary." It would be "inappropriate for an employer to substitute his judgment for that of a qualified actuary," and "if such a circumstance were to arise an actuary would have to refuse giving his favorable opinion . . ." S. REP. NO. 93-383, at 70 (1973), *reprinted in* 1974 U.S.C.C.A.N. 4890, 4955. Congress initially rejected any attempt to standardize assumptions. The House Ways and Means Committee stated, "[T]he proper actuarial assumptions may differ substantially between industries, among firms, geographically, and over time. Further...each actuarial assumption may be reasonable over a significant range and it would appear that the proper test would be whether all actuarial assumptions used together are reasonable. These considerations strongly indicate that any attempt to specify actuarial assumptions and funding methods for pension plans would in effect place these plans in a straitjacket... and would be likely to result in cost estimates that are not reasonable." H.R. Rep. No. 93-807 (1974), *reprinted in* 1974 U.S.C.C.A.N. 4670, 4694. Though suits against pension actuaries are subject to defenses, actuarial malpractice is actionable. *See, e.g., Gerosa v. Savasta & Co.*, 329 F.3d 317 (2d Cir. 2003) (holding actuarial malpractice claim under state law is not preempted by ERISA).

2. Amendments to the Minimum Funding Standards and the Need for Further Reform

For single-employer plans, the funding rules have been amended many times. For the first few decades after ERISA's enactment, the rules were mainly strengthened. For example, Congress adopted a deficit reduction contribution in 1987. A sponsor whose plan was less than 90% funded using prescribed assumptions (GAM-83 mortality and up to 105% of the four-year average of 30-year Treasury yields) had to contribute an additional amount to eliminate the deficit within three to seven years.¹⁰⁸ In the mid-2000s, however, Congress exempted plans in the airline and steel industries from the deficit reduction contribution for a number of years, and allowed them to use a higher interest rate to compute their contributions.¹⁰⁹

The 1987 amendments also introduced the quarterly contributions and the lien, and joint and several liability among controlled group members.¹¹⁰ The 1994 amendments prohibited benefit increases during bankruptcy by poorly funded plans.¹¹¹

Nevertheless, critics pointed out continuing weaknesses in ERISA's funding standards, either standing alone or when combined with regulatory gaps in other areas. For example, PBGC Executive Director Steven Kandarian testified before Congress in 2003 that:

- funding targets are the result of legislative compromise rather than an objective measure of full funding, don't recognize that business reverses often result in subsidized early retirements, and don't recognize the cost of annuitization;
- credit balances permit funding holidays, despite possible investment losses in the interim;
- funding rules do not take employer credit risk into account;

¹⁰⁸ Pension Protection Act of 1987, Title IX, Subtitle D of the Omnibus Budget Reconciliation Act of 1987, Pub. L. No. 100-203 § 9303, 101 Stat. 1330-333-343 (1987), (codified as 26 U.S.C. § 412(I) (1988)).

¹⁰⁹ Pension Funding Equity Act of 2004, Pub. L. No. 108-218, §102, 118 Stat. 596, 599-602 (Apr. 10, 2004), *codified as* 26 U.S.C. § 412 (I)(12) (2006).

¹¹⁰ 101 Stat. 1330-344-347, 1330-348-50, 1330-352-53 (codified as 26 U.S.C §§ 412(b)(2), 430(c)(11), (j), (k)).

¹¹¹ Retirement Protection Act of 1994, Title VII, Subtitle F of the Uruguay Round Agreement Act/General Agreement on Tariffs and Trade, Pub. L. No. 103-465, § 766, 108 Stat. 4809, 5036-37 (codified as 26 U.S.C. § 401(a)(33) (2006)).

- the full funding limit and maximum deductible limit do not allow plans to build up an adequate surplus for bad times;
- funding rules do not take account of lump sum elections;
- funding is too volatile, in part because smoothing rules don't work as well as they should.¹¹²

Kandarian cited the example of Bethlehem Steel, whose plan terminated with a \$3.9 billion shortfall. Due to credit balances, Bethlehem made no contributions for the three years leading up to plan termination.

Kandarian also noted that pension liabilities are correlated with bond yields but not equity returns. Equity investments therefore result in greater volatility, and tend to shift risk from employers and employees to the insurance system.¹¹³

David Walker, the U.S. Comptroller General, and Barbara Bovbjerg, the Government Accountability Office's Director of Education, Workforce and Income Security Issues, echoed some of these observations. They also noted that Bethlehem's plan was heavily invested in equities, leading to significant losses in the run-up to plan termination in 2003, and that Polaroid's plan was severely underfunded at termination partly because contributions had been capped by the deductible limit.¹¹⁴

¹¹² *Hearing Before the H. Comm. on Educ. & the Workforce*, H.R. (2003) (Statement of Steven A. Kandarian, Executive Director, Pension Benefit Guaranty Corporation), <http://archives.republicans.edlabor.house.gov/archive/hearings/108th/fc/pbgc090403/kandarian.htm>.

¹¹³ Under ERISA's fiduciary standards, no investment is per se prudent or imprudent. Under a Labor Department "safe harbor," an investment is prudent if a fiduciary has "given appropriate consideration to those facts and circumstances that, given the scope of such fiduciary's investment duties, the fiduciary knows or should know are relevant to the particular investment," and has "acted accordingly." "Appropriate consideration" includes whether the investment is "reasonably designed . . . to further the purposes of the plan, taking into consideration the risk of loss and the opportunity for gain (or other return)," "the composition of the portfolio with regard to diversification," "liquidity and current return . . . relative to . . . anticipated cash-flow requirements . . .," and "projected return . . . relative to the funding objectives of the plan." 29 C.F.R. § 2550.404a-1 (2015).

¹¹⁴ U.S. GOV'T ACCOUNTABILITY OFF., GAO-03-873T, PENSION BENEFIT GUARANTY CORPORATION: SINGLE-EMPLOYER PENSION INSURANCE PROGRAM FACES SIGNIFICANT LONG-TERM RISKS: TESTIMONY BEFORE THE H. COMM. ON EDUC. & THE WORKFORCE, H.R. (2003), <http://www.gao.gov/assets/120/110278.pdf>; U.S. GOV'T ACCOUNTABILITY OFF., GAO-04-176T, PRIVATE PENSIONS: CHANGING FUNDING RULES AND ENHANCING INCENTIVES CAN

David Wilcox, Deputy Director of the Federal Reserve, noted that weak restrictions on lump sums and early retirement benefits could lead to significant deterioration of plan funding. He added that the funding standards did not permit, let alone require, pre-funding of shutdown benefits or other unpredictable contingent event benefits.¹¹⁵

3. PPA and Beyond

The 2006 Pension Protection Act made a major overhaul, removing virtually all remaining actuarial discretion in the case of single-employer plans, and imposing strict rules to shore up the defined benefit system.¹¹⁶ For single-employer plans, there is no longer a set of charges and credits, to be amortized over various periods. Rather, each year, the shortfall is reckoned, the unamortized portions of prior year shortfalls are netted, and the yearly contribution is computed based on seven-year amortization, plus normal cost.

The assumptions were constrained, as noted, to the corporate-bond yield curve and mortality factors prescribed by the Treasury Department. Asset values could be smoothed over no more than two years, and the result had to be within a 90-100% corridor of fair market value. A single actuarial method (the unit benefit method) was required. The special funding rules and benefit restrictions were adopted for “at-risk” plans.¹¹⁷ And the deductible limit was increased to normal cost plus 150% of the funding target, less assets.¹¹⁸

IMPROVE PLAN FUNDING: TESTIMONY BEFORE THE COMM. ON EDUC. & THE WORKFORCE, H.R. (2003), <http://www.gao.gov/assets/120/110468.pdf>.

¹¹⁵ David W. Wilcox, *Reforming the Defined-Benefit Pension System*, BROOKINGS, 235 (2016), http://www.brookings.edu/~media/projects/bpea/spring-2006/2006a_bpea_wilcox.pdf.

¹¹⁶ The pre-PPA rules are summarized in Cook & Holland, *supra* note 75, at A-141-75, and in STAFF OF J. COMM. ON TAXATION, 109TH CONG., PRESENT LAW AND BACKGROUND RELATING TO EMPLOYER-SPONSORED DEFINED BENEFIT PENSION PLANS AND THE PENSION BENEFIT GUARANTY CORPORATION (Feb. 28, 2005), <http://www.jct.gov/x-3-05.pdf>. The PPA changes are summarized in PATRICK PURCELL, CONG. RESEARCH SERV., RL 33703: SUMMARY OF THE PENSION PROTECTION ACT OF 2006 (2006), <https://www.worldatwork.org/waw/adimLink?id=15322>.

¹¹⁷ Pension Protection Act of 2006 §§ 112, 113, 120 Stat. at 839-42, 847-51.

¹¹⁸ Cook & Holland, *supra* note 75, at A-113-40.

While multiemployer plan actuaries retained discretion on funding methods and assumptions, the amortization period for post-PPA experience was shortened to fifteen years.¹¹⁹

But the new rules largely took effect just as the Great Recession began. So Congress adopted relief provisions.¹²⁰ For single-employer plans, they included allowing the smoothing of asset values for the bleak years 2008 and 2009, the averaging of interest rates over a 25-year look-back period, and, in lieu of the standard seven-year amortization schedule, an election of interest-only payments for two years followed by seven-year amortization (“2 and 7”) or fifteen-year amortization. For multiemployer plans, they included allowing 30-year amortization of investment losses that occurred in 2008 or 2009, and ten-year averaging of those losses for asset-valuation purposes.¹²¹

These provisions gave sponsors more flexibility, but traded off PPA’s goal of shoring up the system as a whole. By 2013, the ERISA agencies were reporting that, despite improvements, many multiemployer plans could still fail. In 2014, the Congressional Research Service reported that the PBGC multiemployer insurance system itself was at risk of failing within a decade or so.¹²² MPRA followed, as part of the “Cromnibus” spending bill at the end of 2014.

Funding legislation is often enacted as part of a larger package. For example, the 1987 amendments were part of the Omnibus Budget Reconciliation Act, and the 1994 amendments were part of the General

¹¹⁹ Pension Protection Act of 2006, Pub. L. No. 109-280, § 201, 120 Stat. 780, 858-68 (2006), *codified as* 26 U.S.C. § 431(b).

¹²⁰ PPA itself provided relief to airlines, allowing them to use pre-PPA funding rules with generous interest assumptions and seventeen-year amortization. Pub. L. No. 109-208, § 402(e)(2), 120 Stat. 780, (codified at 925-28, 26 U.S.C. § 430 note (2012)).

¹²¹ Preservation of Access to Care for Medicare Beneficiaries and Pension Relief Act of 2010, Pub. L. No. 111-192, §§ 201-02, 211, 124 Stat. 1280, 1283-85, 1290-93, 1297-99, 1302-06 (2010); Moving Ahead for Progress in the 21st Century Act, Pub. L. No. 112-141, § 40211, 126 Stat. 405, 846-50 (codified as 26 U.S.C. § 404 (2012); 29 U.S.C. § 1021 (2012)).

¹²² U.S. DEP’T OF LABOR, U.S. DEP’T OF TREASURY & PENSION BENEFIT GUARANTY CORP., MULTIEMPLOYER PENSION PLANS: REPORT TO CONGRESS REQUIRED BY THE PENSION PROTECTION ACT OF 2006, 113TH CONG. (2013), <http://www.pbgc.gov/documents/pbgc-report-multiemployer-pension-plans.pdf>; JOHN J. TOPOLESKI, CONG. RESEARCH SERV., R43305, MULTIEMPLOYER DEFINED BENEFIT (DB) PENSION PLANS: A PRIMER AND ANALYSIS OF POLICY OPTIONS (2015), <https://www.fas.org/sgp/crs/misc/R43305.pdf>

Agreement on Tariffs and Trade. But, that leaves the pension changes open to revenue-scoring objectives. For example, recent rounds of legislation that provided funding relief—as well as PBGC premium increases—helped to raise federal revenue estimates as part of federal budget legislation and to keep the Highway Trust Fund afloat.¹²³ Two bills have recently been introduced to prevent use of PBGC premium increases this way: one would take PBGC off-budget, and the other would prohibit use of PBGC premium increases as an offset to pay for other federal spending.¹²⁴

IV. REPORTING AND DISCLOSURE AND OTHER CONTROLS

Disclosure to plan participants, investors, and, for pooled funds, to employers and their stakeholders, can influence funding.¹²⁵ Both single-employer and multiemployer plans must file an Annual Report (Form 5500) with the ERISA agencies. A defined benefit plan's Annual Report must include:

- statements of assets and liabilities and changes in net assets available for benefits (including revenue and expenses);
- schedules of investment assets and related-party transactions, among others;
- footnote disclosures on significant plan amendments and their impact on benefits and on the plan's funding policy and any changes to it;
- a certified public accountant's opinion that the financial statements are presented fairly in conformity with generally accepted accounting principles; and

¹²³ Title V of the Bipartisan Budget Act of 2015, Pub. L. No. 114-74, §§ 501-04, 129 Stat. 591-594 (codified as 29 U.S.C. § 1306(a)(3)(A)(i)(VI) - (VIII), (G), (a)(8)(C); 29 U.S.C. § 1307(a); 26 U.S.C. § 430(h)(2)(C)(iv)(II)); Title II of the Highway and Transportation Funding Act ("HATFA") of 2014, Pub. L. No. 113-159, § 2003, 128 Stat. 1839, 1849-51 (codified as 26 U.S.C. § 430(h)(2)(B) & (C)(iv) (2012)); *see* PBGC, TECH. UPDATE 14-1: EFFECT OF HATFA ON PBGC PREMIUMS (2014), <http://www.pbgc.gov/prac/other-guidance/tu/tu14-1.html>.

¹²⁴ Pension and Budget Integrity Act of 2016, H. R. 4955, 114th Cong. (2016) (would take PBGC off-budget); Pension and Budget Integrity Act of 2016, S. 3240, 114th Cong. (2016) (would prohibit use of PBGC premium increases as an offset for other federal spending).

¹²⁵ Fitzpatrick & Monahan, *supra* note 1, at 1347-49; Shnitser, *supra* note 1, at 688-91.

- an enrolled actuary’s statement of the required contributions, including the normal cost, funding target, and asset values; current-year and unreported prior-year-contributions; the methods and assumptions and any changes to them; and a statement that the report is complete and accurate and the assumptions are reasonable.¹²⁶

Under PPA, a plan with a funding shortfall must provide participants and beneficiaries with an annual funding notice (“AFN”). The AFN must disclose:

- the amount of the shortfall;
- that the shortfall is based on a 25-year average of interest rates;
- what it would be using a two-year average;
- the funding target attainment percentage;
- the minimum funding contributions for the past three years; and
- the limits of PBGC’s guaranty.¹²⁷

Statement of Financial Accounting Standards No. 87 requires a public company to record its net periodic pension expense on its financial statements. Net periodic pension expense is a spreading of the total cost of the plan over the plan’s lifetime, using a prescribed method. For more than a decade, FAS 158 (and now Accounting Standard Codification 715) has also required a company to record the shortfall or surplus on the balance sheet, on both an Accumulated Benefit Obligation (current service and salary) and a Projected Benefit Obligation (current service and projected salary) basis.¹²⁸

For that purpose, the Financial Accounting Standards Board (“FASB”) requires that the interest assumption reflect closeout costs, *e.g.*, using rates on high-quality corporate bonds with maturities consistent with

¹²⁶ 29 U.S.C. §§1023(a), (b), (d).

¹²⁷ 29 U.S.C. § 1021(f) (2012); 29 C.F.R. § 2520.101-4(a).

¹²⁸ FIN. ACCOUNTING STANDARDS BD., CONCEPT STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 87 5 (1985); FIN. ACCOUNTING STANDARDS BD., CONCEPT STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 132 6 (1998).

expected payouts.¹²⁹ Annual surveys by consulting firms reflect the range of mainstream assumptions.¹³⁰

As of 2011, FASB also requires a company participating in a multiemployer plan to disclose information about the plan's zone status, among other things. The company need not disclose potential withdrawal liability, except (under rules on accounting for contingencies) when withdrawal is probable or reasonably possible.¹³¹

The annuity marketplace provides a useful benchmark. Insurers regularly bid on pension plan closeout annuity contracts. PBGC's regulatory method for valuing benefit liabilities is based on this market. PBGC has historically based its valuation assumptions on annuity prices, ascertained from double-blind surveys of annuity issuers. Financial economists generally support using risk-free rates to value pension liabilities, which generally provides similar results.¹³²

¹²⁹ *News Release: FASB Improves Employer Disclosures for Multiemployer Pension Plans*, FIN. ACCOUNTING STANDARDS BD. (Jul. 27, 2011) http://www.fasb.org/cs/ContentServer?pagename=FASB/FASBContent_C/NewsPage&cid=1176158794021 (noting the pooling effect of state "cost-sharing multiple-employer" plans, akin to private-sector multiemployer plans, can obscure an individual employer's obligations and shield them from the scrutiny of lenders and other stakeholders); Shnitser, *supra* note 1, at 689-91.

¹³⁰ *E.g.*, KEN STOLER, KEVIN HASSAN & DEBBIE RUDIN, PENSION/OPEB 2014 ASSUMPTION AND DISCLOSURE SURVEY (PRICEWATERHOUSECOOPERS, 2014).

¹³¹ *Media Advisory 09/21/11: FASB Issues Accounting Standards Update to Improve Employer Disclosures for Multiemployer Pension Plans*, FIN. ACCOUNTING STANDARDS BD. (Sept. 21, 2011), http://www.fasb.org/cs/ContentServer?pagename=FASB/FASBContent_C/NewsPage&cid=1176158943432; *see* Shnitser, *supra* note 1, at 705 (noting that the contribution of the ARC has been considered a measure of funding discipline); KEITH BRAINARD & ALEX BROWN, SPOTLIGHT ON THE ANNUAL REQUIRED CONTRIBUTION EXPERIENCE OF STATE RETIREMENT PLANS, FY 01- TO FY 13 9 (NAT'L ASS'N. OF ST. RETIREMENT ADMINS., 2015).

¹³² Fitzpatrick & Monahan, *supra* note 1, 1324; *In re US Airways Group*, 303 B.R. 784, 795-96 (E.D. Va. 2003) (stating "The real issue is one of risk. Annuity issuers base their pricing on returns offered by low-risk investments (typically high-quality corporate bonds). Those returns are lower than the returns that might be achieved by investing in the stock market. The stock market, however, is highly volatile and far from certain . . . [N]o one can predict with certainty what returns the stock market will produce over the next 50 years. Given the strong societal interest in protecting pension benefits, a risk-free or nearly risk-free rate to value the pension liability is more appropriate than a rate based on optimistic projections (even if those projections are widely-shared by fund managers) as to the stock market's future long-term performance.").

Actuarial independence and licensure are important controls.¹³³ Under ERISA, an enrolled actuary (one licensed by a federal board, the Joint Board for Enrollment of Actuaries, or “JBEA”) must certify the required contribution. The JBEA can suspend or terminate an actuary’s enrollment for misfeasance.¹³⁴ More generally, actuaries are subject to a uniform Code of Conduct, whose main Precept reads, “An Actuary shall act honestly, with integrity and competence, and in a manner to fulfill the profession’s responsibility to the public and to uphold the reputation of the actuarial profession.” The Code also requires adherence to Actuarial Standards of Practice (“ASOP”).¹³⁵ ASOP 4, Measuring Pension Obligations, and Determining Pension Plan Costs or Contributions, is the principal standard in this area.¹³⁶

V. WHAT LESSONS CAN BE LEARNED FROM THE EXPERIENCE UNDER ERISA?

Like PBGC-insured plans, public plans involve risks to workers and retirees and uncertainties for sponsors and their stakeholders. Based on the private-sector experience, reformers might propose that state lawmakers:

A. Adopt responsible funding rules, and avoid the cycle of tightening and relaxing them. The history of ERISA’s funding rules suggests that funding rules should be strong but should have enough flexibility to obviate temporary relief measures. That observation seems fully applicable to the public sector.

¹³³ Fitzpatrick & Monahan, *supra* note 1, at 1349-52, 1361 (noting not all state laws require actuarially based contributions. Of those that do, not all require that assumptions be reasonable).

¹³⁴ 29 U.S.C. §§ 1241, 1242 (2011).

¹³⁵ AM. ACAD. OF ACTUARIES, CODE OF PROFESSIONAL CONDUCT 2 (2001).

¹³⁶ACTUARIAL STANDARDS BD., ACTUARIAL STANDARDS OF PRACTICE NO. 4: MEASURING PENSION OBLIGATIONS AND DETERMINING PENSION PLAN COSTS OR CONTRIBUTIONS (Dec. 2013), http://www.actuarialstandardsboard.org/wp-content/uploads/2013/12/asop004_173-3.pdf; *see, e.g.*, Press Release, Society of Actuaries, Society of Actuaries Response to Actuarial Standards Bd. Request for Comments-ASOPS & Pub. Pension Plan Funding & Accounting (Oct. 30, 2014), <https://www.soa.org/News-and-Publications/Newsroom/Press-Releases/Society-of-Actuaries-Response-to-Actuarial-Standards-Board-Request-for-Comments-%E2%80%93-ASOPS-and-Public-Pension-Plan-Funding-and-Accounting.aspx>.

B. *Require actuarial independence.* ERISA's emphasis on actuarial independence removes discretion from the employer. Because public plans are inherently political, this could be a useful complement to other governance reforms suggested by the literature.

C. *Require conservative actuarial assumptions.* Under ERISA, actuarial discretion has become more and more constrained at least for single-employer plans. But even a facially sound assumption can be weakened by a gimmick, like the 25-year lookback on corporate bond yields. Given the dynamics of budget politics, it would be hard to put gimmicks off-limits, but model legislation could help to define best practices.

D. *Provide self-executing enforcement tools.* The ERISA funding lien requires only perfection to have the status of a federal tax lien. It may then become senior to a revolving credit arrangement, which tends to bring the parties to the table. That remedy would almost certainly not apply in the public sector, due to sovereign immunity and concerns about holding municipal services hostage. But for local plans, withholding of state revenue-sharing funds seems an even more effective way of ensuring that pension contributions are made.

E. *Make funding status and its implications transparent to stakeholders.* ERISA's reporting and disclosure regime is a robust model, and its Annual Funding Notice highlights the relationship between poor funding and potential loss of benefits. Accounting standards have advanced in both the private and public sectors. They may generate pressure for funding discipline by lenders and other stakeholders. Disclosure of the ARC/ADC would promote that objective.

F. *Encourage pre-funding to provide a reserve against lean times.* The experience with the Tax Code's full funding and deductible limits illustrates the tension between revenue and social objectives, and the effect on plans of weak employers. Income tax treatment is not relevant for public plans, but, as shown by events in Illinois and New Jersey, pension funding always competes with other budget imperatives.

G. *Invest with an eye to funding level, risk, and demographics.* Public plan investing and risk management strategies are beyond the scope of this article, though they also have a significant effect on plan funding. ERISA has no per se investment constraints. The core guidance emphasizes the need to consider risk, return, and cash-flow objectives, which logically requires an understanding of the plan's funding level, risk tolerance, and plan population.

H. *Guard against undue cross-subsidies.* ERISA's withdrawal liability helped to hold multiemployer plans together for three decades, ameliorating the shift of legacy costs from some employers to others. Though some multiemployer plans now are severely distressed, the situation surely would have been worse if there had been no cost for withdrawal. Many state systems are multiple-employer arrangements. As illustrated by the Stockton case, statutory and contractual withdrawal fees may help to keep employers in the fold.

I. *Guard against extraordinary payouts.* The ERISA experience with lump sums and contingent event benefits demonstrates the risk, at least for plans that are poorly funded or whose employers are declining. If these benefits are triggered by workforce reductions, the plan may be less sustainable.

J. *Set a balance between funding and benefit promises.* The PPA regime for troubled multiemployer plans includes reductions of future accruals, and MPRA introduced reductions of accrued benefits for the most troubled. Neither is possible under most state constitutions, except for local plans in a bankruptcy context. Rather, as the Illinois Supreme Court held, a constitutional protection of pensions may imply a taxpayer guaranty. This suggests the importance of setting a balance between benefit promises and expected funding.

FRIEDRICHS AND THE MOVE TOWARD PRIVATE ORDERING OF WAGES AND BENEFITS IN THE PUBLIC SECTOR

MARIA O'BRIEN HYLTON*

In its recent Harris v. Quinn opinion, the U.S. Supreme Court (in particular Justice Alito) seemed to welcome a future opportunity to reconsider the 1977 landmark Abood decision in which public sector closed shop employees were not required to join a union but could be subject to fees that cover the costs of “collective bargaining, contract administration, and grievance adjustment purposes.” Supporters of the Abood approach argue that it is a reasonable compromise that prevents non-members from free riding on the union’s efforts (i.e. enjoying the wages and benefits negotiated by the union without sharing the costs incurred). Detractors and the plaintiffs in Friedrichs argue that free riding concerns are insufficient to overcome serious First Amendment objections. The central idea is that all bargaining in the public sector is inherently political. Public sector pays, tenure and benefits (especially expensive retiree health care and pension promises), it is claimed, now profoundly affect the ability of state and local governments to function in many jurisdictions. This article briefly reviews the major claim in Friedrichs—that public sector agency agreements violate the First Amendment--and considers the implications of a decision that, but for Justice Scalia’s unexpected death almost certainly would have overturned Abood. What would this mean for financially strapped state and local governments? To understand what a victory for the Friedrichs plaintiffs would mean, this paper looks at recent data from Wisconsin which dramatically constrained public sector agency agreements a few years ago and has seen public union membership, union revenue and political power plunge as a result. If Friedrichs had overturned Abood during the 2016 term, we would now expect to see national patterns similar to those observed in Wisconsin. In many places around the country a drop in public sector

*I am indebted to attendees of the 5th Annual Employee Benefits Conference in Hartford, CT for valuable comments and feedback and to individuals at AFSCME Council 32 in Wisconsin and Jim Underhill, Director of the Bureau of Compensation and Labor Relations for the State of Wisconsin for helpful conversations and suggestions about how to obtain post Act 10 data. Thanks also to Harrison Kaplan, Tyler Patterson, and Jordan Shelton for top notch research assistance.

union political power would be expected to translate into a climate more supportive of reduced future expenditures on public pensions and health care.

I. INTRODUCTION

Until recently, conventional wisdom suggested that the petitioners in the *Friedrichs*¹ case were likely to prevail on their core claim that payment of agency fees to a public sector union (in this case the California Teachers Association) violated non-union members' First Amendment rights by forcing them to subsidize political speech with which they disagree.² The

¹ The petitioners first filed their suit to end mandatory union dues on April 29, 2013. The case was decided rather fast by the district court on December 5, 2013 because the petitioners requested judgment be entered for the defendant unions. Though the move seems odd, the petitioners believed their case brought up a unique legal issue and that only the Supreme Court possessed the authority to grant the relief they requested. Upon immediate appeal to the Ninth Circuit, the petitioners again requested judgment for the defendants, and, on November 18, 2014, the Ninth Circuit granted a Summary Affirmance of the district court. *Friedrichs* and her co-plaintiffs filed for *certiorari* on January 26, 2015, and the Supreme Court granted *cert* on June 30, 2015. The case was argued on Jan. 11, 2016 before a full Supreme Court; however, the sudden death of Associate Justice Antonin Scalia on February 13, 2016 left only eight justices to decide the case. Justice Scalia, "who hinted strongly during oral arguments in January that he considered mandatory dues unconstitutional, would have likely been a deciding vote." However, on March 29, 2016, the Supreme Court issued a Per Curiam, one-line opinion: "The judgment is affirmed by an equally divided Court." The death of Scalia certainly led to the divided opinion, as the late justice was an all but official fifth vote for the petitioners, and allowed the unions to continue to collect mandatory union dues. Though the plaintiffs petitioned for a rehearing on April 8, 2016, the still short-handed Supreme Court denied the petition on June 28, 2016, leaving the unions the freedom to collect mandatory dues for the foreseeable future. See *Friedrichs v. Cal. Teachers Assoc.*, 578 U. S. ____ (2016); Haley Sweetland Edwards, *How Antonin Scalia's Death Will Help Teachers' Unions*, TIME (Feb. 16, 2016); *Friedrichs v CTA: Case Timeline*, THE CTR. FOR INDIVIDUAL RTS. (July 16, 2016), <https://www.cir-usa.org/cases/friedrichs-v-california-teachers-association-et-al/friedrichs-v-cta-timeline/>.

² Justice Alito's opinions in *Knox v. SEIU Local 1000* and in *Harris v. Quinn* make clear his view that *Abood* was wrongly decided and that agency fee arrangements by non-members amount to state-coerced speech, which cannot withstand the strict scrutiny required under the First Amendment.

Acceptance of the free-rider argument as a justification for compelling nonmembers to pay a portion of union dues represents something of an anomaly—one that we have found to be justified by the interest in furthering “labor peace” [citation omitted]. But it is an anomaly nonetheless. Similarly, requiring objecting nonmembers to opt out of paying the nonchargeable portion of union dues—as opposed to exempting them from making such payments unless they opt in—represents a remarkable boon for unions. Courts “do not presume acquiescence in the loss of fundamental rights.” [citation omitted] Once it is recognized, as our cases have, that a nonmember cannot be forced to fund a union's political or ideological activities, what is the justification for putting the burden on the nonmember to opt out of making such a payment? Shouldn't the default rule comport with the probable preferences of most nonmembers? And isn't it likely that most employees who choose not to join the union that represents their bargaining unit prefer not to pay the full amount of union dues? An opt-out system creates a risk that the fees paid by nonmembers will be used to further political and ideological ends with which they do not agree. But a “[u]nion should not be permitted to exact a service fee from nonmembers without first establishing a procedure which will avoid the risk that their funds will be used, even temporarily, to finance ideological activities unrelated to collective bargaining.

Knox v. SEIU Local 1000, 132 S. Ct. 2277, 2290 (2012).

In upholding the constitutionality of the Illinois law, the Seventh Circuit relied on this Court's decision in *Abood supra*, which held that state employees who choose not to join a public-sector union may nevertheless be compelled to pay an agency fee to support union work that is related to the collective-bargaining process. [citation omitted] Two Terms ago, in *Knox* [citation omitted], we pointed out that *Abood* is “something of an anomaly.” [citation omitted] “‘The primary purpose’ of permitting unions to collect fees from nonmembers,” we noted, “is ‘to prevent nonmembers from free-riding on the union's efforts, sharing the employment benefits obtained by the union's collective bargaining without sharing the costs incurred.’” [citations omitted] But “[s]uch free-rider arguments . . . are generally insufficient to overcome First Amendment objections.” [citation omitted] For this reason, *Abood* stands out, but the State of Illinois now asks us to sanction what amounts to a very significant expansion of *Abood*—so that it applies, not just to full-fledged public employees, but also to others who are deemed to be public employees solely for the purpose of unionization and the collection of an agency fee.

Supreme Court, following oral argument on January 11, 2016, seemed poised to undo the decades-old compromise embodied in *Abood v. Detroit Board of Education*,³ which allowed non-members to pay an amount less than the full membership fee but sufficient to cover the costs of “collective bargaining, contract administration, and grievance adjustment purposes.”⁴ The startling death of Justice Scalia deprived the Court of the fifth vote

Harris v. Quinn, 134 S. Ct. 2618, 2627 (2014).

³ *Abood v. Detroit Bd. of Ed.*, 431 U.S. 209, 235-6 (1977) (holding that the Constitution allows public sector unions to “spend funds for the expression of political views, on behalf of political candidates, or toward the advancement of other ideological views,” but restricting these expenditures to employees who do not object to those ideas and were not “coerced” into joining the union by threat of the loss of their position); *See also* *Ellis v. Bhd. of Ry.*, 466 U.S. 435, 448-56 (1984) (holding that public unions could use funds from objecting members forced into union contributions to pay for union conventions, publications, and “*de minimus*” social activities, but not for organizing costs or litigation that is not “directly concerned” with the union and its bargaining function); *see also* *Chicago Teachers Union v. Hudson*, 475 U.S. 292, 310 (1986) (holding that “the constitutional requirements for [a] [u]nion’s collection of agency fees include an adequate explanation of the basis for the fee, a reasonably prompt opportunity to challenge the amount of the fee before an impartial decision maker, and an escrow for the amounts reasonably in dispute while such challenges are pending”); *see also* *Knox*, 132 S. Ct. at 2295-6 (stating that public sector unions have a right to express political and social views “without government interference,” but dissenters who chose not to join the union and are required to pay dues have the same right; thus, the Court held, “when a public-sector union imposes a special assessment or dues increase, the union must provide a fresh *Hudson* notice and may not exact any funds from nonmembers without their affirmative consent”); *see also* *Harris*, 134 S. Ct. at 2636, 2638 (limiting “*Abood*’s reach to full-fledged state employees” and refusing to extend it to semi-public employees when the union does not have “the full scope of powers and duties generally available under American Labor law.”).

⁴ *Abood*, 431 U.S. at 232.

needed to overturn *Abood*.⁵ The Court issued a 4-4 split decision on March 29, 2016, which means *Abood* lives on—at least for a while.⁶

⁵ On March 29, 2016, Adam Liptak of The New York Times called the *Friedrichs* decision “the starkest illustration yet of how the sudden death of Antonin Scalia last month has blocked the power of the court’s four remaining conservatives to move the law to the right.” Adam Liptak, *Victory for Unions as Supreme Court, Scalia Gone, Ties 4-4*, N.Y. TIMES, Mar. 29, 2016 (“the starkest illustration yet of how the sudden death of Antonin Scalia last month has blocked the power of the court’s four remaining conservatives to move the law to the right). However, Liptak went further, explaining the broader effects of Scalia’s death on the Court: “His death changed the balance of power in this case, and most likely in many others. The clout of the court’s four-member liberal wing has increased significantly. Its members — Justices Ruth Bader Ginsburg, Stephen G. Breyer, Sonia Sotomayor and Elena Kagan — can create deadlocks, as they did Tuesday, and they can sometimes attract the vote of Justice Anthony M. Kennedy for a liberal result.” *Id.*

⁶ See Daniel Hamel & David Louk, *Much Abood About Nothing?*, WHATEVER SOURCE DERIVED (Mar. 29, 2016), <https://medium.com/whatever-source-derived/much-abood-about-nothing-447dbe2758eb#.hd1dp0tcc>. Hamel and Louk lay out the significance of allowing *Abood* to live on, but suggest there may be an alternative for *Abood*’s “agency shops” in a so-called “direct payment alternative.” *Id.* However, they recognize that this alternative would not be feasible in states with a Democratic legislature and a Republican governor, where *Abood* is all that allows unions the power to collect from unwilling participants.

Laws in almost half of U.S. states allow unions and public sector employers to set up so-called “agency shops.” Employees in an agency shop need not join their local union, but the workers who opt not to join the union still must pay a “fair-share” or “agency” fee to cover their pro rata portion of the union’s collective bargaining costs. Starting with the 1977 case *Abood v. Detroit Board of Education*, the Supreme Court has said that agency shop arrangements do not violate the First Amendment rights of public sector employees. The primary question in today’s case, *Friedrichs v. California Teachers Association*, was whether *Abood* remains good law. For now, it does. Today’s 4–4 split means that the lower court’s decision in *Friedrichs* is affirmed, and the lower court (the Ninth Circuit) abided by *Abood*. So agency shops can continue to exist in the 20-odd states that allow them. . . . To be sure, there are some agency shop states in which *Abood*’s fate matters significantly for public sector unions. Prime examples include Illinois and New Jersey—states with Democratic majorities in the legislature but Republicans in the governor’s mansion. If agency shop laws had been struck down and the legislatures in those states had passed bills to implement the direct payment alternative, we think it quite likely that the governors in

This less-than-total membership cost is either a constitutionally impermissible compulsory payment or a reasonable compromise that has served both labor and public sector employers' interests well for many years. At oral argument it certainly appeared there were five votes in favor of the former position and, as one commentator noted, "*Abood* is in plenty of trouble."⁷

This paper is not about the merits of the arguments made in *Friedrichs* nor does it offer a theory of the First Amendment or of collective bargaining in the public sector. There exists a substantial body of work, which attempts to do one or more of these things.⁸ This paper examines the

those states (Bruce Rauner and Chris Christie, respectively) would have exercised their veto power. In states like Hawaii and California, by contrast, the demise of *Abood* likely would have led Democratic lawmakers to pass—and the Democratic governor to sign—legislation implementing the direct payment alternative.

Id.

⁷ Lee H. Adler, *Free Speech, Free Riders and the Fate of the Union Agency Fee*, 27 DLR I-1, Feb. 11, 2016.

The fact that the U.S. Supreme Court granted certiorari in *Friedrichs* after its recent decisions in *Knox* and *Harris* means that *Abood* is in plenty of trouble. The longstanding consensus, which balances an actual but modest infringement on nonmembers' association and speech rights with a union's need to pay for the services it renders to all in a bargaining unit, is in question. . . . th[is] new jurisprudence reflects an active change of focus toward "individual" rights that has an effect of undermining the ability of public employees to accomplish collective objectives. Collective bargaining and union representation require a funding source, and that source must be the employees who receive the benefits of union representation. But *Knox* and *Harris* and the petitioners in *Friedrichs* would make raising those funds as difficult as possible, even when state governments believe it is in their own best interests. This indifference towards state's rights, the distaste shown by Justice Alito and the *Friedrichs* petitioners towards the compromise thinking in *Abood*, and the apparent rush of the Court to consider altering the careful First Amendment balance still alive in *Locke* suggest an exaltation of individual rights over the common weal that is not particularly well-explained.

Id.

⁸ See Jake Wasserman, *Gutting Public Sector Unions: Friedrichs v. California Teachers Association*, 11 DUKE J. CONST. L. & PUB. POL'Y SIDEBAR 229 (2016) (discussing a potential constitutional challenge public-sector unions would face in *Friedrichs* that might "lead to their demise;" further discussing the potential for

expected effects of a decision, which was on the verge of overturning *Abood*, and, in particular, the effect of such a change on public sector employee benefits costs and total budgets.

Using data from Wisconsin following that state’s enactment of Act 10 (the 2011 Wisconsin Budget Repair Bill),⁹ which largely eliminated collective bargaining for state public employees, I trace the effects on membership in Wisconsin’s largest teacher union and on its lobbying efforts and membership levels. Act 10 has been nothing short of catastrophic for Wisconsin’s public sector unions.¹⁰ There is every reason to believe that the

Friedrichs to “have a broad impact on public-sector unions’ financial health and political clout, as well as politics more broadly,” should *Abood* have been overruled.); *Id.* at 236-237 (noting that the constitutional arguments *Friedrichs* advanced in her brief were not complicated, calling *Abood* a constitutionally indefensible compromise, a “jurisprudential outlier,” and irreconcilable with [the Supreme] Court’s decision in every related First Amendment context,” further rejecting the notions that employees who opt out of unions are “free-riding” and that this issue is compelling enough to “withstand exacting scrutiny. *Id.* at 234-36. However, the union’s arguments were even simpler, noting that *stare decisis* should result in *Abood* being reaffirmed because it “correctly reflects” the state’s interest in managing labor relations and that the employee’s 1st Amendment “interests against compelled agency fees are ‘certainly not *stronger* than the interest in affirmative expression.’”). *Id.* at 237 (noting, the unions “point[ed] out that ‘strong reliance interests have developed around the agency-shop model,’ and note outlawing agency-shop agreements would ‘overrule the judgments of 23 States plus the District of Columbia’ . . . [and] tens of thousands of collective-bargaining agreements governing public employees would be thrown into disarray.”).

⁹ Assemb. B. 11, 2011-2012 Legis. Spec. Sess. (Wis. 2011).

¹⁰ See, e.g., Steven Greenhouse, *Wisconsin’s Legacy for Unions*, N.Y. TIMES, Feb. 22, 2014.

Three years ago, a labor leader named Marty Beil was one of the loudest opponents of Gov. Scott Walker’s “budget repair bill,” a proposal that brought tens of thousands of protesters out to the Wisconsin State Capitol in Madison in frigid February weather. A gruff-voiced grizzly of a man, Mr. Beil warned that the bill was rigged with booby traps that would cripple the state’s public-sector unions. He gets no satisfaction from being right. Since the law was passed, membership in his union, which represents state employees, has fallen 60 percent; its annual budget has plunged to \$2 million from \$6 million. Mr. Walker’s landmark law — called Act 10 — severely restricted the power of public-employee unions to bargain collectively, and that provision, among others, has given social workers, prison guards, nurses and other public employees little reason to pay dues to a union that can no longer

parties which organized and funded the *Friedrichs* litigation will try again given Justice Alito's near invitation to litigate the constitutionality of *Abood*.¹¹ One would expect that the re-try will take place fairly quickly in the event the next Supreme Court appointee is viewed as sharing Scalia's views.¹²

do much for them. Members of Mr. Beil's group, the Wisconsin State Employees' Union, complain that their take-home pay has fallen more than 10 percent in recent years, a sign of the union's greatly diminished power. "It's had a devastating effect on our union," Mr. Beil, its executive director, said of Act 10. He was sitting in his Madison office, inside the headquarters that his union, hard up for cash, may be forced to sell. The building is underused anyway, as staff reductions have left many offices empty.

Id.

¹¹ In his harsh and unyielding opinion, Justice Alito criticized nearly every facet of the *Abood* decision.

The *Abood* Court's analysis is questionable on several grounds. Some of these were noted or apparent at or before the time of the decision, but several have become more evident and troubling in the years since then. The *Abood* Court seriously erred in treating *Hanson* and *Street* as having all but decided the constitutionality of compulsory payments to a public-sector union. As we have explained, *Street* was not a constitutional decision at all, and *Hanson* disposed of the critical question in a single, unsupported sentence that its author essentially abandoned a few years later. Surely a First Amendment issue of this importance deserved better treatment. . . . *Abood* does not seem to have anticipated the magnitude of the practical administrative problems that would result in attempting to classify public-sector union expenditures as either "chargeable" (in *Abood's* terms, expenditures for "collective-bargaining, contract administration, and grievance-adjustment purposes," (citation omitted) or nonchargeable (*i.e.*, expenditures for political or ideological purposes, (citation omitted). In the years since *Abood*, the Court has struggled repeatedly with this issue (citations omitted). . . . Finally, a critical pillar of the *Abood* Court's analysis rests on an unsupported empirical assumption, namely, that the principle of exclusive representation in the public sector is dependent on a union or agency shop.

Harris, 134 S. Ct. at 2632-2634.

¹² See Adam Liptak, *Study Calls Snub of Obama's Supreme Court Pick Unprecedented*, N.Y. TIMES, June 13, 2016 (noting that The Republican Senate is fighting hard to ensure that the next Justice on the Court shares Scalia's view.

It is for this reason that the conditions in Wisconsin post-Act 10 provide a near-perfect laboratory in which to examine what happens when public sector unions can no longer compel even a modest level of support for their activities from members and non-members. What can be observed in Wisconsin is an astonishing drop in public sector union membership levels, and lobbying activity (which I view as a reasonable proxy for political strength). To the extent that public sector union strength accounts for the level of spending on employee benefits—especially pensions and high cost health insurance for active employees and retirees—we should expect to see these costs come down over time in Wisconsin and in any other state that outlaws agency fees. This means that strained state budgets could well be the first beneficiaries of the movement to eliminate agency fees.¹³ This move—toward private ordering of wages and benefits in the public sector and away from the morally hazardous process that currently determines the overall compensation of public employees¹⁴—will have a profound effect on

President Obama’s current nominee, Merrick Garland, has failed to even be given a hearing in the Senate at the time this paper was written); *Id.* (“Senate Republicans say they will not consider any nominee offered by Mr. Obama to replace Justice Antonin Scalia, who died in February. The power to appoint Justice Scalia’s successor, they say, should belong to the next president.”).

¹³ The MacIver Institute, a Wisconsin-based conservative think tank, suggests that Act 10 has been remarkably successful in saving Wisconsin taxpayer dollars and lowering the state funds spent on public sector pensions and benefits:

[Act 10] has saved Wisconsin taxpayers \$5.24 billion, according to a new analysis by the MacIver Institute. The analysis found that Wisconsin saved \$3.36 billion by requiring government employees contribute a reasonable amount to their own retirement. The analysis also estimates local units of governments saved an additional \$404.8 million total by taking common sense steps like opening their employees’ health insurance to competitive bidding. Milwaukee Public Schools saved \$1.3 billion in long-term pension liabilities, and Neenah saved \$97 million in long-term pension liabilities in addition to other savings.

Brett Healy, *Act 10 Saves Wisconsin Taxpayers More Than \$5 Billion Over 5 Years, MacIver Analysis Finds*, MACIVER INST. (Feb. 11, 2016) <http://www.maciverinstitute.com/2016/02/act-10-saves-wisconsin-taxpayers-more-than-5-billion-over-5-years-maciver-analysis-finds/>.

¹⁴ Daniel Disalvo, *The Trouble with Public Sector Unions*, NAT’L AFF. Fall 2010, at 3.

The very nature of many public services — such as policing the streets and putting out fires — gives government a monopoly or near monopoly; striking public employees could therefore hold the public hostage. As long-time *New York Times* labor reporter

public sector budgets and the ability of public unions to seek rents that result in wages and benefits that are relatively generous when compared with the private sector. This process appears to be underway in Wisconsin. When the issue in *Friedrichs* once again comes before the Court¹⁵ the experience in Wisconsin should provide some guidance about what to expect on a national scale.

II. LESSONS FROM WISCONSIN AFTER ACT 10

To understand what a post-*Friedrichs* world might have looked like, it helps to look back at the changes that have taken place in Wisconsin since the passage of Act 10 in 2011. Also known as the Wisconsin Budget Repair Bill, Act 10 was signed into law by then newly-elected Governor Scott Walker.¹⁶ Act 10 largely eliminated collective bargaining for public employees in the state except for law enforcement and fire protection personnel.¹⁷ Act 10 expressly forbid general employees from bargaining

A. H. Raskin wrote in 1968: "The community cannot tolerate the notion that it is defenseless at the hands of organized workers to whom it has entrusted responsibility for essential services." "When it comes to advancing their interests, public-sector unions have significant advantages over traditional unions. For one thing, using the political process, they can exert far greater influence over their members' employers — that is, government — than private-sector unions can. Through their extensive political activity, these government-workers' unions help elect the very politicians who will act as "management" in their contract negotiations — in effect handpicking those who will sit across the bargaining table from them, in a way that workers in a private corporation (like, say, American Airlines or the Washington Post Company) cannot. Such power led Victor Gotbaum, the leader of District Council 37 of the AFSCME in New York City, to brag in 1975: "We have the ability, in a sense, to elect our own boss."

Id. at 6-7, 10.

¹⁵ How fast this happens will be a function of the perceived political orientation of Justice Scalia's replacement.

¹⁶ Assemb. B. 11, 2011-2012 Legis. Spec. Sess. (Wis. 2011).

¹⁷ See Martin H. Mail, *The Legislative Upheaval in Public Sector Labor Law: A Search for Common Elements*, 27 A.B.A. J. LAB. & EMP. L. 149 (2012) (noting that when the bill was introduced "Senate Democrats fled to Illinois, denying the super-majority quorum needed under state law to consider fiscal legislation. While the Democrats were still out of the state, the Republicans stripped out provisions that they believed required the super quorum and enacted the bill. The controversy

collectively on issues other than base wages;¹⁸ prohibits municipal employers from deducting labor organization dues from paychecks of general employees;¹⁹ imposes annual recertification requirements²⁰ and

produced public demonstrations on a scale Madison had not seen since the Vietnam War. The Dane County Circuit Court enjoined the enactment on the ground that the legislature violated the state's open meeting laws, but in a party-line four to three vote, the Wisconsin Supreme Court reversed, and Act 10 took effect.”)

¹⁸ Wisc. Stat. § 111.70 (4) (mb),

Prohibited subjects of bargaining; general municipal employees. The municipal employer is prohibited from bargaining collectively with a collective bargaining unit containing a general municipal employee with respect to any of the following: 1. Any factor or condition of employment except wages, which includes only total base wages and excludes any other compensation, which includes, but is not limited to, overtime, premium pay, merit pay, performance pay, supplemental compensation, pay schedules, and automatic pay progressions.

Id.

¹⁹ *Id.* at § 111.06 (1) (i).

It shall be an unfair labor practice for an employer individually or in concert with others . . . [t]o deduct labor organization dues or assessments from an employee's earnings, unless the employer has been presented with an individual order therefore, signed by the employee personally, and terminable by the employee giving to the employer at least 30 days' written notice of the termination. This paragraph applies to the extent permitted under federal law.

Id.

²⁰ *Id.* at § 111.83 (3) (b).

Annually, no later than December 1, the commission shall conduct an election to certify the representative of a collective bargaining unit that contains a general employee. There shall be included on the ballot the names of all labor organizations having an interest in representing the general employees participating in the election. The commission may exclude from the ballot one who, at the time of the election, stands deprived of his or her rights under this subchapter by reason of a prior adjudication of his or her having engaged in an unfair labor practice. The commission shall certify any representative that receives at least 51 percent of the votes of all of the general employees in the collective bargaining unit. If no representative receives at least 51 percent of the votes of all of the general employees in the collective bargaining unit, at the expiration of the collective bargaining agreement, the commission shall decertify the current representative and the general employees shall be nonrepresented.

disallows fair share agreements which require non-represented general employees to make contributions to labor organizations.²¹

A. THE STATE COURT CHALLENGE

In August 2011, unhappy with the new law, two Wisconsin unions—the Madison Teachers, Inc. and Public Employees Local 61²² filed suit in Wisconsin state court against Governor Walker.²³ The unions alleged, *inter*

Notwithstanding s. 111.82, if a representative is decertified under this paragraph, the affected general employees may not be included in a substantially similar collective bargaining unit for 12 months from the date of decertification. The commission's certification of the results of any election is conclusive unless reviewed as provided by s. 111.07 (8).

Id.

²¹ *Id.* at § 111.85 (1) (a)-(b).

(a) No fair-share or maintenance of membership agreement covering public safety employees may become effective unless authorized by a referendum. The commission shall order a referendum whenever it receives a petition supported by proof that at least 30 percent of the public safety employees in a collective bargaining unit desire that a fair-share or maintenance of membership agreement be entered into between the employer and a labor organization. A petition may specify that a referendum is requested on a maintenance of membership agreement only, in which case the ballot shall be limited to that question. (b) For a fair-share agreement to be authorized, at least two-thirds of the eligible public safety employees voting in a referendum shall vote in favor of the agreement. For a maintenance of membership agreement to be authorized, at least a majority of the eligible public safety employees voting in a referendum shall vote in favor of the agreement. In a referendum on a fair-share agreement, if less than two-thirds but more than one-half of the eligible public safety employees vote in favor of the agreement, a maintenance of membership agreement is authorized.

Id.

²² Madison Teachers Inc. is a union representing over 4000 municipal employees of the Madison Metropolitan School District. Local 61 represents approximately 300 City of Milwaukee employees.

²³ *See* Madison Teachers Inc. v. Walker, 851 N.W.2d 337 (2014).

In August 2011, Madison Teachers, Inc. and Public Employees Local 61 sued Governor Walker and the three commissioners of the Wisconsin Employment Relations

alia, that Act 10 violated the constitutional free speech, free association and equal protection rights of the represented employees. The Wisconsin Circuit Court agreed with the unions and invalidated several provisions of Act 10, including those related to collective bargaining. On July 31, 2014 the Wisconsin Supreme Court, in a 5 to 2 decision reversed the lower court ruling and upheld Act 10 in its entirety. The Court’s view was that while union members certainly enjoy a constitutional right to free association, that protection does not extend to collective bargaining. Justice Gableman wrote for the majority:

This point is vital and bears repeating: the plaintiff’s associational rights are in no way implicated by Act 10’s modifications to Wisconsin’s collective bargaining framework. At issue in this case is the State’s implementation of an exclusive representation system for permitting public employers and public employees to negotiate certain employment terms in good faith . . . Represented municipal employees, non-represented municipal employees, and certified representatives lose no right or ability to associate to engage in constitutionally protected speech because their ability to do so outside the framework of statutory collective bargaining is not impaired. Act 10 merely provides general employees with a statutory mechanism to force their employer to collectively bargain; outside of this narrow context, to which the plaintiffs freely concede public employees have no constitutional right, every avenue for petitioning the government remains available.²⁴

Essentially, the majority in *Walker* adopts the view that constitutional protections of freedom of association are not impaired because

Commission challenging several provisions of Act 10. The plaintiffs alleged, among other things, that four aspects of Act 10—the collective bargaining limitations, the prohibition on payroll deductions of labor organization dues, the prohibition of fair share agreements, and the annual recertification requirements—violate the constitutional associational and equal protection rights of the employees they represent. The plaintiffs also challenged Wis. Stat. § 62.623 (2011-12), a separate provision created by Act 10, which prohibits the City of Milwaukee from paying the employee share of contributions to the City of Milwaukee Employees’ Retirement System, alleging it violates the home rule amendment to the Wisconsin Constitution. The plaintiffs argued, in the alternative, that if Wis. Stat. § 62.623 does not violate the home rule amendment, it nevertheless violates the constitutionally protected right of parties to contract with each other.

Id. at 345.

²⁴ *Id.* at 355-365.

Act 10 does not limit the ability of any member to associate outside of the “framework”.²⁵ Fairly predictable responses followed the Wisconsin Supreme Court’s decision.²⁶

B. FEDERAL LITIGATION

The Seventh Circuit has twice had occasion to consider Act 10. In *Wisconsin Education Assoc. Council v. Walker*²⁷ and *Laborers Local 236 v. Walker*,²⁸ the Court considered the payroll deduction provisions and the free

²⁵ *Id.* at 356 (“The defendants are not barring the plaintiffs from joining any advocacy groups, limiting their ability to do so, or otherwise curtailing the ability to join other ‘like-minded’ individuals to associate for the purpose of expressing commonly held views...”).

²⁶ Nick Novak, *Wisconsin Supreme Court Upholds Scott Walker’s Act 10 “in its Entirety”*, MACIVER INST. (Jul. 31, 2014, 11:27 AM), <http://www.maciverinstitute.com/2014/07/wisconsin-supreme-court-upholds-act-10-in-its-entirety/> (“Act 10 has saved Wisconsin taxpayers more than \$3 billion. Today’s ruling is a victory for those hard-working taxpayers”); *See also id.* (“Wisconsin’s proud history of protecting worker’s rights is marred by Walker and Republicans’ dismantling of collective bargaining for our public sector workers. Today’s Supreme Court ruling is extremely disappointing for the teachers, nurses, prison guards, and other professionals who serve the public each day.”).

²⁷ *Wis. Educ. Ass’n Council v. Walker*, 705 F. 3d 640 (7th Cir. 2013). Plaintiffs and cross-appellants, representing seven of Wisconsin’s largest public sector unions (the “Unions”), filed suit against defendants-appellants Governor Scott Walker and other state actors, challenging three provisions of the statute—the limitations on collective bargaining, the recertification requirements, and a prohibition on payroll deduction of dues—under the Equal Protection Clause. They also challenged the payroll deduction provision under the First Amendment. The district court invalidated Act 10’s recertification and payroll deduction provisions, but upheld the statute’s limitation on collective bargaining. We now uphold Act 10 in its entirety.

Id. at 642.

²⁸ *Laborers Local 236, AFL-CIO v. Walker*, 749 F. 3d 628 (7th Cir. 2014).

This case raises more challenges to the constitutionality of Wisconsin’s Act 10, which we last addressed in [*Wis. Educ. Ass’n Council v Walker*]. Act 10 made significant changes to Wisconsin public-sector labor law: it prohibited government employers from collectively bargaining with their general employees over anything except base wages, made it more challenging for general-employee unions to obtain certification as exclusive bargaining

association implications of Act 10. The 7th Circuit rejected the argument that the prohibition on payroll deductions violated the First Amendment, reasoning that the unions' previous use of the payroll system was the equivalent of the state subsidizing the unions' speech and that Wisconsin was free to withdraw this subsidy so long as it did so on a viewpoint neutral basis.²⁹

The second case—*Laborers Local 236*—rehashed arguments made unsuccessfully in Wisconsin state court—i.e. that Act 10 impaired union members' right to freedom of association. The argument, which the 7th Circuit rejected, was essentially that Act 10 undermines the ability of labor organizations to continue to function and weakens their association to a devastating extent, thereby depriving members of the right to freedom of association. Judge Flaum wrote for the majority:

[T]he First Amendment does not require the state to maintain policies that allow certain associations to thrive...Act 10 only acts upon the state. The law's changes

agents, and precluded general-employee unions from using automatic payroll deductions and fair-share agreements. The plaintiffs, two public-employee unions and an individual union member, argue that these changes infringe their First Amendment petition and association rights. They also argue that Act 10 denies union members the equal protection of the laws.

Id. at 628.

²⁹ See *Wis. Educ. Ass'n Council*, 705 F.3d at 645.

Act 10's payroll deduction prohibitions do not violate the First Amendment. The Unions offer several different First Amendment theories to rebut the compelling deference of rational basis review required under applicable law. Ultimately, none apply because the Supreme Court has settled the question: use of the state's payroll systems to collect union dues is a state subsidy of speech that requires only viewpoint neutrality. (citations omitted) Admittedly, the Unions do offer some evidence of viewpoint discrimination in the words of then-Senate Majority Leader Scott Fitzgerald suggesting Act 10, by limiting unions' fundraising capacity, would make it more difficult for President Obama to carry Wisconsin in the 2012 presidential election. While Senator Fitzgerald's statement may not reflect the highest of intentions, his sentiments do not invalidate an otherwise constitutional, viewpoint neutral law. Consequently, Act 10's prohibition on payroll dues deduction does not violate the First Amendment.

Id.

prevent public employers from acting in certain ways, or adopting certain procedures, that were once beneficial to Wisconsin public-sector unions and their members. We take the plaintiffs' point that Act 10 will likely have the effect of making things more challenging for general-employee unions . . . But this type of impairment is not one that the Constitution prohibits . . . An organization cannot come up with an associational purpose—even a purpose that involves speech—and then require support from the state in order to realize its goal.³⁰

C. FINANCIAL CONSEQUENCES OF ACT 10

Perhaps the most important consequence of Act 10 has been its debilitating effect on the many public sector unions affected by its terms. The state's largest teachers union, The Wisconsin Education Association (WEAC) had approximately 100,000 members prior to the passage of Act 10.³¹ Since then, membership has dropped by more than 50% to

³⁰ *Labors Local 236 v. Walker*, 749 F.3d 628 (7th Cir. 2014).

In *Smith*, the Supreme Court observed that '[f]ar from taking steps to prohibit or discourage union membership or association, all that [the state] has done in its challenged conduct is simply to ignore the union. That it is free to do.' 441 U.S. at 466, 99 S.Ct. 1826."); The same holds true here. The unions cannot wield the First Amendment to force Wisconsin to engage in a dialogue or continue the state's previous policies. For this reason, none of Act 10's proscriptions—individually or cumulatively—infringe the unions' associational rights.

Id. at 638-639.

³¹ Molly Beck, *WEAC Turns to Local Focus After Massive Membership Loss*, WISC. STATE J., Feb. 22, 2015, http://host.madison.com/wsj/news/local/education/local_schools/weac-turns-to-local-focus-after-massive-membership-loss/article_4e31a55e-575b-598f-bb40-6b8ab1e440c5.html.

Four years after public school teachers lost their guaranteed spot at the bargaining table, Wisconsin's largest teachers union has lost more than half its membership and its spending at the Capitol has all but disappeared. Now, local members of the Wisconsin Education Association Council are turning their efforts toward school board races and reaching out to parents in an effort to eventually regain some influence in Madison. . . . About 40,000 public school employees are represented by WEAC, Dustin Beilke, Region 6 director told the State Journal editorial board last week. WEAC spokeswoman, Christina Brey said it was thousands

approximately 40,000 members as of early 2015. Dues cost approximately \$750.00 per teacher and it appears that many former members have decided not to incur that expense.³²

higher but declined to provide an exact number. Either way, membership is down more than 50 percent from the union's 98,000-member levels before Gov. Scott Walker signed his signature legislation in 2011 that significantly diminished collective bargaining rights for most public employees. WEAC's lobbying dollars have dropped dramatically, too. A decade ago, WEAC spent \$1.5 million on lobbying during the 2005-2006 legislative session, state records show. The next session: \$1.1 million. During the two sessions leading up to the passage of Act 10, WEAC spent \$2.5 million and \$2.3 million, respectively. But during the 2013-14 session, after Walker signed the bill into law, the union spent just \$175,540. It was the first time in at least 10 years that the union was not among the state's top 12 lobbying spenders, according to the Government Accountability Board.

Id.

³² Richard Moore, *Members Chipped in \$23.4 million to WEAC in 2008 Union Dues*, LAKELAND TIMES (July 1, 2011), <http://www.lakelandtimes.com/main.asp?SectionID=9&subsectionID=110&articleID=13387>.

In addition to the \$295.01 in annual dues that full-time teachers shell out to the state unit, full-time professional members pay \$19.99 to the WEAC political action committee for political campaigns and lobbying, as well as local union dues and \$166 to the National Education Association. Contributions to WEAC and the NEA thus cost every full-time teacher \$461 a year, while total dues can swell to more than \$750 a year per teacher. For example, in the Lakeland area, teachers from Lakeland Union High School, MHLT, AV-W, North Lakeland, and Lac du Flambeau chipped in union dues totaling \$191,746 for the 2010-11 year. According to Rich Vought, the superintendent at North Lakeland, teachers pay \$759 per person there, for a total of \$15,180. At AV-W, teachers paid \$40,194.40. For the 2010-11 school year, the local teachers' association at LUHS will pay a total of \$50,611.59 to their union, says district administrator Todd Kleinhans. He said a full-time teacher will pay \$783 while dues for part-time teachers are pro-rated. MHLT teachers will pay a total of \$38,832 in union dues - \$15,120 goes directly to WEAC - while the lump sum annual amount Lac du Flambeau teachers paid in 2010-11 was \$46,928. Union dues are collected from employee paychecks and a monthly check is cut from the district to the local union and sent to the Northern Tier UniServe office in Rhinelander on behalf of the

Financial hardship has translated into reduced political power. According to the state of Wisconsin Government Accountability Board, for each of the three years leading up to Act 10's passage, WEAC was either first or second in total dollars spent lobbying at the state level.³³ From 2009 to 2011 WEAC spent an average of \$1.9 million per year on lobbying. After Act 10, WEAC spent only \$175,540 which meant it was not even in the top twelve of lobbying spenders.³⁴

Why did membership drop so dramatically? Act 10 meant that dues could no longer be automatically withdrawn from member paychecks and non-members were no longer required to make a "fair share" payment. If you did not want to be a union member, you were now free to go it alone and no longer compelled to pay the agency fee. This is precisely the result the *Friedrichs* plaintiffs hoped for on a national scale.

A sample of comments from former WEAC members demonstrates their post-Act 10 thinking:

- "I don't see the point of being in a union anymore. Everyone is on their own island now. If you do a good job, everything will take care of itself. The money I'd spend on dues is way more valuable to buy groceries for my family."³⁵

union, Kleinhans said in an email. Because teachers are paid their salaries over a 12-month period, union dues are sent for any particular school year beginning in September and continuing through August, he added.

Id.

³³ See generally, Wis. Gov't Accountability Bd., 2009-2010 Legislative Session Lobbying Summary Reports (2014), http://www.gab.wi.gov/sites/default/files/publication/68/2009reg_slaesummaryreport_pdf_20437.pdf; Wis. Gov't Accountability Bd., 2011-2012 Legislative Session Lobbying Summary Reports (2014), http://www.gab.wi.gov/sites/default/files/publication/68/2011reg_slaesummaryreport_pdf_16649.pdf.

³⁴ Beck, *supra* note 30, ("Walker spokeswoman Laurel Patrick said Saturday that Act 10 'put the power back in the hands of the people and local governments, saving Wisconsin taxpayers more than \$3 million in the process and allowing public employees the freedom to choose if they want to join a union.'").

³⁵ Robert Samuels, *Walker's Anti-Union Has Labor Reeling in Wisconsin*, THE WASH. POST (Feb. 22, 2015), https://www.washingtonpost.com/politics/in-wisconsin-walkers-anti-union-law-has-crippled-labor-movement/2015/02/22/1eb3ef82-b6f1-11e4-aa05-1ce812b3fdd2_story.html (statement from 34-year old technology teacher Dan Anliker).

- “[Unions] are just not something I concern myself with...I just look to keep improving my teaching in the best way I can and try to keep my nose out of the other stuff.”³⁶

A few unions were reported to have resorted to home visits designed to get teachers to sign up for dues collection.³⁷ None of these efforts appear to have paid off though. In August 2001, WEAC issued layoff notices to about 40% of its staff.³⁸ This trend has not diminished—the New York Times reports:

³⁶ *Id.* (quoting Sean Karsten, a 32-year-old middle and high school reading instructor).

³⁷ Lindsay Fiori, *Teachers Unions Visit Homes for Dues Option*, THE J. TIMES, July 11, 2011, http://journaltimes.com/news/local/teachers-unions-visit-homes-for-dues-option/article_ff07cf4a-abb0-11e0-bf87-001cc4c03286.html.

Racine County teachers may have union representatives show up on their doorsteps this summer. Area teachers’ unions no longer able to automatically deduct dues from teachers’ paychecks because of the state’s new budget repair law are using a variety of methods including home visits to sign up members to voluntarily pay dues. . . .The unions . . . are using a combination of meetings, emails, phone calls and home visits to get teachers signed up for dues collection, said officials from United Lakewood Educators, which includes the Muskego-Norway School District, and Southern Lakes United Educators, which includes the Burlington, North Cape, Union Grove, Washington-Caldwell, Waterford and Drought districts. Officials from the union representing the 10th district, Yorkville Federation of Teachers, which serves Yorkville Elementary School, could not be reached.

Id.

³⁸ Erin Richards, *Diminished in the Wake of Act 10, 2 Teachers Unions Explore Merger*, J. SENTINEL (Jan. 7, 2014), <http://archive.jsonline.com/news/education/diminished-in-wake-of-act-10-2-teachers-unions-explore-merger-b99174118z1-239150441.html>.

Facing reduced membership, revenue and political power in the wake of 2011 legislation, Wisconsin's two major state teacher’s unions appear poised to merge into a new organization called Wisconsin Together. The merger would combine the Wisconsin Education Association Council, the state's largest teacher’s union, and AFT-Wisconsin, a smaller union that includes technical college, higher education and state employees . . .The developments underscore the changing landscape for Wisconsin teachers unions since the passage of Act 10, which limits collective bargaining and makes it more difficult for unions to collect dues. After Act 10, WEAC has lost about a third of its

“[s]ince [Act 10 passed] ... union membership has dropped precipitously. Long a labor stronghold, the state has lost tens of thousands of union members, leaving Wisconsin with a smaller percentage of union members than the national average, new federal figures show. . . . The drop is most pronounced in the public sector: more than half of Wisconsin’s public workers were in unions before Mr. Walker’s cuts took effect. A little more than a quarter of them remain.”³⁹

How and why did this happen in Wisconsin? It helps to understand that in 2011 the state faced a \$3.6 billion dollar deficit that looked to extend into 2012 and 2013 budget years. Wisconsin attempted layoffs and furloughs⁴⁰ but the lingering recession and rising compensation levels for public employees appears to have created an environment toxic to the claims of the public sector unions. While Act 10 protected the status quo for public safety employees,⁴¹ Walker argued persuasively that it was the inflexibility of the state’s public sector unions that created the crisis. Act 10, he asserted,

approximately 98,000 members and AFT-Wisconsin is down to about 6,500 members from its peak of approximately 16,000, leaders of both organizations have reported. . . . Both have downsized staff and expenses.

Id.

³⁹ Monica Davey, *With Fewer Members, a Diminished Political Role for Wisconsin Unions*, N.Y. TIMES (Feb. 27, 2016), http://www.nytimes.com/2016/02/28/us/with-fewer-members-a-diminished-political-role-for-wisconsin-unions.html?_r=0.

⁴⁰ Melanie Trotman, *Public-worker Unions Steel for Budget Fights*, WALL STREET J. (Feb. 14, 2011), <http://www.wsj.com/articles/SB1000142405274870398950457612850231640306>.

Public-sector unions have begun using their clout against efforts to roll back government workers’ wages and benefits, cut jobs and curtail contract bargaining rights as political leaders from both parties look for ways to cut spending. Two of the nation’s biggest public-sector unions, which together represent about 2.2 million government workers, are facing a backlash against the rising costs of public workers’ pay, benefits and pensions. As states and local governments seek to trim costs in a difficult economy, the unions are struggling to defend pay and benefit packages negotiated when times were flush.

Id.

⁴¹ Gesina M. Seiler, *Court Upholds Part of Controversial Wisconsin Collective Bargaining Law*, 21 WIS. EMP. L. LETTER 1 (2012) (included in the category of public safety employees are “police officers, deputy sheriffs, firefighters, state patrol officers and state motor vehicle inspectors.”).

was a way to avoid cutting budgets and popular eliminating programs in the face of public sector union intransigence.⁴²

For example, the Mequon-Thiensville School District near Milwaukee froze teacher salaries for two years thereby saving \$560,000. It saved an additional \$400,000 by requiring higher contributions to healthcare plans. Administrators argue that circumventing the collective bargaining process and the union allowed them to “shift money out of the health plan and back into the classroom. [They]’ve increased programming” as a result.⁴³

It is clear that Walker successfully portrayed the public unions as selfish and intransigent in the face of financial crisis. It is also clear that the consequences of Act 10 have been nothing short of catastrophic for those unions.⁴⁴ Shockingly, between 2011 and 2014, membership of the American Federation of State, County and Municipal Employees (AFSCME) fell from 1000 to 122.⁴⁵ The loss of members and revenue of course meant a loss in political clout as well. The long-term question for Wisconsin and other states that have eliminated agency fees⁴⁶ is whether, in addition to the short-term

⁴² *See id.*

There’s no question that Wisconsin may bar its public employees from engaging in collective bargaining. The only question for the court was whether the state could restrict the rights of general employees while granting full rights to public-safety employees. The law allows such “line drawing” as long as the government can articulate a rational basis for doing so and a suspect class isn’t involved. State officials argued that the law doesn’t limit the bargaining rights of members who perform the most essential functions of maintaining public safety because of concerns over strikes.

Id.

⁴³ Greenhouse, *supra* note 10 (quoting Ted Neitzke, school superintendent in West Bend, Wisconsin). *See id.* (statement of James R. Scott, chairman of the Wisconsin Employment Relations Commission) (“[A]s a result of Act 10, the advantages that labor held have been diminished. . . . It’s fair to say that employers have the upper hand now.”).

⁴⁴ *See generally*, Charles J. Russo, *Collective Bargaining in Public Education: It Was the Best of Times, It Was the Worst of Times*, 291 ED. L. REP. 545 (2013); Paul M. Secunda, *The Wisconsin Public-Sector Labor Dispute of 2011*, 27 ABA J. LAB. & EMP. L. 293 (2012); Samuels, *supra* note 35. *See also* Appendix A.

⁴⁵ Greenhouse, *supra* note 10, at 8 (statement from Wisconsin attorney, Lester A. Pines) (“The law . . . is destroying unions with a thousand cuts and making it seem that it’s their fault.”).

⁴⁶ *See* Mike Antonucci, *Teachers Unions at Risk of Losing “Agency Fees”*, 16 EDU. NEXT 22, fig. 1 at 27 (2016), <http://educationnext.org/teachers-unions-risk->

savings the state and its municipalities were able to obtain, a longer term restructuring of wages and benefits will be possible. Benefits are likely to be the primary focus both in Wisconsin and beyond as the compensation gap between private and public employees seems to support a conclusion that it is benefits and not wages that are exceptional in the public sector.

III. ARE PUBLIC SECTOR EMPLOYEES OVERPAID?

Were cities and towns that responded to Act 10 by freezing salaries, cutting benefits and generally holding the line on public employee labor costs after 2011 in fact “right sizing” or were they simply taking advantage of a newly politically vulnerable group of employees? It turns out that figuring out whether or not public employees are overcompensated is trickier than it seems. There is a substantial literature that purports to demonstrate that public school teachers and other public sector workers are overpaid.⁴⁷ Public Sector unions, for their part, have made some attempts to refute this

losing-agency-fees-friedrichs-california/ (providing map of which states allow for agency fees to be collected and which do not).

⁴⁷ See, e.g., Andrew G. Biggs & Jason Richwine, *Assessing the Compensation of public-school teachers*, AM. ENTERPRISE INST. (2011) (“[w]e conclude that public-school teacher salaries are comparable to those paid to similarly skilled private sector workers, but that more generous fringe benefits for public-school teachers, including greater job security, make total compensation 52 percent greater than fair market levels, equivalent to more than \$120 billion overcharged to taxpayers each year.”); Steven Greenhut, *California Faces Death by Pension*, THE AMERICAN SPECTATOR (Oct. 29, 2014 8:00 AM), http://spectator.org/60778_california-faces-death-pension/ (Governor Arnold Schwarzenegger’s chief pension adviser, David Crane, giving testimony in 2010 before the California Senate) (“All of the consequences of rising pension costs fall on the budgets for programs such as higher education, health and human services, parks and recreation and environmental protection that are junior in priority and therefore have their funding reduced whenever more money is needed to pay for pension costs[.]”); Robert C. Pozen, *The Other Debt Bomb in Public Employee Benefits*, THE WALL ST. J., Jan. 15, 2015, <http://www.wsj.com/articles/robert-c-pozen-the-other-debt-bomb-in-public-employee-benefits-1421367030> (noting that New York City has unfunded retiree health care liabilities of \$22,857 per household and recommending that jurisdictions increase disclosure of costs as a mechanism which would encourage voters to consider reform); Mark Casciari & Barbara Borowski, *Rightsizing Public Employee Retirement Benefits: How Have State Courts Resolved the Constitutional Issues?*, 26 BENEFITS. L. J. 22 (2013) (suggesting that states will continue to try and cutback state and local employee benefits as long as they are facing funding shortfalls).

view.⁴⁸ Scholarly work that is not overly politicized seems to provide some support for the Walker view:

After controlling for skill differences and incorporating employer costs for benefits packages, we find that, on average, public sector workers in state government have compensation costs 3-10 percent greater than those for workers in the private sector, while in local government the gap is 10-19 percent. We caution that this finding is somewhat dependent on the chosen sample and specification, that averages can obscure broader differences in distributions, and that a host of worker and job attributes are not available to us in these data. Nonetheless that data suggest that public sector workers, especially local government ones, on average, receive greater remuneration than observably similar private sector workers.⁴⁹

A. A MORAL HAZARD STORY

As I've argued elsewhere,⁵⁰ there is certainly a growing body of evidence which supports the Walker narrative: that when public finances are

⁴⁸ See Nicholas Kristof, *Pay Teachers More*, N.Y. TIMES, Mar. 13, 2011, at WK10 (“A basic educational challenge is not that teachers are raking it in, but that they are underpaid. If we want to compete with other countries, and chip away at poverty across America, then we need to pay teachers more so as to attract better people into the profession. . . . These days, brilliant women become surgeons and investment bankers — and 47 percent of America’s kindergarten through 12th-grade teachers come from the bottom one-third of their college classes [as measured by SAT scores]”).

⁴⁹ Maury Gittleman & Brooks Pierce, *Compensation for State and Local Government Workers*, 26 J. ECON. PERSPECTIVES 217 (2011) (observing two sets of data) (“[I]n both data sets, the raw wage gap shows public sector workers being paid more. In [one], the raw gap in hourly earnings is about 4 percent; in the [other], hourly wages in government sectors exceed those in the private sector by an average of about 30 percent.”).

⁵⁰ See e.g., Maria O’Brien Hylton, *Central Falls Retirees v. Bondholders: Assessing Fear of Contagion in Chapter 9 Proceedings*, 59 WAYNE L. REV. 525 (2013).

If the core problem is . . . a strong tendency to overpromise because of strong forces that encourage morally hazardous behavior, who should bear the cost when a municipality cannot keep the promises it made? Does it matter that municipal creditors are typically either very sophisticated—i.e., bondholders and their

insurers—or possibly less savvy but often intimately involved in a long pattern of reckless spending that has directly contributed to the financial crisis—i.e., public employees and the unions that represent them? . . . Culpability for the mess in Central Falls certainly resides with the political actors who, aided and abetted by public employees, promised benefits far beyond what the poor town could afford. . . . Politicians are well known for their cavalier attitude toward “other people’s money. . . . The guilty role played by public employees and their representatives is by now so well understood that it requires little further explanation. Suffice it to say that the public employee/legislator relationship was beneficial to all concerned save the current and future taxpayer. Can the elected official/lender/public employee axis be broken? The only way forward appears to be some combination of structural changes and increased transparency. A variety of proposals have been advanced in recent years; terminating defined benefit plans and moving employees to defined contribution arrangements similar to the private sector’s 401 (k) vehicle is among the most promising. Modest reforms include requiring public plans to use realistic, market-based rates of return when making assumptions about asset growth that directly impact the size of future liabilities. More radical, but perhaps not unreasonable in extreme situations . . . is the call to simply bar legislators from negotiating with public unions about pensions and/or retiree health benefits.

Id. at 529, 543, 555-557.

See also Maria O’Brien Hylton, *The Case for Public Pension Reform: Early From Kentucky*, 47 CREIGHTON L. REV. 585 (2014).

The first sign that over promising has occurred with pension promises is often the failure of the state, as with Kentucky, to make its required contribution. Why is payment not made as promised? Well, legislators remember that they have a variety of other commitments besides pensions - public education, roads, prisons, public health - to name a few. These generally require immediate spending in order to satisfy the public's demand for services. Pensions, on the other hand, are a future expense which can be delayed. Over time, of course, repeated delay creates a larger and larger shortfall which must one day be made up. But, that long term horizon is not the horizon for the typical politician who hopes/expects to have moved on to bigger and better things by the time the shortfall has mushroomed into a full blown crisis.

Id. at 596-597.

See also Maria O’Brien Hylton, *After Tackett: Incomplete Contracts for Post-Employment Healthcare*, 36 PACE L. REV. 317, 368-369 (2016) (“Numerous state and local government employers have been forced to reckon with the size and scope

tight and tax increases are politically infeasible, the natural cost cutting response one might expect to see is often thwarted by labor agreements which bind local governments to a cost structure that is unsustainable. It is not generally wages but instead the promises made with respect to employee benefits—pension costs and active and retiree health care commitments—that overwhelm states⁵¹ and municipalities alike. The reason for this, like all stories about morally hazardous⁵² behavior, is rooted in the cavalier way in

of benefits that had been promised to public employees - often without much thought to the future cost to taxpayers. Indeed, some states are still trying, very publicly, to come to terms with the cost of post-employment benefits that threaten to crowd out all other spending.”).

⁵¹ See e.g., David W. Chen & Mary Williams Walsh, *New York City Pension System Is Strained by Costs and Politics*, N.Y. TIMES (Aug. 3, 2014), <http://www.nytimes.com/2014/08/04/nyregion/new-york-city-pension-system-is-strained-by-costs-and-politics.html>.

For years, New York City has been dutifully pumping more and more money into its giant pension system for retired city workers. . . . But instead of getting smaller, the city’s pension hole just keeps getting bigger, forcing progressively more significant cutbacks in municipal programs and services every year. Like pension systems everywhere, New York City’s has been strained by a growing retiree population that is living longer, global market conditions and other factors. But a close examination of the system’s problems reveals a more glaring issue: Its investment strategy has failed to keep up with its growing costs, hampered by an antiquated and inefficient governing structure that often permits politics to intrude on decisions. The \$160 billion system is spread across five separate funds, each with its own board of trustees, all making decisions with further input from consultants and even lawmakers in Albany. . . . Like many public systems, New York has promised irrevocable pension benefits to city workers on the thinking that fund investments would grow enough to cover the cost — but they have not. Its response so far has been to take advantage of a recovering local economy and inject a lot more city money into the pension system quickly — an option not available to declining cities like Detroit, which filed for bankruptcy last year, or a tax-averse state like New Jersey, which has been underfunding its pension system for years.

Id.

⁵² See *Definition of ‘Moral Hazard’*, ECON. TIMES (Oct. 7, 2016), <http://economictimes.indiatimes.com/definition/moral-hazard> (the Economic Times defining moral hazard as “[A] situation in which one party gets involved in a risky event knowing that it is protected against the risk and the other party will incur the

which human beings behave when they are tasked with spending other people's money.

The key insight offered by the study of moral hazard is that people treat valuable resources differently—the degree of care exercised depends on the ownership of those resources. When dollars that belong to someone else are being spent the level of care is much lower than what is observed when owned dollars are expended. This phenomenon is easy to observe in almost any insurance context. Homeowners and automobile insurers, for example, routinely require deductibles in order to minimize the likelihood that an insured will simply exercise an unacceptable level of care given the presence of the insurance. The homeowner, for example, who carelessly neglects to put out a cigarette or extinguish a fire in the fireplace or the automobile owner who parks in a dangerous neighborhood and fails to lock her vehicle are much more likely to be careful with their property in the absence of any insurance. Insurance, well aware of this problem, insist on “sharing the loss” by requiring deductibles; health insurers, wary of unnecessary visits to the doctor do the same thing by way of co-pays and other forms of cost sharing.

How is this connected to public sector employee benefits? The story of how so many cities and states have ended up overpaying for employee benefits is fundamentally a story about simple moral hazard too. Elected officials, entrusted by voters to negotiate wages and benefits with public sector employees are especially vulnerable to the moral hazard encountered when considering how to spend taxpayer dollars. Aware that the taxpayer is almost certainly not paying attention to the details⁵³ and eager to keep well organized groups of public employees who both vote and provide support during election campaigns happy, elected officials have, time and again,

cost. It arises when both the parties have incomplete information about each other.”). An example of moral hazard would be a homeowner with full homeowner's insurance choosing not to install a security system because he or she know the insurance company will bear the burden, should a burglary occur. *See id.*

⁵³ Hence the calls by Pozen and others for greater transparency. Since 2003, the Governmental Accounting Standards Board (“GASB”) has been studying government action and suggested that states should be more transparent in their functions, particularly in financial statements. GASB even suggests that derivatives be included in financial statement in order make more transparent what the government is leveraging to accomplish deals and transactions. *See Derivatives: GASB Proposes More Transparency*, USER'S PERSP. (Gov't Accounting Standards Bd. Norwalk, C.T.) May 2006, http://gasb.org/cs/ContentServer?c=GASBContent_C&pagename=GASB%2FGASBContent_C%2FUsersArticlePage&cid=1176156737013.

opted to over promise in the present and let future generations worry about how to pay later. This is unequivocally the subtext from Illinois⁵⁴ to California⁵⁵ and Rhode Island.⁵⁶

⁵⁴ See Hal Dardick, *Illinois Supreme Court ruling forces city to find new fix for 2 pension funds*, CHICAGO TRIBUNE (Mar. 24, 2016, 6:28 PM), <http://www.chicago.tribune.com/news/local/politics/ct-chicago-pension-law-ruling-0325-20160323-story.html>.

The Illinois Supreme Court dealt Mayor Rahm Emanuel — and in turn Chicago taxpayers — a big blow on Thursday when it found unconstitutional a law that aimed to shore up two city pension funds by cutting benefits and requiring workers to pay more toward retirement. A group of unions, current workers and retired employees sued in response to the law, noting the 1970 Illinois Constitution states that pension benefits, once granted, ‘shall not be diminished or impaired.’ In a 5-0 ruling, the state’s high court once again agreed with that argument, less than a year after reaching the same conclusion in a separate case covering state pension systems. . . . The new ruling raises further questions about the city’s precarious financial situation. . . . [T]he loss also exacerbates the city’s massive financial problems over the long term — the funding shortfall in the two retirement funds would continue to grow by about \$900 million a year, and taxpayers could end up plugging the gap.

Id.

⁵⁵ See Melody Petersen, *California public workers may be at risk of losing promised pensions*, L.A. TIMES (Mar. 17, 2015), <http://www.latimes.com/business/la-fi-pension-controversy-20150317-story.html>.

As millions of private employees lost their pension benefits in recent years, government workers rested easy, believing that their promised retirements couldn’t be touched. Now the safety of a government pension in California may be fading fast. Feeling the heat is the state’s huge public pension fund, the California Public Employees’ Retirement System, known as CalPERS. The fund spent millions of dollars to defend itself and public employee pensions in the bankruptcy cases of two California cities — only to lose the legal protections that it had spent years building through legislation. The agency’s most significant setback came in Stockton’s bankruptcy case. The judge approved the city’s recovery plan, including maintaining employees’ pensions, but ruled that Stockton could have legally chosen to cut workers’ retirements Part of the problem is that many cities have promised workers pensions that are more generous than those still offered in the private sector. Many government workers retire at 50 or 55 on lifelong payments that can nearly match their salaries

In Wisconsin it really did not matter whether the unions were as intransigent as Walker portrayed them; what was critical is that the public came to believe that when a financial crisis struck, public sector employees were unwilling to face the same reduced circumstances as private sector taxpayers. Job loss, pay cuts, increased health care expenses⁵⁷—painfully

if they were longtime employees. Increasing payments to CalPERS was one reason that Stockton and San Bernardino were forced to file for bankruptcy. . . . CalPERS' efforts to protect itself and workers' retirements began decades ago when it pushed through two state laws with help from the politically powerful unions. The first law said that a city's contract with CalPERS could not be canceled in bankruptcy. The second allowed CalPERS to place a costly lien on a city's property — in essence, a new and far more expensive bill for pensions — if the city left CalPERS and provided retirement benefits through a different fund. The cost of the threatened lien was so steep — in Stockton, CalPERS demanded \$1.6 billion — that no city in bankruptcy has left the fund.

Id.

⁵⁶ See Mary Williams Walsh & Abby Goodnough, *A Small City's Depleted Pension Fund Rattles Rhode Island*, N.Y. TIMES (July 11, 2011), <http://www.nytimes.com/2011/07/12/business/central-falls-ri-faces-bankruptcy-over-pension-promises.html>.

The small city of Central Falls, R.I., appears to be headed for a rare municipal bankruptcy filing, and state officials are rushing to keep its woes from overwhelming the struggling state. The impoverished city, operating under a receiver for a year, has promised \$80 million worth of retirement benefits to 214 police officers and firefighters, far more than it can afford. Those workers' pension fund will probably run out of money in October, giving Central Falls the distinction of becoming the second municipality in the United States to exhaust its pension fund, after Prichard, Ala. . . . Some of the retirees are in their 90s, and Central Falls, like many American cities, has not placed its police and firefighters in Social Security. Many have no other benefits to fall back on.

Id.

⁵⁷ The Cadillac Tax in the Affordable Care Act will begin enforcing a 40% tax of any health plan for the amount of the plan that exceeds \$10,200 (for an individual plan) and \$27,500 (for a family plan) in 2018. This was meant to ensure employees kept the cost of health insurance in mind and did not require employers to dole out too much for high insurance, but it resulted in union resentment, as unions have begun to have the tax leveraged against them in collective bargaining agreements.

experienced by those without the benefit of a union—did not result in union envy but in union resentment. Private sector workers did not wish they could join a public sector union; instead they wished that those who were already members would accept less so that taxes would not have to be increased or services decreased in order to survive the crisis.

The Great Recession which began in 2008 laid bare the huge differences in job protections, health care costs and retirement benefits enjoyed by public and private sector employees.⁵⁸ Private sector employers shed workers rapidly as needed. Meanwhile, the public sector unions seemed impervious to the resentment their generous benefits and job security engendered.⁵⁹ People who collected unemployment benefits⁶⁰ and struggled

See Kate Taylor, *Health Care Law Raises Pressure On Public Unions*, N.Y. TIMES (Aug. 5, 2013), at A1.

⁵⁸ See Michael Cooper, *Government Jobs Have Grown Since Recession*, N.Y. TIMES (Aug. 19, 2009), <http://www.nytimes.com/2009/08/20/us/20states.html>.

While the private sector has shed 6.9 million jobs since the beginning of the recession, state and local governments have expanded their payrolls and added 110,000 jobs The expansion, coming as many states and localities are raising taxes, troubled Tad DeHaven, a budget analyst for the Cato Institute, a libertarian research group in Washington. ‘That is disturbing,’ Mr. DeHaven said. ‘Basically what you have is your producers in society losing their jobs and looking for work, and their tax burden isn’t necessarily going down — and as a matter of fact they are likely to face tax increases going forward — and government growing.’ The disparity between the public and private sector job market is striking in places like Boise, Idaho. Since the recession began, the area’s unemployment rate has more than doubled, to over 10.1 percent in June, as big employers, especially in the technology sector, shed workers. The Boise area lost 20,000 jobs in the year ending in June, the Idaho Labor Department said, and saw real gains only in government, which had an increase of 1,400 jobs, mostly in the public schools.

Id.

⁵⁹ Dave Umhoefer, *Gov. Scott Walker says he asked unions for concessions and they refused*, POLITIFACT (Sept. 16, 2011), <http://www.politifact.com/wisconsin/statements/2011/sep/16/scott-walker/gov-scott-walker-says-he-asked-unions-concessions/> (quoting a campaign fundraising letter written by Scott Walker, dated Sept. 2, 2011) (“I asked the unions to pay into their own health care insurance and they said I was being unreasonable I requested that they contribute toward their own pensions and they screamed it was unfair.”).

⁶⁰ Each state’s unemployment system works slightly differently, but to qualify there are some general requirements most states include. The unemployed worker

to hold onto their homes⁶¹ could simply not be counted on to listen sympathetically to proposals to raise taxes in order to honor promises made to teachers and others whose still—employed status inspired raw envy.

It appears that in Wisconsin and elsewhere public sector unions either couldn't or wouldn't confront the relatively luxurious status of their members. Walker saw an open door and walked through it. The plaintiffs

must be unemployed (not part-time or self-employed), must make a claim and cooperate with their local unemployment office, and must be ready, willing, and able to work. If an unemployed worker meets all the eligibility requirements and follows the guidance of their local unemployment office, they can generally collect pay through federal and state unemployment taxes. *See The Unemployment Benefits System: How it Works and When to Contest a Claim*, BIZFILINGS (May 2, 2016), <http://www.bizfilings.com/toolkit/sbg/office-hr/managing-the-workplace/unemployment-benefits-system-info.aspx>.

⁶¹ Ingrid Gould Ellen & Samuel Dastrup, *Housing and the Great Recession*, RECESSION TRENDS, STAN. CTR. POVERTY AND INEQ. (Oct. 2012).

Since the first quarter of 2006, U.S. households have lost over \$7 trillion in home equity. As a result, CoreLogic estimates that 22 percent of homeowners with mortgages are now “underwater,” or have an outstanding mortgage balance that exceeds the value of their home. . . . Equity losses also appear to have been particularly severe for minority households. A recent study by the Pew Research Center found that median wealth fell by 66 percent from 2005 to 2009 among Hispanic households and 53 percent among Black households, as compared with just 16 percent among White households. . . . Reductions in homeownership rates following the housing crash have also been more extreme for minority groups. While all racial and ethnic groups have experienced a decline in homeownership in recent years, the fall has been sharpest for Blacks and Latinos . . . just 44.2 percent of Black households and 47.1 percent of Latino households owned their homes in 2010, down from 46.3 and 49.3 percent respectively in 2006. . . . homeownership rates have also fallen much more sharply for young adults as compared to older adults. This is both because transitions out of homeownership are less likely for older homeowners and because transitions into homeownership have slowed due to the weak labor market, uncertainty about prices, and tightened underwriting. . . . Data from the U.S. Department of Housing and Urban Development show that the estimated number of homeless families in the United States rose by 30 percent to 170,000 from 2007 to 2009, with the average length of stays in shelters rising during the recession as well.

Id. at 2-5.

in *Friedrichs* sensed the same vulnerability and, but for the unexpected change in the composition of the Supreme Court, almost obtained the same result. There is no doubt but that Wisconsin's experience would have been duplicated around the country in states that permit the collection of agency fees. It is certain that membership in public sector unions would have declined rapidly along with revenue and lobbying efforts. States would suddenly discover that public sector employee benefits were slightly more vulnerable at least to future reductions.⁶²

⁶² See, e.g., Amy Monahan, *Understanding the Legal Limits on Public Pension Reform*, AM. ENTERPRISE INST. at 5 (2013) ("Arizona's constitution specifically protects public employee pensions by providing that 'membership in a public retirement system is a contractual relationship that is subject to Article II, §25, and public retirement system benefits shall not be diminished or impaired'"); Amy B. Monahan, *Public Pension Plan Reform, The Legal Framework*, U. of Minn. L. School, Legal Studies Research Paper Series No. 10-13.

A handful of states have rejected a contract-based approach to public pensions in favor of a property-based approach. To the extent that rights in a public pension plan are considered property, they are protected under the Fifth and Fourteenth Amendments to the U.S. Constitution from deprivation without due process of law. In addition, the Fifth Amendment to the U.S. Constitution prohibits the taking of property without just compensation.

Id. at 24.

See also David J. Kahne, *Protecting Pensions And Contract Rights For Public Sector Employees*, STROOCK REPS. (STROOCK & STROOCK & LAVAN LLP) August 4, 2015.

Public sector employees in certain states can use the non-impairment clause to protect their pension rights from unilateral reductions imposed by a state or local government. Under many state constitutions, including New York's, pensions are granted contractual status. Article V § 7 of the New York State Constitution declares that, "membership in any pension or retirement system of the state or of a civil division thereof shall be a contractual relationship, the benefits of which *shall not be diminished or impaired*." Notably, there is no qualification. Thus, any judicial or legislative action that seeks to impair pension rights is arguably a violation of New York's Non-Impairment Clause. Case law and the legislative history confirms that the purpose of New York's Non-Impairment Clause was "to fix the rights of the employees at the time of commencement of membership in the [pension] system, rather than as previously at retirement." The clause prohibits unilateral action by either the Legislature or the

B. *FRIEDRICHS AGAIN?*

It seems likely that the organizations⁶³ which coordinated and funded the *Friedrichs* litigation will try again. Public school teachers will probably

employer that would diminish or impair the rights employees have gained through their membership in the system.

Id.

Further, states like Illinois have declared benefits such as healthcare for retired state workers to be a “constitutionally protected pension benefit.” See Karl Plume, *Illinois high court rules constitution protects health benefits*, REUTERS (July 3, 2014) <http://www.reuters.com/article/usa-illinois-retiree-healthcare-idUSL2N0PE10720140703> (“It’s too soon to say what the implications of this ruling are,” said . . . senior credit officer Ted Hampton. But he added that it ‘casts doubt’ on the pension reform law.”).

⁶³ One such example is the Center for Individual Rights (“CIR”). See *Mission*, CENTER FOR INDIVIDUAL RIGHTS (2016), <https://www.cir-usa.org/mission/> (“The Center for Individual Rights (CIR) is a non-profit public interest law firm dedicated to the defense of individual liberties against the increasingly aggressive and unchecked authority of federal and state governments.”); *Friedrichs v. CTA: Case Timeline*, *supra* note 1. On September 10th and 11th, 2015, there were 25 different *Amicus* Briefs filed in support of the Plaintiff. See Docket 14-915, *Friedrichs v. Cal. Teachers Ass’n*, 136 S.Ct. 2545 (2016). One *Amicus Brief*, filed by the Cato Institute, delivered a stinging and unrelenting attack on labor unions’ “opt-out” practices currently in place, requiring people who rejected joining the union, but are forced to pay agency fees, to affirmatively opt-out of particular ideological or political speech. Brief for the Cato Institute As *Amicus Curiae* In Support of Petitioners, *Friedrichs v. Cal. Teachers Ass’n*, 136 S.Ct. 2545 (2016).

For the reasons stated in *Harris v. Quinn*, (citation omitted), the First Amendment does not permit government to compel public employees to associate with a labor union and subsidize its speech on matters of public concern. The Court should therefore overrule its aberrant decision to the contrary in *Abood* . . . the opt-out scheme administered by Respondents is designed to ensnare dissenting teachers who inadvertently fail to register an objection during the prescribed opt-out period, as well as those who subsequently come to oppose the union’s political speech. A teacher, for example, might assume that the California Teachers Association’s political and ideological speech is confined to issues relating to education and public schools and may well be surprised to learn partway through the school year that it engages in advocacy on abortion, immigration reform, and other controversial issues. Yet that teacher is required to subsidize the union’s speech on those matters—with funds deducted from her

remain a fertile group from which to recruit plaintiffs given the ongoing fights around the country over charter schools and the efficacy of public schools.⁶⁴ The speed with which the Court is asked to review *Abood* will certainly depend on the perceived receptivity of Scalia’s replacement to the First Amendment claims made by the *Friedrichs* plaintiffs.⁶⁵ Taxpayers,

paycheck week after week—until the next opportunity to opt out. This is a plain-as-day violation of the “bedrock principle” that “no person in this country may be compelled to subsidize speech by a third party that he or she does not wish to support.” *Harris*, 134 S. Ct. at 2644. A decision flipping the presumption—from opt out to opt in—would correct this wholesale infringement of First Amendment rights and put labor unions on an equal footing with all other groups that rely on truly voluntary contributions.

Id. at 1-3.

⁶⁴ One principal, Kelian Betlach, at Elmhurst Community Prep in Oakland, California faces the same problem every year:

[A] common one at schools like Elmhurst, where 91 percent of students qualify for free- or reduced-price lunch, a federal measure of poverty, and 33 percent are classified as English language learners. Many of the factors keeping teachers from showing up at schools like his are beyond the control of any single principal. Across the country, an improving economy has pulled teachers and potential teachers away from the profession, creating a growing national shortage. In California . . . competition for qualified teachers is particularly stiff. . . . Chronic underfunding of schools in California means that teaching jobs are not as secure as they once were and, in many parts of the state, a teacher’s salary won’t sustain a middle-class lifestyle. At the same time, a growing number of urban charter schools, focused on the same population as schools like Elmhurst, offer bigger paychecks for young, ambitious teachers willing to tie their salaries to their performance—a particularly fraught issue in California. . . . Finding and keeping teachers who can excel at working in urban schools may seem a Sisyphean task. And yet it is one at which principals like Betlach must succeed, every year, or risk their students’ fragile educational progress.

Lillian Mongeau, *Teachers Wanted: Passion a Must, Patience Required, Pay Negligible: Turnover is highest in the neediest schools, and competition for new educators is getting stiffer*, ATLANTIC (Sept. 9, 2015), <http://www.theatlantic.com/education/archive/2015/09/teachers-wanted-passion-a-must-patience-required-pay-negligible/404371/>.

⁶⁵ The Senate is trying its hardest to ensure that Scalia’s replacement is at least somewhat ideologically close to the late Justice. The Senate has evaded voting, or

legislators and public sector unions everywhere should both anticipate the renewal of this dispute and focus on the core policy questions it raises. Are public sector benefits too generous? Are public employees overpaid in some fundamental sense? If indeed public sector collective bargaining is just a species of lobbying which has resulted in the “capture” of various legislatures around the country,⁶⁶ then legislators and public sector unions might do well to reconsider the cozy relationships they have cultivated. Maybe it is time for legislators not just to be seen negotiating but to actually negotiate with an eye toward financial commitments that are affordable and sustainable.

Act 10 was not so much an endorsement of Scott Walker as a furious rejoinder to the failure of Wisconsin political actors to adequately represent the interests of the people who elected them. Hostility to agency fees is based on a sense that public unions have a disproportionately large voice in public affairs; that they have created and coddled an entrenched and inefficient workforce,⁶⁷ and harmed school aged children, especially those from poor

even holding hearings, on President Obama’s middle-of-the-road nomination, Merrick Garland, for over 100 days at the time of this article’s writing. Though there has been similar backlash and stalling late in other presidents’ final terms, the Garland blockade is unprecedented in length and a shining display of the ideological split the country is facing, as well as the importance of late Justice Scalia’s seat. *See* Ed. Bd., *The Senate’s Confirmation Shutdown*, N.Y. TIMES, June 9, 2016, at A22.

⁶⁶ *See* Rachel E. Barkow, *Insulating Agencies: Avoiding Capture Through Institutional Design*, 89 TEX. L. REV. 15 (2010).

To achieve either expert or nonpartisan decision making, one must avoid undue industry influence, or ‘capture.’ Unfortunately, as Richard Stewart has observed, “[i]t has become widely accepted, not only by public interest lawyers, but by academic critics, legislators, judges, and even by some agency members, that the comparative overrepresentation of regulated or client interests in the process of agency decision results in a persistent policy bias in favor of these interests.” . . . one can never hope to avoid all hints of capture. But as with expertise, the question is whether one can achieve *some* insulation from interest group pressure.

Id. at 21-24.

⁶⁷ One example of this is the use of “rubber rooms” where teachers awaiting disciplinary hearings draw full salary and benefits not to work, but to sit and wait. *See* Jennifer Medina, *Deal Reached to Fix Teacher Discipline Process*, N.Y. TIMES (Apr. 16, 2010), at A1 (discussing the supposed removal of “rubber rooms” in NYC and how unions continue impede the disciplinary process by making teachers very difficult to fire). *See generally* WAITING FOR SUPERMAN (Walden Media 2010)

and moderate income families who do not enjoy the luxurious option of private school education.⁶⁸ One cannot help but ask, if public unions are *not* coercing speech, then how to understand the dramatic drop in membership? Why aren't employees supporting an organization that is accurately reflecting its members' positions on a wide range of issues?

Taxpayers are asking what they have to lose if public sector union power is dramatically reduced. Wisconsin has answered that question. In the short run, as salaries are contained or reduced, budget pressure is relieved and dollars can go to services which might otherwise be cut in times of crisis. Public sector unions become less politically important and less able to articulate their views as their staffs shrink. Over the longer term we should expect to see relief for taxpayers as well from onerous benefits commitments—especially those for retiree health care, active employee health care and pensions. As others have suggested, we may see more and more public employees getting their insurance from a state of federal health care exchange.⁶⁹ In the same way the private sector shed many of the obligations⁷⁰ we would expect that state and local governments would

(criticizing the American public school system for how it handles disciplining, reprimanding, and firing tenured teachers).

⁶⁸ Some advocate for charter schools as a “replacement system for the failed urban [school] system.” A solution like this would involve “closing low-performing traditional and charter schools” to only allow schools that are successful educators, as deemed by the local government or educational authority, to continue operating. In addition, these advocates suggest allowing failing public school to be taken over by a charter company if it means the students' quality of education will increase. Under their view, urban students are the most needy students, yet their needs are not close to being met and “well-meaning education reformers” are simply not meeting these students' needs properly. See Emma Brown, *Can traditional school systems be replaced by charters?*, THE WASH. POST (Jan. 30, 2013), https://www.washingtonpost.com/blogs/dc-schools-insider/post/can-traditional-school-systems-be-replaced-by-charters/2013/01/30/e33a013a-6a71-11e2-95b3-272d604a10a3_blog.html.

⁶⁹ See Natalya Shnitser, *Accounting and the ACA: New Choices and Challenges for Public Sector Retiree Health Plans*, 20 EM. RTS. & EMP. POL'Y J. 147 (2016).

⁷⁰ See Susan E. Cancelosi, *VEBAS to the Rescue: Evaluating One Alternative for Public Sector Retiree Health Benefits*, 42 J. MARSHALL L. REV. 879, 880-81 (2009).

When private sector employers realized the impact of FAS 106 on their balance sheets, many chose to terminate retiree health benefits. Others imposed a variety of cost-containment measures. Collectively bargained employers, however, generally could not take such steps. Constrained by their agreements with unions, they

follow. The private ordering that has dominated everywhere but in the unionized public sector should creep into the public sector as union power there declines.

IV. CONCLUSION

Many supporters of pension and health care benefits reform for the public sector were disappointed by the stalemate produced by *Freidrichs* following the death of Justice Scalia. The Court seemed poised to overturn *Abood* and usher in a new era of in which fees for contract administration, grievance adjustment, etc. were forbidden as impermissible interference with employee free speech rights. *Abood* has long been justified on anti-free riding grounds, although no one seriously argued that concerns about free riding were sufficient to overcome interference with the constitutional rights of public employees. The recent experience in Wisconsin provides a window into what a post-*Abood* world will almost certainly look like. It is an environment in which public union power is significantly constrained,

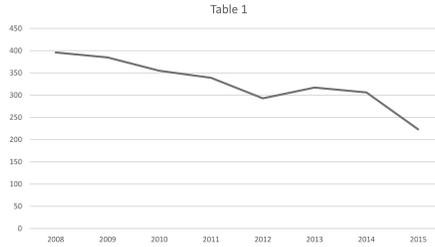
had little flexibility in managing their retiree health expenses. Large, traditional manufacturing companies - with high concentrations of unionized retirees and historically generous benefit packages, but shrinking active workforces and negative economic forecasts - found themselves struggling to remain financially viable in the face of overwhelming liabilities. The public sector today faces similar problems. Because GASB 45 demands that government employers acknowledge the true level of retiree health offers, they risk balance sheet disasters. Most have financed retiree health benefits on a pay-as-you-go basis, with no assets set aside for future expenses. Many are heavily unionized, with little room to shift costs to retirees, much less to terminate benefits. Some have constitutional or statutory guarantees that protect benefit commitments. Although they do not risk liquidation the way private sector employers do, financial insolvency affects state and local governments' ability to raise money to finance public services and projects. Government employers, moreover, depend on the good will of taxpayers. They cannot easily raise taxes or divert funds from other sources. Meanwhile, the current depressed economy translates to severe budget problems for state and local governments across the country. The similarities between the public sector today and the private sector of the early 1990s raise intriguing questions about possible solutions for the public sector.

Id. at 880-881.

membership levels drop and public union political activity decreases. These changes appear to have made unilateral reductions in the cost of public sector employee benefits politically feasible resulting in savings to taxpayers. The *Freidrichs* decision leaves the problem of forced speech by public employees unresolved. As states continue to grapple with rapidly escalating benefits costs in the public sector, one would expect to see another *Freidrichs*-type challenge emerge in the not too distant future.

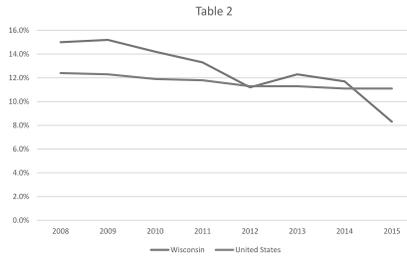
Appendix A

Public and Private Union Membership Levels in Wisconsin¹



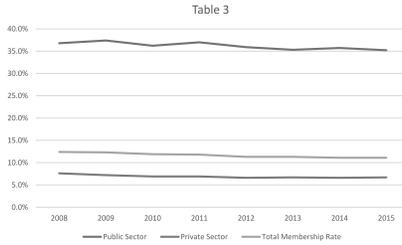
¹US DEPT. OF LABOR, BUREAU OF LABOR STATISTICS, UNION MEMBERSHIP HISTORICAL TABLE FOR WISCONSIN 1989-2014, available at http://www.bls.gov/regions/midwest/data/unionmembershiphistorical_wisconsin_table.htm; US DEPT. OF LABOR, BUREAU OF LABOR STATISTICS, UNION MEMBERS 2015, available at <http://www.bls.gov/news.release/pdf/union2.pdf>.

Percentage of all U.S. versus all Wisconsin Employees that are Union Members²



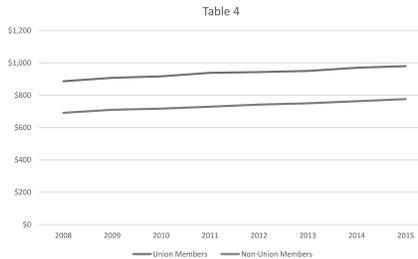
²US DEPT. OF LABOR, BUREAU OF LABOR STATISTICS, UNION MEMBERSHIP CHARTS 2008-2015, available at <http://www.bls.gov/cps/lfcharacteristics.htm#union>.

National Union Membership Rates Public v. Private Sector³



³US DEPT. OF LABOR, BUREAU OF LABOR STATISTICS, UNION AFFILIATION DATA – PRIVATE SECTOR, available at http://data.bls.gov/timeseries/LUU0204906600?years_option=all_years; US DEPT. OF LABOR, BUREAU OF LABOR STATISTICS, UNION AFFILIATION DATA – PUBLIC SECTOR, available at http://data.bls.gov/timeseries/LUU0204922700?years_option=all_years.

Median Weekly Earnings of Public and Private Union Members v. Non-Union Members⁴



⁴US DEPT. OF LABOR, BUREAU OF LABOR STATISTICS, UNION DATABASE RETRIEVAL TOOL, available at <http://www.bls.gov/cps/lfcharacteristics.htm#union>.

Wisconsin Education Association Council Lobbying Analysis – Pre and Post Act 10⁵

	2009-2010	2011-2012	2013-2014
Dollar Rank	1st	2nd	< 25th
Dollars Spent	\$2,493,485	\$2,349,500	Not listed
Hours Rank	3rd	2nd	< 25th
Hours Spent	12,364	11,415	Not listed

⁵STATE OF WISCONSIN, GOVERNMENT ACCOUNTABILITY BOARD, GOVERNMENT ACCOUNTABILITY REPORT FOR 2009-2010, *available at* http://www.gab.wi.gov/sites/default/files/publication/68/2009reg_slaetoporganizationdollars_pdf_16658.pdf; STATE OF WISCONSIN, GOVERNMENT ACCOUNTABILITY BOARD, GOVERNMENT ACCOUNTABILITY REPORT FOR 2011-2012, *available at* http://www.gab.wi.gov/sites/default/files/publication/68/2011reg_slaetoporganizationdollars_pdf_76233.pdf; STATE OF WISCONSIN, GOVERNMENT ACCOUNTABILITY BOARD, GOVERNMENT ACCOUNTABILITY REPORT FOR 2013-2014, *available at* http://www.gab.wi.gov/sites/default/files/publication/68/slae_top_organization_by_dollars_2013_2014_pdf_18518.pdf.

A CLOSER LOOK AT THE IRAS IN STATE AUTOMATIC ENROLLMENT IRA PROGRAMS

KATHRYN L. MOORE¹

I. INTRODUCTION

The United States faces a serious retirement savings funding gap.² This gap is due, in part, to the fact that only about half of the American workforce is covered by an employer-sponsored pension.³

In theory, workers who are not covered by an employer-sponsored pension can save for retirement through an individual retirement account, or IRA. However, in fact, few workers do.⁴

Recognizing that inertia plays an important role in retirement savings, a new strategy for retirement savings was conceived: automatic

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² See, e.g., Jack VanDerhei, *Auto-IRAs: How Much Would They Increase the Probability of 'Successful' Retirements and Decrease Retirement Deficits? Preliminary Evidence from EBRI's Retirement Security Projection Model*, 36 EMP. BENEFIT RES. INST. NOTES 11, 19 (2015) (estimating retirement savings shortfalls in present value (in 2014 dollars) at age 65 of \$36,387 (per individual) for those ages 60-64 and \$54,120 for those ages 35-39 for an estimated aggregate national retirement deficit of \$4.13 trillion for all U.S. households where the head of household is between 35 and 64 years of age).

³ See, e.g., Alicia H. Munnell, *Falling Short: The Coming Retirement Crisis and What To Do About It*, CTR. FOR RETIREMENT RES. AT B.C., Apr. 2015, at 4 (noting that “at any given time, only about half of private-sector workers are participating in any employer-sponsored plan, and this share has remained relatively constant over the past 30 years”).

⁴ See THE PEW CHARITABLE TR., HOW STATES ARE WORKING TO ADDRESS THE RETIREMENT SAVINGS CHALLENGE 1 (2016), <http://www.pewtrusts.org/en/research-and-analysis/reports/2016/06/how-states-are-working-to-address-the-retirement-savings-challenge> (stating that “less than 10 percent of all workers contribute to a plan outside of work”); U.S. GOV'T ACCOUNTABILITY OFF., GAO-13-699 5, AUTOMATIC IRAS: LOWER-EARNING HOUSEHOLDS COULD REALIZE INCREASES IN RETIREMENT INCOME (2013) (noting that about 95 percent of money contributed to traditional IRAs in 2008 was attributable to rollovers, principally from employer-sponsored plans).

enrollment IRAs.⁵ Although automatic enrollment IRAs were initially intended to apply at the national level, the strategy failed to gain traction⁶ and states have stepped in to fill the breach. Between September 2012 and June 2016, five states enacted state automatic enrollment IRA programs.⁷ Moreover, a number of other states are also considering such programs.⁸

This Article takes a closer look at the IRAs in these state automatic enrollment IRA programs.⁹ It begins by providing an overview of the state laws creating automatic enrollment IRA programs.¹⁰ It then discusses the requirements that the state programs must satisfy in order to qualify as IRAs for purposes of the Internal Revenue Code and how effective the state programs are in satisfying these requirements.¹¹ Finally, it concludes by

⁵ J. MARK IWRY & DAVID C. JOHN, PURSUING UNIVERSAL RETIREMENT SECURITY THROUGH AUTOMATIC IRAS (2006), <http://www.heritage.org/research/reports/2006/02/pursuing-universal-retirement-security-through-automatic-iras>.

⁶ A host of federal bills providing for the creation of a federal automatic enrollment IRA have been introduced since 2006. See, e.g., American Savings Account Act of 2016, S. 2472, 114th Cong. (2016); Automatic IRA Act of 2015, S. 245, 114th Cong. (2015); Automatic IRA Act of 2015, H.R. 506, 114th Cong. (2015). Moreover, the President's budget has regularly called for a federal automatic enrollment IRA program. See, e.g., OFFICE OF MGMT. & BUDGET, EXEC. OFFICE OF THE PRESIDENT, BUDGET OF THE UNITED STATES GOVERNMENT, FISCAL YEAR 2017 160 (2016) at Table S-9; OFFICE OF MGMT. & BUDGET, EXEC. OFFICE OF THE PRESIDENT, BUDGET OF THE UNITED STATES GOVERNMENT, FISCAL YEAR 2016 120 (2015) at Table S-9. Nevertheless, an automatic enrollment IRA program has not been enacted at the federal level.

⁷ See *infra* Section II.

⁸ See Juliette Fairley, *Advisors Cry Foul over Mandated Auto-IRAs*, INSURANCENEWSNET (Aug. 19, 2016), <http://insurancenewsnet.com/innarticle/advisors-cry-foul-state-mandated-auto-iras> (reporting that Vermont, Iowa, Colorado, Georgia, Louisiana, Hawaii, and New York are considering state automatic enrollment IRA programs). See also *Fact Sheet: State-Based Retirement Plans for the Private Sector*, PENSION RTS. CTR.; <http://www.pensionrights.org/issues/legislation/state-based-retirement-plans-private-sector> (providing general overview of state activity); Alicia H. Munnell, *Could the Saver's Credit Enhance State Coverage Initiatives?*, CTR. FOR RETIREMENT RES. AT B.C., April 2016 at 2 Figure 2 (showing state activity as of March 2016).

⁹ For a discussion of other issues raised by the state automatic enrollment IRA programs, see Kathryn L. Moore, *Closing the Retirement Savings Gap: Are State Automatic Enrollment IRAs the Answer?*, GEO. MASON L. REV. (forthcoming 2016).

¹⁰ See *infra* Section II.

¹¹ See *infra* Section III.

discussing the distinction between Roth and traditional IRAs, and which type of IRA is best suited to serve as the default IRA.¹²

II. OVERVIEW OF STATE AUTOMATIC ENROLLMENT IRA PROGRAMS

In September 2012, California became the first state to enact legislation creating a state automatic enrollment IRA program. Illinois followed suit in January 2015. By June 2016, Oregon, Connecticut, and Maryland had also enacted such programs.

This section provides an overview of each of these programs.

A. CALIFORNIA SECURE CHOICE RETIREMENT SAVINGS TRUST

On September 28, 2012, California Governor Jerry Brown signed the California Secure Choice Retirement Savings Trust Act (California Act) into law. The California Act creates the California Secure Choice Retirement Savings Investment Board (California Board)¹³ to administer the California Secure Choice Retirement Savings Trust (California Trust) “for the purpose of promoting greater retirement savings for California private employees in a convenient, voluntary, low-cost, and portable manner.”¹⁴

Generally, the California Act requires private-sector employers with five or more employees that do not offer an employer-sponsored retirement plan to establish a payroll deposit retirement savings arrangement that automatically enrolls their employees into the California Program.¹⁵ The California Act provides for covered employees to automatically contribute three percent of their salary to the program unless they affirmatively opt out of participation or elect a different contribution rate.¹⁶ The Board is authorized to adjust the automatic contribution rate to as low as two percent and as high as five percent¹⁷ and may implement an automatic escalation provision.¹⁸

Employees’ payroll contributions are pooled into the California Trust. The California Board is authorized to establish managed accounts invested in United States Treasuries, myRAs, or similar investments for the

¹² See *infra* Section IV.

¹³ CAL. GOV’T CODE § 100002(a)(1) (2012).

¹⁴ *Id.* § 100004(a).

¹⁵ *Id.* § 100032(a)-(e).

¹⁶ *Id.* § 100032(i).

¹⁷ *Id.* § 100032(j).

¹⁸ *Id.* § 100032(k).

first three years of the Program's operation.¹⁹ During this initial period, the board is directed to develop and implement an investment policy that defines the program's investment objectives and establishes policies and procedures that enable investment objectives to be met in a prudent manner.²⁰ The policy is to describe investment options which encompass a range of risk and return opportunities and allow for a rate of return that is commensurate with an appropriate level of risk.²¹ The board is authorized to develop investment option recommendations that address risk-sharing and smoothing of market losses and gains.²² Authorized option recommendations may include the creation of a reserve fund or customized investment products.²³

The California Act provides that the California Program may not be implemented if (1) the IRA arrangements offered under the program fail to qualify for the favorable income tax treatment normally accorded IRAs under the Internal Revenue Code or (2) the Department of Labor determines that the program is an employee benefit plan and State or employer liability is established under ERISA.²⁴

The California Act charged the California Board with conducting a market analysis and feasibility study and reporting to the California legislature its recommendations as to whether the legislature should enact further legislation implementing the California Program.²⁵ The market analysis and feasibility study, which found the program to be "feasible, sustainable, and legally permissible," was issued on January 31, 2016.²⁶

¹⁹ *Id.* § 100002(e)(1)(A).

²⁰ *Id.* § 100002(e)(2)(A).

²¹ *Id.*

²² *Id.* § 100002(e)(2)(B).

²³ *Id.*

²⁴ *Id.* § 100043. In September, 2016, the Department of Labor issued a final regulation, 29 C.F.R. § 2510.3-2(h), providing that a state automatic enrollment IRA program does not constitute an employee benefit plan for purposes of ERISA if it satisfies eleven separate requirements. For a discussion of the regulation, see Moore, *supra* note 9. California law requires the California Program to be structured to meet the requirements of the Department of Labor's regulation. *Id.* § 100043(b)(1)(B).

²⁵ The provisions imposing these requirements, §§ 100040 and 100042, were repealed when legislation approving the program was enacted in September 2016. S.B. 1234, Gen. Assemb. Ch. 804 (Cal. 2016).

²⁶ See CAL. SECURE CHOICE MKT. ANALYSIS, FEASIBILITY STUDY, & PROGRAM DESIGN CONSULTATION SERV. RFP NO. CSCRSIB03-14, OVERTURE FIN. LLC, FINAL REPORT TO THE CALIFORNIA SECURE CHOICE RETIREMENT SAVINGS INVESTMENT BOARD (2016), <http://www.treasurer.ca.gov/scib/>.

Legislation approving the program and implementing it as of January 1, 2017, was enacted on September 29, 2016.²⁷

B. ILLINOIS SECURE CHOICE SAVINGS PROGRAM

Illinois Governor Pat Quinn signed the Illinois Secure Choice Savings Program Act (Illinois Act)²⁸ into law in January 2015. The Illinois Act establishes “a retirement savings program in the form of an automatic enrollment payroll deduction IRA...for the purpose of promoting greater retirement savings for private-sector employees in a convenient, low-cost, and portable manner.”²⁹

Generally, the Illinois Act requires private-sector employers with 25 or more employees that do not offer an employer-sponsored retirement plan to establish a payroll deposit retirement savings arrangement that automatically enrolls their employees into the Illinois Program unless the employee opts out of the Program.³⁰ The default contribution level is set at three percent of wages.³¹ However, employees may select a different contribution level which may be expressed either as a percentage of wages or a dollar amount up to the I.R.C. § 219(b)(1)(A) limit,³² which is \$5,500 in 2016.³³

The Act calls for the creation of a trust fund (Illinois Fund) that is separate from the State Treasury.³⁴ Monies in the Illinois Fund are to consist of the employee contributions to the Illinois Fund, which are accounted for as individual accounts.³⁵ Amounts held in the Illinois Fund are not to be commingled with State funds and the State is to have no claim to or against, or any interest in, money held in the Illinois Fund.³⁶

²⁷ CAL. GOV'T CODE § 100046.

²⁸ Illinois Secure Choice Savings Program Act, S. Res. 2758, 2014 Leg. (Ill. 2014).

²⁹ 820 ILL. COMP. STAT. § 80/10 (2015).

³⁰ *Id.* § 80/60(b).

³¹ *Id.* § 80/60(c).

³² *Id.*

³³ *IRS Announces 2016 Pension Plan Limitations: 401(k) Contribution Limit Remains Unchanged at \$18,000 for 2016*, 2015-118 I.R.B. (Oct. 21, 2016).

³⁴ 820 ILL. COMP. STAT. § 80/15(a).

³⁵ *Id.*

³⁶ *Id.* § 80/15(b).

The Illinois Secure Choice Savings Board (Illinois Board)³⁷ is charged with designing, establishing, and operating the Fund.³⁸ The Illinois Board is required to engage an investment manager or managers to invest the Illinois Fund.³⁹ At the minimum, a single investment option must be established and offered: a life-cycle fund with a target date based upon the age of the employee enrolled in the plan.⁴⁰ In addition, four other investment options may be established and offered: (1) a conservation principal protection fund; (2) a growth fund; (3) a “secure return” fund;⁴¹ and (4) an annuity fund.⁴² The life-cycle fund is to serve as the default investment option for employees who do not elect an investment option unless and until a secure return fund is established and the Board determines that the secure return fund should replace the target date or life-cycle fund as the default investment option.⁴³

Employees may select any of the available investment options and may change their investment option at any time, subject to rules promulgated by the Illinois Board.⁴⁴ Interest and investment earnings and losses are to be allocated to each individual employee’s Program account.⁴⁵ Each participant’s benefit is equal to the participant’s individual Program account balance at the time the participant’s retirement savings benefit becomes payable.⁴⁶

The Illinois Act provides that the Illinois Board may not implement the Illinois Program if (1) the IRA arrangements offered under the Illinois Program fail to qualify for the favorable income tax treatment normally accorded IRAs under the Internal Revenue Code or (2) the Department of

³⁷ The composition of the Board is set forth in 820 ILL. COMP. STAT. § 80/20.

³⁸ 820 ILL. COMP. STAT. § 80/30.

³⁹ *Id.* § 80/40.

⁴⁰ *Id.* § 80/45(a).

⁴¹ A “secure return” fund is a fund “whose primary objective is the preservation of the safety of principal and the provision of a stable and low-risk rate of return.” If the Board elects to establish a secure return fund, the Board is authorized to procure any insurance, annuity, or other product to insure the value of the individuals’ accounts and guarantee a rate of return. The cost of such a funding mechanism must be paid out of the Fund and under no circumstances is the Board, Program, Fund, State, or participating employer to assume any liability for investment or actuarial risk. *Id.* § 80/45(b)(3).

⁴² *Id.* § 80/45(b).

⁴³ *Id.* §§ 80/45(a), (c).

⁴⁴ *Id.* § 80/60(d).

⁴⁵ *Id.* § 80/50.

⁴⁶ *Id.*

Labor determines that “the Program is an employee benefit plan and State or employer liability is established under [ERISA].”⁴⁷

C. OREGON RETIREMENT SAVINGS PLAN

On June 25, 2015, Oregon Governor Kate Brown approved legislation establishing the Oregon Retirement Savings Board (Oregon Board). The Oregon Board is charged with developing the Oregon Retirement Savings Plan (Oregon Plan) for Oregon employees who do not have access to a retirement savings plan at work.⁴⁸

The Oregon statute broadly outlines the requirement for the Oregon Plan. It calls for mandatory participation by employers that do not otherwise offer an employer-sponsored retirement plan.⁴⁹ It provides for automatic enrollment by employees but permits employees to opt out of participation.⁵⁰ It does not set a default contribution rate but instead leaves it to the Oregon Board to establish the default contribution rate⁵¹ and authorizes the Board to provide for automatic escalation of contributions.⁵²

The Oregon statute requires that the Oregon Plan be professionally managed⁵³ and permits the Oregon Board to use private-sector partnerships to administer and invest the contributions to the plan under the supervision and guidance of the Oregon Board.⁵⁴ It requires that separate records and accounting be maintained for each plan account⁵⁵ but provides for the pooling of accounts for investment purposes.⁵⁶

The Oregon statute provides that if the Oregon Board finds that the Oregon Plan would qualify as an employee benefit plan under ERISA, the Oregon Board may not establish the Oregon Plan.⁵⁷ Otherwise, the Oregon Board is directed to establish the Oregon Plan so that individuals may begin to contribute to the plan by July 1, 2017.⁵⁸

⁴⁷ *Id.* § 80/95.

⁴⁸ 2015 Or. Laws, ch. 557, H.B. 2960, § 2(1).

⁴⁹ *Id.* § 3(1)(b).

⁵⁰ *Id.* § 3(1)(c).

⁵¹ *Id.* § 3(1)(d).

⁵² *Id.* § 3(1)(e).

⁵³ *Id.* § 3(1)(m).

⁵⁴ *Id.* § 3(1)(r).

⁵⁵ *Id.* § 3(1)(i).

⁵⁶ *Id.* § 3(1)(l).

⁵⁷ *Id.* § 15(2).

⁵⁸ *Id.* § 15(1).

D. MARYLAND SMALL BUSINESS RETIREMENT SAVINGS PROGRAM AND TRUST

On May 10, 2016, Maryland Governor Lawrence Hogan signed the Maryland Small Business Retirement Savings Program and Trust (Maryland Program and Trust)⁵⁹ into law. The law establishes the Maryland Small Business Retirement Savings Board (Maryland Board) to implement, maintain, and administer the Maryland Program and Trust to assist Maryland employees without access to employer-sponsored savings arrangements to initiate individual retirement accounts.

Generally, the Maryland law requires private-sector employers that do not offer an employer-sponsored retirement plan to establish a payroll deposit savings program that allows employees to participate in the Maryland Program.⁶⁰ Employees will be automatically enrolled in the Maryland Program unless they opt out of participation.⁶¹ The default contribution amount is to be established by the Maryland Board.⁶²

The Maryland Board is directed to evaluate and establish a range of investment options, including a default investment.⁶³ When selecting investment options, the Maryland Board is directed to consider methods to minimize the risk of significant investment losses at the time a participant retires.⁶⁴ The Maryland Board is authorized to provide an investment option that provides an assured lifetime income.⁶⁵ The Maryland Board is directed to delegate administration of the trust to a third party administrator.⁶⁶

The Maryland Program takes effect on July 1, 2016,⁶⁷ but may not be implemented until it is determined that the Maryland Program qualifies for favorable tax treatment under the Internal Revenue Code.⁶⁸

⁵⁹ MD. CODE, LAB. & EMPL. § 12-401 (2016).

⁶⁰ *Id.* § 12-402(a)(1).

⁶¹ *Id.* § 12-402(a)(2).

⁶² *Id.* § 12-403(f).

⁶³ *Id.* § 12-401(c).

⁶⁴ *Id.* § 12-401(d).

⁶⁵ *Id.* § 12-401(e).

⁶⁶ *Id.* § 12-301(b)(2).

⁶⁷ 2016 Md. Laws, Chapter 323 § 5.

⁶⁸ *Id.* § 3.

E. CONNECTICUT RETIREMENT SECURITY PROGRAM

On May 27, 2016, Connecticut Governor Dannel Malloy signed the Connecticut Retirement Security Program (Connecticut Program) into law.⁶⁹ The law establishes the quasi-public/private Connecticut Retirement Security Authority (Connecticut Retirement Authority)⁷⁰ to oversee the Connecticut Program for the purpose of promoting and enhancing retirement savings for private-sector employees in Connecticut.⁷¹

Generally, the Connecticut Program requires private-sector employers with five or more employees that do not offer an employer-sponsored retirement plan to participate in the program.⁷² Employees will be automatically enrolled in the Connecticut Program unless they elect out of participation.⁷³ The default contribution level is set at three percent of wages, but employees may elect a different contribution level which may be expressed either as a percentage of wages or a dollar amount up to the I.R.C. § 219(b)(1)(A) limit.⁷⁴

The Connecticut Retirement Authority is directed to provide for each participant's account to be invested in an age-appropriate target date fund or other investment vehicle as the authority may provide.⁷⁵ Program features are to include the designation of a lifetime income investment intended to provide participants with a source of retirement income for life.⁷⁶ At least fifty percent of a participant's account balance is to be invested in the lifetime income investment at retirement.⁷⁷

The Connecticut Program is scheduled to begin operation in 2018.⁷⁸

III. FEDERAL LAW GOVERNING IRAS

The California Act provides that the California Program may not be implemented if the IRA arrangements offered under the California Program fail to qualify for the favorable income tax treatment normally accorded

⁶⁹ 2016 Conn. Acts No. 16-29

⁷⁰ *Id.* § 2

⁷¹ *Id.* § 3(a).

⁷² *Id.* §§ 1(7), 7(a)(4).

⁷³ *Id.* §§ 7(a)(2)-(3).

⁷⁴ *Id.* § 1(3).

⁷⁵ *Id.* § 8.

⁷⁶ *Id.* § 9(b)(2).

⁷⁷ *Id.* § 9(b)(3).

⁷⁸ *Id.* § 7(a)(1).

IRAs under the Internal Revenue Code.⁷⁹ The Illinois Act⁸⁰ and the Maryland Act⁸¹ contain similar admonishments. Although the Connecticut Act does not include such an express prohibition on implementation, it defines the term IRA for purposes of the Connecticut Act in terms of the Internal Revenue Code's definition of IRA⁸² and provides that program assets will be held in trust or custodial accounts that satisfy the requirements of the Internal Revenue Code governing IRAs.⁸³

Thus, the California, Illinois, Maryland, and Connecticut Acts all require that their IRAs satisfy the Internal Revenue Code's requirements for IRAs. The Oregon Act does not expressly refer to IRAs. However, material presented by consultants to the Oregon Board states that Oregon must decide which type of IRA to use,⁸⁴ and the Oregon Act directs the Oregon Board to obtain legal advice regarding the applicability of the Internal Revenue Code to the plan before establishing the plan.⁸⁵

This section identifies the requirements that the state programs must satisfy in order to qualify as IRAs for purposes of the Internal Revenue Code. It then discusses how effective the state programs are in satisfying each of these requirements.

A. REQUIREMENTS OF I.R.C. §§ 408(A) AND 408(C)

Section 408(a) of the Internal Revenue Code defines the term "individual retirement account" as a "trust created or organized in the United States for the exclusive benefit of an individual or his beneficiaries but only if the written instrument creating the trust meets the following requirements:"

- (1) Except in the case of a rollover contribution, no contribution will be accepted unless it is in cash, and the contribution does not exceed the I.R.C. § 219(b)(1)(A) limit;

⁷⁹ CAL. GOV'T CODE § 100043 (2012).

⁸⁰ 820 ILL. COMP. STAT. § 80/95 (2015).

⁸¹ 2016 Md. Laws, Chapter 323 § 3.

⁸² 2016 Conn. Acts No. 16-29 § 1(9).

⁸³ *Id.* § 5(a).

⁸⁴ Memorandum from the Ctr. for Ret. Research at Bos. Coll. to Or. Ret. Sav. Plan (May 22, 2016), <https://www.oregon.gov/treasury/ORSP/Documents/CRR%20Memo%20-%20Roth%20vs%20Conventional%20IRA%201JUNE16%20-%20BC.pdf> [hereinafter *BCCRR Oregon Memo*].

⁸⁵ 2015 Or. Laws, ch. 557, H.B. 2960 § 7(b).

- (2) The trustee is a bank or other person who demonstrates that the trust will be administered in accordance with the requirements of section 408;
- (3) No part of the trust funds will be invested in life insurance contracts;
- (4) The individual's interest in his account balance is nonforfeitable;
- (5) The trust assets will not be commingled with other property except in a common trust fund or common investment fund; and
- (6) Minimum distribution and incidental death benefit requirements are satisfied.

Section 408(c) of the Internal Revenue Code provides that an employer may establish an IRA so long as the six requirements of section 408(a) are satisfied, and there is a separate accounting for the interest of each employee.

B. STATE LAWS' SATISFACTION OF REQUIREMENTS OF I.R.C. §§ 408(A) AND (C)

All of the state laws, with the exception of Oregon, are clearly intended to satisfy the requirements of I.R.C. §§ 408(a) and (c). By implication, Oregon law also appears to be intended to satisfy the requirements of I.R.C. §§ 408(a) and (c).

1. Introductory Trust Requirements

As noted above, I.R.C. § 408(a) defines the term "individual retirement account" as a "trust created or organized in the United States for the exclusive benefit of an individual or his beneficiaries."

All of the state laws, with the exception of Oregon, expressly provide for the establishment of a trust created or organized in the United States.⁸⁶ Oregon law implicitly satisfies the trust requirement by providing

⁸⁶ See CAL. GOV'T CODE § 100004(a) (2016) (establishing retirement savings trust known as California Secure Choice Retirement Savings Trust); 2016 Conn. Acts No. 16-29, § 5(a) (providing that "Program assets shall be held in trust or

that the investment administrator for the plan must be the trustee of all contributions and earnings on contributions to the plan.⁸⁷ Thus, all of the state laws satisfy the introductory requirement that there be a trust created or organized in the United States.

In addition, all of the state laws,⁸⁸ with the exception of Oregon,⁸⁹ require that the trust be operated for the exclusive benefit of the participants and beneficiaries. Thus, all of the state laws, with the exception of Oregon, satisfy the exclusive benefit requirement. The Oregon program, when finalized, must include an express provision requiring that the plan be operated for the exclusive benefit of the participants and beneficiaries in order to satisfy the I.R.C. § 408(a) introductory trust requirements.

2. Limitation on Contributions

As noted above, I.R.C. § 408(a)(1) requires that except in the case of a rollover contribution, no contribution be accepted unless it is in cash, and the contribution must not exceed the I.R.C. § 219(b)(1)(A) limit.

All of the state laws satisfy this provision. Specifically, all of the state laws provide for contributions solely⁹⁰ in the form of payroll

custodial accounts meeting the requirements of [I.R.C. § 408(a) or (c)]”); 820 ILL. COMP. STAT. § 80/15(a) (providing that Illinois Secure Choice Savings Program Fund is established as trust outside of State treasury); MD. CODE, LAB. & EMPL. § 12-301(a).

⁸⁷ 2015 Or. Laws, ch. 557, H.B. 2960, § 3(o).

⁸⁸ See CAL. GOV'T CODE § 100002(d)(1); 2016 Conn. Acts No. 16-29 § 6(a); 820 ILL. COMP. STAT. § 80/25; MD. CODE, LAB. & EMPL. § 12-203(a).

⁸⁹ See 2015 Or. Laws ch. 557, H.B. 2960, § 3(a), 1 (requiring Oregon Board to develop plan that permits eligible employees to contribute to account through payroll deduction).

⁹⁰ Connecticut law would also permit rollover contributions in accordance with I.R.C. § 408(a)(1) (2012). See 2016 Conn. Acts No. 16-29 § 7(d). Rollover contributions do not need to be in cash. I.R.C. § 408(a)(1).

deductions⁹¹ and expressly or implicitly incorporate the I.R.C. § 219(b)(1)(A) limit.⁹²

3. Trustee Requirement

I.R.C. § 408(a)(2) requires that the trustee be a bank or other person who demonstrates that the trust will be administered in accordance with the requirements of section 408.

The Connecticut and Illinois laws expressly satisfy this requirement. Specifically, Section 30(b) of the Illinois Act charges the Board with “appoint[ing] a trustee to the I.R.A. Fund in compliance with Section 408 of the Internal Revenue Code.”⁹³ The Connecticut law provides that “Program assets shall be held in trust or custodial accounts meeting the requirements of [I.R.C. § 408(a) or (c)].”⁹⁴

Although the California and Maryland laws do not explicitly satisfy this requirement, they do so implicitly. The California law implicitly satisfies this requirement by providing that the California Board, in its capacity as trustee, has the authority to “[f]acilitate compliance by the retirement savings program or arrangements established under the program with all applicable requirements for the program under the Internal Revenue Code.”⁹⁵ Similarly, the Maryland law implicitly satisfies this requirement

⁹¹ See CAL. GOV'T CODE § 100032(h) (providing for default contribution of three percent of employee's salary or wages); 2016 Conn. Acts No. 16-29 § 1(3) (defining “contribution level” in terms of percentage of wages or dollar amount and providing for default contribution of three percent of wages); ILL. COMP. STAT. § 80/60(c) (defining “contribution level” in terms of percentage of wages or dollar amount and providing for default contribution of three percent of wages); MD. CODE, LAB. & EMPL. § 12-403(e); 2015 Or. Laws ch. 557, H.B. 2960, § 3(a) (requiring Oregon Board to develop plan that permits eligible employees to contribute to account through payroll deduction).

⁹² See CAL. GOV'T CODE § 100010(a)(11) (requiring the California Board to “[s]et minimum and maximum investment levels in accordance with contribution limits set for IRAs by the Internal Revenue Code.”); 2016 Conn. Acts No. 16-29 § 5(c) (requiring Connecticut Authority to establish processes to prevent contributions from exceeding I.R.C. § 219(b)(1) limit); 820 ILL. COMP. STAT. § 80/60(c) (limiting “contribution level” to I.R.C. § 219(b)(1)(A) limit); MD. CODE, LAB. & EMPL. § 12-204(a)(11); 2015 Or. Laws, ch. 557, H.B. 2960, § 4(6) (directing the Oregon Board to “[s]et minimum, maximum and default contribution levels in accordance with limits established by the Internal Revenue Code.”).

⁹³ 820 ILL. COMP. STAT. § 80/30(b).

⁹⁴ 2016 Conn. Acts No. 16-29 § 5(a).

⁹⁵ CAL. GOV'T CODE § 100010(a)(14).

by providing that the Maryland “Board shall adopt regulations and take any other action necessary to implement this title consistent with the Internal Revenue Code and regulations issued in accordance with the Internal Revenue Code to ensure that the Program meets all criteria for federal tax deferral or tax-exempt benefits or both.”⁹⁶

The Oregon law, which provides a broad outline for the development of the Oregon Plan, does not address the trustee requirement. When developed, the Oregon plan will need to ensure that the plan’s trustee is a bank or other person who demonstrates that the trust will be administered in accordance with requirements of I.R.C. § 408.

4. Prohibition on Investment in Life Insurance Contracts

I.R.C. § 408(a)(3) provides that no part of the trust funds may be invested in life insurance contracts.

None of the state laws expressly prohibit investment in life insurance contracts. In fact, the original California statute authorized investments in insurance agreements⁹⁷ and thus could have violated this provision if investments in life insurance were in fact made. The Illinois Act contains similar troubling language authorizing the Illinois Board to “procure *any insurance*, annuity, or other product to insure the value of individuals’ accounts and guarantee a rate of return.”⁹⁸

In order to ensure satisfaction of the life insurance prohibition, the states should include language prohibiting investments in life insurance contracts in the final implementing provisions governing their programs.

5. Nonforfeiture

I.R.C. § 408(a)(4) provides that the individual’s interest in his account must be nonforfeitable.

Although none of the state laws include provisions permitting participants’ interests to be forfeited under any circumstances, none of the state laws expressly provide that individuals’ interests in their account balances are nonforfeitable.⁹⁹ Thus, the state laws’ final implementing

⁹⁶ MD. CODE, LAB. & EMPL. § 12-204(b).

⁹⁷ See CAL. GOV’T CODE § 100002(e)(3)(G), prior to amendment by S.B. 1234, 2016 Leg. (Ca. 2016).

⁹⁸ 820 ILL. COMP. STAT. § 80/45(b)(3) (emphasis added).

⁹⁹ Maryland law expressly states that the assets in a participant’s individual account are the individual’s property. MD. CODE, LAB. & EMPL. §12-403(g). The state law does not, however, expressly state that that interest is nonforfeitable. See

language should expressly provide that participants' interests are nonforfeitable.

6. Commingling of Assets

I.R.C. § 408(a)(5) provides that trust assets must not be commingled with other property except in a common trust fund or common investment fund.

Illinois law expressly prohibits the commingling of money in the Illinois Fund with state funds.¹⁰⁰ Maryland law implicitly prohibits impermissible commingling of funds.¹⁰¹ None of the other state statutes expressly prohibit commingling of trust assets with other property except in a common trust fund or common investment fund. Thus, in order to satisfy I.R.C. § 408(c), the state laws' final implementing language should expressly prohibit such commingling.

7. Minimum Distribution and Incidental Death Benefit Requirements

I.R.C. § 408(a)(6) provides that minimum distribution and incidental death benefit requirements must be satisfied. The minimum distribution and incidental death benefits requirements are set forth in the Treasury regulations.¹⁰²

None of the state laws expressly include provisions satisfying the minimum distribution and incidental death benefit requirements.¹⁰³ Thus, in

also 820 ILL. COMP. STAT. §80/15(b) (2015) (stating that amounts deposited in the Illinois fund shall not be State property); 2015 Or. Laws ch. 557, H.B. 2960, § 3(n) (providing that "Oregon and employers that participate in the plan have no proprietary interest in the contributions to or earnings on amounts contributed to accounts established under the plan").

¹⁰⁰ 820 ILL. COMP. STAT. § 80/15(b).

¹⁰¹ MD. CODE, LAB. & EMPL. §12-204(a)(12) (authorizing Maryland Board to "arrange for collective, common and pooled investments of assets of the Program or arrangements, including investments in conjunction with other funds *with which those assets are authorized to be collectively invested* with a view to saving costs through efficiencies and economies of scale") (emphasis added).

¹⁰² Treas. Reg. §§ 1.408-2(b)(6), (7).

¹⁰³ *Cf.* 2016 Conn. Acts No. 16-29 § 9(a) & (b) (providing that Connecticut Authority shall establish rules and procedures governing the distribution of funds that allow for such distributions as may be permitted or required by the Internal Revenue Code and directing distributions to begin within ninety days after participant reaches normal retirement age).

order for the state programs to satisfy these requirements, the final implementing language in the state laws should expressly incorporate these requirements.

8. Separate Accounting

I.R.C. § 408(c) requires employers that establish IRAs to provide a separate account for the interest of each employee.

All of the state laws provide for a separate accounting for each employee's interest.¹⁰⁴ Thus, all of the state laws expressly satisfy the I.R.C. § 408(c) separate accounting requirement.

9. Summary

As currently written, the state laws expressly satisfy some, but not all, of the requirements of I.R.C. §§ 408(a) and (c). In order to satisfy I.R.C. §§ 408(a) and (c), the state programs, when implemented, will need to incorporate and expressly satisfy all of the elements of I.R.C. §§ 408(a) and (c).

IV. TRADITIONAL VERSUS ROTH IRAS

There are two basic types of IRAs: traditional IRAs and Roth IRAs.¹⁰⁵ Traditional IRAs were added to the Internal Revenue Code with

¹⁰⁴ See CAL. GOV'T CODE § 100008(c) (stating that "individual's retirement savings benefit under the program shall be an amount equal to the balance in the individual's program account on the date the retirement savings benefit becomes payable."); 2016 Conn. Acts No. 16-29 § 4(b)(1) (requiring participants to be provided with a statement no less than quarterly of the account balance in their individual retirement account, including the value in each investment option); 820 ILL. COMP. STAT. §80/15 (stating that Illinois "Fund shall include the individual retirement accounts of enrollees, which shall be accounted for as individual accounts."); 2015 Or. Laws ch. 557 § 3(i) (requiring maintenance of separate records and accounting for each plan account). Cf. MD. CODE, LAB. & EMPL. § 12-204(a)(13).

¹⁰⁵ In addition, participants in employer-sponsored pension plans may roll over assets from their employer-sponsored pension into a third type of IRA, a rollover IRA. I.R.C. § 408(d)(3) (2012).

the enactment of ERISA in 1974.¹⁰⁶ Roth IRAs were introduced in legislation enacted in 1997.¹⁰⁷

The principal distinction between traditional IRAs and Roth IRAs is the timing of taxation. Specifically, individuals may deduct contributions to traditional IRAs from their income when the contributions are made,¹⁰⁸ no tax is imposed on IRA earnings so long as the assets are held by the IRA,¹⁰⁹ and distributions from IRAs are subject to tax when made.¹¹⁰ In contrast, contributions to Roth IRAs are taxable when made¹¹¹ but generally neither the earnings on¹¹² nor the distributions from Roth IRAs are subject to income tax.¹¹³

Although the timing of taxation is the most significant difference between traditional and Roth IRAs, there are four other distinctions as well: (1) income limits apply to traditional IRAs in a different manner than to Roth IRAs; (2) there are differences in the contribution limits; (3) there are greater penalties for distributions from traditional IRAs before age 59 ½ than for distributions from Roth IRAs before age 59 ½; and (4) minimum distribution rules apply to traditional IRAs but generally do not apply to Roth IRAs.¹¹⁴

¹⁰⁶ Employee Retirement Income Security Act of 1974, Pub. L. No. 93-406, § 2002(b), (e), 88 Stat. 829, 959-64, 968-69. For a discussion of the history of IRAs, see Patricia E. Dilley, *Hidden in Plain View: The Pension Shield Against Creditors*, 74 IND. L.J. 355, 419-24 (1999); Edward Morse, *Travails of the Entrepreneurial Ant: Reforming Tax-Favored Retirement Saving for Small Business Owners*, 50 DEPAUL L. REV. 49, 71-74 (2000).

¹⁰⁷ Taxpayer Relief Act of 1997, Pub. L. No. 105-34 § 302(a), 111 Stat. 788, 825 (1997) (adding new Code § 408A).

¹⁰⁸ I.R.C. § 219(a) (2014). Individuals may also make after-tax contributions to traditional IRAs. I.R.C. § 408(o) (2015).

¹⁰⁹ I.R.C. § 408(e) (2015).

¹¹⁰ I.R.C. § 408(d) (2015).

¹¹¹ I.R.C. § 408A(c)(1) (2010).

¹¹² I.R.C. § 408A(a) (2010); I.R.C. § 408(e) (2015).

¹¹³ Distributions of contributions to Roth IRAs are never taxable. Moreover, distributions of earnings on Roth contributions are not taxable if they are distributed at least five years after the Roth IRA was established and the distribution (1) was made on or after the owner reaches age 59 ½, (2) the owner is disabled, (3) is made to a beneficiary on account of the owner's death, or (4) the owner uses the money for the first-time purchase of a home. I.R.C. § 408A(d)(2); Treas. Reg. § 1.408A-6 Q & A1(b).

¹¹⁴ For high-income workers, there are other distinctions between Roth and traditional IRAs. See, e.g., *Medicare premiums a factor in deciding whether to make a deductible contribution to a traditional IRA or a contribution to a Roth IRA*, RIA Pens. Planning 4, 178 (2016). In light of the population targeted by state automatic

By their very nature, state automatic enrollment IRA programs must provide for a default type of IRA. The state legislatures have not been uniform in their choice of default IRA. In its original legislation, California¹¹⁵ and Maryland¹¹⁶ chose a traditional IRA. In contrast, Illinois¹¹⁷ and Connecticut¹¹⁸ chose Roth IRAs. Oregon did not specify a type of IRA in its legislation; the Center for Retirement Research at Boston College (BCCRR), which has served as a consultant to both the Oregon Board¹¹⁹ and the Connecticut Board,¹²⁰ has recommended that the Oregon legislature select the Roth IRA as the default IRA.¹²¹

This section considers which type of IRA is best suited to serve as the default IRA in a state automatic enrollment IRA program. It begins by taking a closer look at the distinctions between traditional and Roth IRAs. It then discusses the implications of these distinctions for the selection of a

enrollment IRAs, these are not significant distinctions. *See* BCCRR Oregon Memo, *supra* note 85, at 2.

¹¹⁵ *See* CAL. GOV'T CODE § 100000(e) (defining "IRA" as "an individual retirement account or individual retirement annuity under Section 408(a) or 408(b) of Title 26 of the United States Code.").

¹¹⁶ MD. CODE, LAB. & EMPL. § 12-101(e) (defining IRA as individual retirement account or individual retirement annuity under I.R.C. §§ 408(a) or (b)).

¹¹⁷ Ill. Secure Choice Savings Program Act, S. Res. 2758, 2014 Leg § 5 (defining "IRA" as "Roth IRA (individual retirement account) under Section 408A of the Internal Revenue Code.").

¹¹⁸ 2016 Conn. Acts No. 16-29 § 1(8) (defining individual retirement account as a Roth IRA). The BCCRR, serving as a consultant to the Connecticut Board, recommended the Roth IRA as the default IRA. Center for Retirement Research at Boston College, *Report on Design of Connecticut's Retirement Security Program* 10-11 (Dec. 2015) [hereinafter *BCCRR Connecticut Report*]. The Connecticut Board, in contrast, recommended to the Connecticut legislature that the Connecticut legislature use a traditional IRA as the default IRA. State of Connecticut Retirement Security Board, Report to Legislature 10 (Jan. 1, 2016) [hereinafter *Connecticut Report to Legislature*], http://www.osc.ct.gov/crsb/docs/finalreport/CRSB_January_1_Report.pdf. The Connecticut legislature selected the Roth IRA as the default IRA but directed the Connecticut Authority to conduct a study of the interests of the participants and potential participants in the Connecticut program in investing in a traditional IRA and report the results of that study to the legislature by January 1, 2019. 2016 Conn. Acts No. 16-29 §§ 1(8) & 12(a).

¹¹⁹ *See* BCCRR Oregon Memo, *supra* note 85.

¹²⁰ *See* Connecticut Report to Legislature, *supra* note 118.

¹²¹ BCCRR Oregon Memo, *supra* note 85, at 1-2. It made a similar recommendation to the Connecticut Board. Connecticut Report to Legislature, *supra* note 118, at 10-11.

default IRA. Finally, it concludes by explaining why the Roth IRA is the more appropriate default IRA.

A. ECONOMIC EFFECT OF DIFFERENCE IN TIMING OF TAXATION FOR TRADITIONAL AND ROTH IRAS

If tax rates remain the same, the tax treatment of traditional and Roth IRAs is essentially economically identical. Specifically, for both types of IRAs it is as though the earnings on the contributions were never taxed.

Tax rates, however, do not always remain constant. For instance, some workers, particularly those in their peak earning years, may be subject to higher tax rates during their working years than during retirement. For these workers, a traditional IRA is more favorable than a Roth IRA. Other workers, such as those early in their careers, may face higher tax rates at retirement than during their working years. For these workers, a Roth IRA is more favorable than a traditional IRA.

This section uses examples to demonstrate these economic principles.

1. Economic Equivalence of Traditional and Roth IRAs – Assuming Constant Tax Rate

Suppose that Angela has \$1,000 that she can save each year, is taxed at a 20% rate, and earns 10% interest on her contributions each year. If each year she contributes \$1,000 to a regular savings account (in which both contributions and earnings are taxed), she will have \$2,804.89 at the end of 3 years. In contrast, if she contributes the same amount to a traditional IRA (in which neither contributions nor earnings are taxed but money distributed from the IRA is taxed), she will have \$2,912.80 after taxes at the end of 3 years. Finally, if she contributes the same amount to a Roth IRA (in which contributions are taxed but neither earnings nor distributions are taxed), she would again have \$2,912.80.¹²²

¹²² The following mathematical formulas illustrate how the tax benefits of a traditional IRA and Roth IRA are virtually identical if tax rates remain constant. (For purposes of the formulas, n = number of years, r = rate of return, and t = tax rate.)

Suppose a worker contributes \$1,000 to a traditional IRA. After n years, the IRA will have grown to $\$1,000(1 + r)^n$. When the worker withdraws the funds, both the original contribution and earnings on the contribution are taxable. Thus, the after-tax value of the traditional IRA in retirement is $(1 - t)\$1,000(1 + r)^n$.

Thus, assuming constant tax rates, contributions to traditional and Roth IRAs are economically equivalent. For both types of IRA, it is as though the earnings were never taxed.

In a Roth IRA, the worker pays tax on the original contribution so a worker's after tax contribution to a Roth IRA is $(1 - t)\$1,000$. After n years, the after-tax contribution will have grown to $(1 + r)^n (1 - t)\$1,000$. Since the Roth distribution is not subject to further tax, the after-tax distribution from the traditional IRA is identical to the nontaxable distribution from the Roth IRA: $(1 - t)\$1,000(1 + r)^n = (1 + r)^n (1 - t)\$1,000$. See *BCCRR Oregon Memo*, *supra* note 85, at 1.

Contributions to Regular Savings Account	(20% tax imposed on contributions and 20% tax imposed on earnings)
Year One:	
$\$1,000 \times 20\% = \200	(tax imposed on \$1,000)
$\$1,000 - \$200 = \$800$	(amount Angela has remaining after taxes to contribute)
$\$800 \times 10\% = \80	(earnings on contribution based on 10% interest rate)
$\$80 \times 20\% = \16	(tax on earnings)
$\$800 + (\$80 - \$16) = \864	(amount at end of Year One after tax on contribution and earnings)
Year Two:	
$\$864 + (\$1,000 - \$200) = \$1,664$	(carryover contribution and earnings from Year One plus Year Two after tax contribution of \$800)
$\$1,664 \times 10\% = \166.40	(earnings on total contributions and past earnings based on 10% interest rate)
$\$166.40 \times 20\% = \33.28	(tax on earnings)
$\$1,664 + (\$166.40 - \$33.28) = \$1,797.12$	(amount at end of Year Two after tax on contributions and earnings)
Year Three:	
$\$1,797.12 + (\$1,000 - \$200) = \$2,597.12$	(carryover contributions and earnings from Years One and Two plus Year Three after tax contribution of \$800)
$\$2,597.12 \times 10\% = \259.71	(earnings on total contributions and past earnings based on 10% interest rate)
$\$259.71 \times 20\% = \51.94	(tax on earnings)
$\$2,597.12 + (\$259.71 - \$51.94) = \$2,804.89$	(amount at end of Year Three after tax on contributions and earnings)

Contributions to Traditional IRA	(tax deferral: no tax imposed on contributions or earnings but 20% tax imposed on distributions)
Year One:	
\$1,000	(no tax imposed when \$1,000 contribution made)
$\$1,000 \times 10\% = \100	(earnings on contribution based on 10% interest rate)
$\$1,000 + \$100 = \$1,100$	(amount at end of Year One – no tax on earnings or contribution)
Year Two:	
$\$1,100 + \$1,000 = \$2,100$	(carryover contribution and earnings from Year One plus Year Two contribution of \$1,000)
$\$2,100 \times 10\% = \210	(earnings on total contributions and past earnings based on 10% interest rate)
$\$2,100 + (\$210) = \$2,310$	(amount at end of Year Two – no tax on earnings or contributions)
Year Three:	
$\$2,310 + \$1,000 = \$3,310$	(carryover contribution from Years One and Two plus Year Three contribution of \$1,000)
$\$3,310 \times 10\% = \331	(earnings on total contributions based on 10% interest rate)
$\$3,310 + \$331 = \$3,641$	(amount at end of Year Three – no tax on contributions and earnings)
$\$3,641 \times 20\% = 728.20$	(tax on distribution of \$3,641 at end of Year Three)
$\$3,641 - 728.20 = \$2,912.80$	(amount remaining after tax on distribution at end of Year Three)

Contributions to Roth IRA	(20% tax imposed on contributions; no tax imposed on earnings and no tax imposed on distributions)
Year One:	
$\$1,000 \times 20\% = \200	(tax imposed on \$1,000)
$\$1,000 - \$200 = \$800$	(amount Angela has remaining after taxes to contribute)
$\$800 \times 10\% = \80	(earnings on contribution based on 10% interest rate)
$\$800 + \$80 = \$880$	(amount at end of Year One after tax on contribution but no tax on earnings)
Year Two:	
$\$880 + (\$1,000 - \$200) = \$1,680$	(carryover contribution and earnings from Year One plus Year Two after tax contribution of \$800)
$\$1,680 \times 10\% = \168.00	(earnings on total contributions and past earnings based on 10% interest rate)
$\$1,680 + \$168.00 = \$1,848$	(amount at end of Year Two after tax on contributions but no tax on earnings)
Year Three:	
$\$1,848 + (\$1,000 - \$200) = \$2,648$	(carryover contributions and earnings from Years One and Two plus Year Three after tax contribution of \$800)
$\$2,648 \times 10\% = \264.80	(earnings on total contributions and past earnings based on 10% interest rate)
$\$2,648 + \$264.80 = \$2,912.80$	(amount at end of Year Three after tax on contributions but no tax on earnings)
$\$2,912.80$	(non-taxable distribution available at end of Year Three)

2. Effect of Higher Tax Rate at Time of Contributions

Again suppose that Angela has \$1,000 that she can save each year for 3 years. Further suppose that she is taxed at a 20% rate for the first two years when she makes the contributions, earns 10% interest on her contributions each year, and is taxed at a 10% rate in the third year when the contributions are distributed at retirement.

If she contributes to a traditional IRA, she will have \$3,267.90 after taxes at the end of 3 years. In contrast, if she contributes to a Roth IRA, she will only have \$3,022.80 after taxes at the end of 3 years. Thus, Angela will be better off with a traditional IRA than a Roth IRA if her tax rates are lower at retirement than during her working years.

Contributions to Traditional IRA

Year One:	(tax deferral: no tax imposed on contributions or earnings but 10% tax imposed on distributions)
\$1,000	(no tax imposed when \$1,000 contribution made)
$\$1,000 \times 10\% = \100	(earnings on contribution based on 10% interest rate)
$\$1,000 + \$100 = \$1,100$	(amount at end of Year One – no tax on earnings or contribution)
Year Two:	(carryover contribution and earnings from Year One plus Year Two contribution of \$1,000)
$\$1,100 + \$1,000 = \$2,100$	(earnings on total contributions and past earnings based on 10% interest rate)
$\$2,100 \times 10\% = \210	(amount at end of Year Two – no tax on earnings or contributions)
$\$2,100 + (\$210) = \$2,310$	
Year Three:	(carryover contribution from Years One and Two plus Year Three contribution of \$1,000)
$\$2,310 + \$1,000 = \$3,310$	(earnings on total contributions based on 10% interest rate)
$\$3,310 \times 10\% = \331	(amount at end of Year Three – no tax on contributions and earnings)
$\$3,310 + \$331 = \$3,641$	(tax on distribution of \$3,641 at end of Year Three)
$\$3,641 \times 10\% = 364.10$	(amount remaining after tax on distribution at end of Year Three)
$\$3,641 - \$364.10 = \$3,276.90$	

Contributions to Roth IRA

(20% tax imposed on first two years of contributions, 10% tax imposed on third year of contributions; no tax imposed on earnings and no tax imposed on distributions)

Year One:

$$\$1,000 \times 20\% = \$200$$

(tax imposed on \$1,000)

$$\$1,000 - \$200 = \$800$$

(amount Angela has remaining after taxes to contribute)

$$\$800 \times 10\% = \$80$$

(earnings on contribution based on 10% interest rate)

$$\$800 + \$80 = \$880$$

(amount at end of Year One after tax on contribution but no tax on earnings)

Year Two:

$$\$880 + (\$1,000 - \$200) = \$1,680$$

(carryover contribution and earnings from Year One plus Year Two after tax contribution of \$800)

$$\$1,680 \times 10\% = \$168.00$$

(earnings on total contributions and past earnings based on 10% interest rate)

$$\$1,680 + \$168.00 = \$1,848$$

(amount at end of Year Two after tax on contributions but no tax on earnings)

Year Three:

$$\$1,848 + (\$1,000 - \$100) = \$2,748$$

(carryover contributions and earnings from Years One and Two plus Year Three after tax contribution of \$900 with 10% tax in Year 3)

$$\$2,748 \times 10\% = \$274.80$$

(earnings on total contributions and past earnings based on 10% interest rate)

$$\$2,748 + \$274.80 = \$3,022.80$$

(amount at end of Year Three after tax on contributions but no tax on earnings)

$$\$3,022.80$$

(non-taxable distribution available at end of Year Three)

3. Effect of Higher Tax Rate at Time of Distribution

Again suppose that Angela has \$1,000 that she can save each year for 3 years. Further suppose that she is taxed at a 10% rate for the first two years when she makes the contributions, earns 10% interest on her contributions each year, and is taxed at a 20% rate in the third year when the contributions are distributed at retirement.

If she contributes to a traditional IRA, she will have \$2,912.80 after taxes at the end of 3 years. In contrast, if she contributes it to a Roth IRA, she will have \$3,166.90 after taxes at the end of 3 years. Thus, Angela will be better off with a Roth IRA than with a traditional IRA if she is subject to a higher tax rate at retirement than during her working years.

Contributions to Traditional IRA		(tax deferral: no tax imposed on initial contributions or earnings, 20% tax imposed on distributions)
Year One:		
\$1,000		(no tax imposed when \$1,000 contribution made)
$\$1,000 \times 10\% = \100		(earnings on contribution based on 10% interest rate)
$\$1,000 + \$100 = \$1,100$		(amount at end of Year One – no tax on earnings or contribution)
Year Two:		
$\$1,100 + \$1,000 = \$2,100$		(carryover contribution and earnings from Year One plus Year Two contribution of \$1,000)
$\$2,100 \times 10\% = \210		(earnings on total contributions and past earnings based on 10% interest rate)
$\$2,100 + \$210 = \$2,310$		(amount at end of Year Two – no tax on earnings or contributions)
Year Three:		
$\$2,310 + \$1,000 = \$3,310$		(carryover contribution and earnings from Years One and Two plus Year Three contribution of \$1,000)
$\$3,310 \times 10\% = \331		(earnings on total contributions based on 10% interest rate)
$\$3,310 + \$331 = \$3,641$		(amount at end of Year Three – no tax on contributions and earnings)
$\$3,641 \times 20\% = 728.20$		(tax on distribution of \$3,641 at end of Year Three)
$\$3,641 - 728.20 = \$2,912.80$		(amount remaining after tax on distribution at end of Year Three)

Contributions to Roth IRA		(10% tax imposed on first two years of contributions and 20% tax imposed on third year of contributions; no tax imposed on earnings and no tax imposed on distributions)
Year One:		
$\$1,000 \times 10\% = \100		(tax imposed on \$1,000)
$\$1,000 - \$100 = \$900$		(amount Angela has remaining after taxes to contribute)
$\$900 \times 10\% = \90		(earnings on contribution based on 10% interest rate)
$\$900 + \$90 = \$990$		(amount at end of Year One after tax on contribution but no tax on earnings)
Year Two:		
$\$990 + (\$1,000 - \$100) = \$1,890$		(carryover contribution and earnings from Year One plus Year Two after tax contribution of \$900)
$\$1,890 \times 10\% = \189.00		(earnings on total contributions and past earnings based on 10% interest rate)
$\$1,890 + \$189.00 = \$2,079$		(amount at end of Year Two after tax on contributions but no tax on earnings)
Year Three:		
$\$2,079 + (\$1,000 - \$200) = \$2,879$		(carryover contributions and earnings from Years One and Two plus Year Three after tax contribution of \$800 – taxed at 20% rate)
$\$2,879 \times 10\% = \287.90		(earnings on total contributions and past earnings based on 10% interest rate)
$\$2,879 + \$287.90 = \$3,166.90$		(amount at end of Year Three after tax on contributions but no tax on earnings)
$\$3,166.90$		(non-taxable distribution available at end of Year Three)

B. OTHER DISTINCTIONS IN TREATMENT BETWEEN TRADITIONAL AND ROTH IRAS

In addition to the difference in the timing of taxation, there are four other noteworthy distinctions in the tax treatment of traditional and Roth IRAs. This section discusses those distinctions.

1. Income Limits

Both traditional and Roth IRAs are subject to income limits.¹²³ The dollar amounts, which are indexed for inflation, are identical, but the dollar amounts apply in a different manner. Specifically, an individual may not contribute to a Roth IRA if the individual's income exceeds the income limit¹²⁴ while an individual may contribute to a traditional IRA, regardless of income, but if an individual's income exceeds the income limit and the individual and/or his or her spouse is covered by an employer-sponsored pension plan, the individual may not deduct his or her contribution to a traditional IRA.¹²⁵

Thus, in 2016, single taxpayers who earn \$132,000 or more, and married taxpayers filing jointly who earn \$194,000 or more are not permitted to contribute to a Roth IRA.¹²⁶ Roth contributions are phased out for single taxpayers with earnings between \$117,000 and \$132,000 and for married taxpayers filing jointly with earnings between \$184,000 and \$194,000.¹²⁷

The state automatic enrollment IRA programs do not apply to workers who are covered by an employer-sponsored plan. Thus, single taxpayers will not be affected by the income limit on deductible contributions to traditional IRAs. Married workers, however, may be affected by the limit if their spouse is covered by an employer-sponsored plan. Specifically, married workers may not deduct their contributions to a traditional IRA under a state automatic enrollment IRA program if their spouse is covered by an employer-sponsored plan and the couple's income

¹²³ For the definition of income for these purposes, see I.R.C. § 219(g)(3) (2014) (modifying adjusted gross income); I.R.C. § 408A(c)(3) (2014) (incorporating I.R.C. § 219(g)(3) definition of income).

¹²⁴ I.R.C. § 408A(c)(3)(A) (2010) (imposing limits); I.R.C. § 408A(c)(3)(D) (2010) (providing for inflation adjustment).

¹²⁵ I.R.C. § 219(g) (2014) (imposing limits); I.R.C. § 219(g)(8) (2014) (providing for inflation adjustment).

¹²⁶ See I.R.S., *supra* note 33.

¹²⁷ *Id.*

in 2016 exceeds \$194,000.¹²⁸ Deductions are phased out in 2016 for incomes between \$184,000 and \$194,000.¹²⁹

2. Contribution Limits

Nominally, the contribution limits for traditional and Roth IRAs are identical for individuals under the age 70 ½.¹³⁰ Specifically, the contribution limit for individuals under the age of 50 is \$5,500¹³¹ while the contribution limit for individuals age 50 to 70 ½ is \$6,500.¹³² For individuals who seek to maximize their contributions, however, the contribution limit for Roth IRAs is effectively higher than the limit for traditional IRAs because the Roth limit is an after-tax limit while the traditional limit is a before-tax limit. To illustrate, if an individual in the 10% income tax bracket contributes the maximum \$5,500 to a traditional IRA, the \$5,500 contribution is equivalent to a \$4,950 after-tax contribution ($\$5,500 - (5,500 \times 10\% = \$550) = \$4,950$). In contrast, if an individual in the 10% income tax bracket contributes the maximum \$5,500 to a Roth IRA, the individual makes an after-tax contribution of \$5,500 and may pay the \$550 tax with other money. In effect, the individual is contributing an extra \$550 to the Roth IRA.

In addition, an age limit applies to contributions to traditional IRAs¹³³ but not to contributions to Roth IRAs.¹³⁴ Specifically, individuals age 70 ½ or older are prohibited from contributing to a traditional IRA¹³⁵ but may contribute up to \$6,500 to a Roth IRA.

3. Excise Tax on Pre-Age 59 ½ Distributions

As discussed above, distributions from traditional IRAs are taxable as income in the year of receipt.¹³⁶ In addition, if the recipient is under the

¹²⁸ *Id.*

¹²⁹ *See id.*

¹³⁰ *See* I.R.C. § 408A(c)(2) (2015) (Roth IRA provision cross-referencing traditional IRA limit provision I.R.C. § 219).

¹³¹ I.R.C. § 219(b)(5)(A) (2014) (establishing basic limit of \$5,000); I.R.C. 219(b)(5)(C) (providing for cost-of-living adjustment). I.R.S., *supra* note 33 (setting limit at \$5,500 for 2016).

¹³² I.R.C. § 219(b)(5)(B) (2014) (permitting \$1,000 catch-up contribution for individuals age 50 or over).

¹³³ I.R.C. § 219(d)(1) (2014).

¹³⁴ I.R.C. § 408(c)(4) (2015).

¹³⁵ I.R.C. § 219(d)(1) (2014).

¹³⁶ I.R.C. § 408(d) (2015).

age of 59 ½, a ten percent excise tax generally applies.¹³⁷ Unlike distributions from traditional IRAs, distributions of Roth contributions are never taxable¹³⁸ nor subject to the ten percent excise tax. Pre-age 59 ½ distributions of earnings on Roth contributions, however, may be subject to regular income taxation¹³⁹ as well as the ten percent excise tax.¹⁴⁰

The Internal Revenue Code provides favorable income tax treatment to IRAs primarily to encourage individuals to save for retirement.¹⁴¹ The ten percent excise tax on early distributions is intended to ensure that funds in tax-favored retirement savings vehicles, such as IRAs, are available for retirement purposes and not withdrawn too early.¹⁴²

Exceptions apply to the excise tax for pre-age 59 ½ distributions from traditional and Roth IRAs.¹⁴³ For example, no excise tax applies if the distributions are made for the first-time purchase of a home,¹⁴⁴ qualified education expenses,¹⁴⁵ or certain medical expenses.¹⁴⁶

4. Minimum Distribution Rules

Minimum distribution rules apply to traditional IRAs¹⁴⁷ but do not apply to Roth IRAs until after the death of the individual who established the Roth IRA.¹⁴⁸

The minimum distribution rules are intended to ensure that retirement savings are used for retirement savings purposes rather than for

¹³⁷ I.R.C. § 72(t)(1) (2015).

¹³⁸ Treas. Reg. § 1.408A-6 Q&A1(b) (2014).

¹³⁹ I.R.C. § 408A(d)(2) (2010). *See also supra* note 113 (discussing rules regarding taxation of distributions from Roth IRAs).

¹⁴⁰ I.R.C. § 72(t)(1) (2015).

¹⁴¹ *See* U.S. DEP'T OF TREAS., General Explanation of the Administration's Fiscal Year 2004 Revenue Proposals, at 118 (2003) (stating that "Individual Retirement Accounts (IRAs), including traditional, Roth, and nondeductible IRAs, are primarily intended to encourage retirement saving").

¹⁴² *Cf.* STAFF OF J. COMM. ON TAXATION, 112TH CONG., PRESENT LAW AND BACKGROUND RELATING TO THE TAX TREATMENT OF RETIREMENT SAVINGS 28 (Comm. Print 2011) (stating that restriction designed to ensure that qualified plan distributions are "not taken too early so that they are depleted prior to retirement").

¹⁴³ I.R.C. § 72(t)(2) (2015).

¹⁴⁴ I.R.C. § 72(t)(2)(F) (2015).

¹⁴⁵ I.R.C. § 72(t)(2)(E) (2015).

¹⁴⁶ I.R.C. § 72(t)(2)(B) (2015).

¹⁴⁷ I.R.C. § 408(a)(6) (2015).

¹⁴⁸ I.R.C. § 408A(c)(5) (2010).

estate planning purposes.¹⁴⁹ The rules require that beginning at age 70 ½, the entire amount of the IRA be distributed over the life expectancy of the individual (or over the lives of the individual and a designated beneficiary).¹⁵⁰

C. IMPLICATIONS OF DISTINCTIONS FOR SELECTING DEFAULT IRAS

In considering which type of IRA should serve as the default IRA, it is important to take into account the characteristics of the individuals most likely to be covered by the state automatic enrollment IRA programs. Thus, this section begins by discussing those characteristics. It then discusses how the interaction of those characteristics with the distinctions between traditional and Roth IRAs affects the selection of a default IRA.

1. Characteristics of Individuals Most Likely to Be Covered by an Automatic Enrollment IRA Program

The state automatic enrollment IRA programs are intended to provide a retirement savings vehicle for individuals who do not have access to an employer-sponsored pension plan. Thus, the individuals most likely to be covered by state automatic enrollment IRA programs are those who currently do not have access to an employer-sponsored pension plan.

¹⁴⁹ Cf. STAFF OF J. COMM. ON TAXATION, Present Law and Background Relating to the Tax Treatment of Retirement Savings, *supra* note 142 (stating that restriction designed to ensure that qualified plan distributions are not “taken too late so that they are primarily a means of estate planning”); STAFF OF J. COMM. ON TAXATION, 107TH CONG., STUDY OF THE OVERALL STATE OF THE FEDERAL TAX SYSTEM AND RECOMMENDATIONS FOR SIMPLIFICATION PURSUANT TO SECTION 8022(3)(B) OF THE INTERNAL REVENUE CODE OF 1986, VOL. II 197 (Comm. Print 2001) (stating that “the minimum distribution rules reflect the perspective that the primary purpose of the special tax benefits for qualified retirement plans is retirement savings and that tax-favored retirement plans should not primarily be used as a means of estate planning.”).

¹⁵⁰ See Treas. Reg. § 1.408-2(b)(6) (2007).

a. Workers Covered by the State Automatic Enrollment IRA Programs Tend to Have Lower Incomes and Be Younger

Surveys and studies done at the national level consistently¹⁵¹ show that individuals who do not have access to an employer-sponsored pension plan tend to be lower-paid¹⁵² and younger¹⁵³ than workers with access to an employer-sponsored pension plan. Surveys and studies focusing on the five states that have enacted automatic enrollment IRA programs confirm that the individuals targeted by these programs share these characteristics.

For example, Drs. Constantijn Panis and Michael Brien prepared a study identifying the target populations of the California and Illinois programs.¹⁵⁴ They found that the California program should cover about 7.8 million workers who are not currently covered by an employer-sponsored

¹⁵¹ Although the surveys and studies do not report identical numbers, they report consistent trends. For a discussion of the reasons why precise numbers differ, *see*, Irena Dushi, et al., *Retirement Plan Coverage by Firm Size: An Update*, 75 SOC. SEC. BULL., no. 2 (2015); Craig Copeland, *Employment-Based Retirement Plan Participation: Geographic Differences and Trends, 2013*, EBRI Issue Brief No. 405, at 8 (Oct. 2014), https://www.ebri.org/pdf/briefspdf/EBRI_IB_405_Oct14.RetPart.pdf.

¹⁵² *See*, e.g., THE PEW CHARITABLE TR., WHO'S IN, WHO'S OUT: A LOOK AT ACCESS TO EMPLOYER-BASED RETIREMENT PLANS AND PARTICIPATION IN THE STATES 14 (2016), http://www.pewtrusts.org/~media/assets/2016/01/retirement_savings_report_jan16.pdf (stating that about 32% of individuals earning less than \$25,000 reported having access to an employer-sponsored retirement plan compared to 75% of those earning \$100,000 or more); BUREAU OF LABOR STATISTICS, News Release: Employee Benefits in the United States – March 2015 6, Table 1 (showing that only 38% of workers with average wages in the lowest 25% and 28% of workers with average wages in the lowest 10% had access to an employer-sponsored pension in March 2013 compared to 85% of workers with average wages in the highest 25% of wages); GAO, *supra* note 4, at 10 (estimating that median adjusted gross income of households without defined contribution plan or IRA in 2010 was \$32,000 compared to \$75,000 for those with defined contribution plan or IRA).

¹⁵³ *See*, e.g., THE PEW CHARITABLE TR., *supra* note 152 (stating that about 47% of individuals between the ages of 18 and 29 reported having access to an employer-sponsored pension compared to 63% of workers ages 45 to 64).

¹⁵⁴ Constantijn W.A. Panis & Michael J. Brien, *Target Populations of State-Level Automatic IRA Initiatives* (Aug. 28, 2015), <https://www.dol.gov/sites/default/files/ebsa/researchers/analysis/retirement/Targetpopulationsofstatelevelautomaticirainitiatives.pdf>.

pension plan¹⁵⁵ while the Illinois program should cover about 1.7 million workers who are not covered by an employer-sponsored pension.¹⁵⁶ They found that the targeted employees in California had median annual earnings of \$21,000 in 2013 compared to \$45,000 for private-sector workers with access to an employer-sponsored pension plan¹⁵⁷ while the targeted employees in Illinois had median annual earnings in 2013 of \$21,000 compared to \$44,000 for private-sector workers with access to an employer-sponsored pension plan.¹⁵⁸ With respect to the age distribution of workers, Drs. Panis and Brien found that 31% of the targeted workers in California are under the age of 30 compared to 21% of comparison workers¹⁵⁹ and 37% of the targeted workers in Illinois are under the age of 30 compared to 24% of comparison workers.¹⁶⁰

b. Workers Covered by the State Automatic Enrollment IRA Programs Tend to be Subject to Lower Income Tax Rates

In the United States, individual income tax rates are progressive; that is, as an individual's income increases so does the rate at which the individual income tax is imposed.¹⁶¹ In 2016, no tax is imposed on single

¹⁵⁵ *Id.* at 6. In a June 2012 study, Nari Rhee of the UC Berkeley Center for Labor and Education found that 6.3 million California workers did not have access to an employer-sponsored pension plan. See Nari Rhee, *6.3 Million Private Sector Workers in California Lack Access to a Retirement Plan on the Job*, UC BERKELEY CTR. FOR LAB. AND EDUC. RES. BRIEF (June 2012), http://laborcenter.berkeley.edu/pdf/2012/ca_private_pension_gap12.pdf.

¹⁵⁶ Panis & Brien, *supra* note 154, at 12.

¹⁵⁷ *Id.* at 6. If the sample is restricted to workers who reported working full time for at least 50 weeks during 2013, overall earnings were \$32,000 for targeted workers compared to \$55,000 for workers with access to an employer-sponsored plan. *Id.* According to the Rhee study, the median annual earnings of California workers who did not have access to an employer-sponsored pension in 2008-2010 was just under \$26,000, half that of workers that did have access to an employer-sponsored pension. Rhee, *supra* note 155, at 7-8.

¹⁵⁸ Panis & Brien, *supra* note 156, at 12. If the sample is restricted to workers who reported working full time for at least 50 weeks during 2013, overall annual earnings were \$35,000 among targeted workers and \$50,000 among the comparison group. *Id.*

¹⁵⁹ *Id.* at 8.

¹⁶⁰ *Id.* at 14.

¹⁶¹ Marvin A. Chirlestien and Lawrence Zelenak, *Federal Income Taxation* 3 (Robert C. Clark, 13th ed. 2015). For a discussion of the justification for the

individuals with income at or below \$10,350¹⁶² or on married couples with income at or below \$20,700.¹⁶³ In essence, income up to those levels is subject to a zero percent tax rate. Once those levels are exceeded, positive tax rates apply.

In 2016, there are seven different positive tax rates or brackets: (1) 10%; (2) 15%, (3) 25%, (4) 28%, (5) 33%, (6) 35%, and (7) 39.6%.¹⁶⁴ Thus, for example, single individuals are subject to tax at the rate of 10% on their first \$9,275 of taxable income (that is, income that exceeds the first \$10,350 of income that is not subject to tax) and 15% on their taxable income over \$9,275 but not over \$37,650.¹⁶⁵ The highest tax bracket, 39.6%, only applies to taxable income over \$415,050.¹⁶⁶ Married couples filing jointly are subject to tax at the rate of 10% on their first \$18,550 of taxable income (that is, income that exceeds the first \$20,700 of income that is not subject to tax) and 15% on their taxable income over \$18,550 but not over \$75,300.¹⁶⁷ The highest tax bracket, 39.6%, applies to taxable income over \$466,950 for married couples.¹⁶⁸

Because the individuals covered by the state automatic enrollment IRA programs tend to have lower incomes and individual income tax rates are progressive, individuals covered by the state programs tend to be subject

progressive income tax, *see* Meredith R. Conway, *Money, It's a Crime, Share it Fairly But Don't Take a Piece of My Pie: The Legislative Case for the Progressive Income Tax*, 39 J. Legis. 119 (2012-2013), <http://scholarship.law.nd.edu/cgi/viewcontent.cgi?article=1030&context=jleg>.

¹⁶² In 2016, the basic standard deduction for single taxpayers is \$6,300. I.R.C. § 63(c)(2) (2015); I.R.S., *IN 2016, SOME TAX BENEFITS INCREASE SLIGHTLY DUE TO INFLATION ADJUSTMENTS, OTHERS ARE UNCHANGED*, (2015). No tax is imposed on income up to the standard deduction. In addition, a personal exemption of \$4,050 is allowed for each taxpayer and each family dependent. I.R.C. § 151(d) (2015); I.R.S., *supra* note 162. Thus, a single individual with no dependents is entitled to receive up to \$10,350 free of taxation in 2016.

¹⁶³ In 2016, the standard deduction for married couples filing jointly is \$12,600. I.R.C. § 63(c)(2) (2015); I.R.S., *supra* note 162. No tax is imposed on income up to this level. In addition, a personal exemption of \$4,050 is allowed for each taxpayer and each family dependent. I.R.C. § 151(d) (2015); I.R.S., *supra* note 162. Thus, a married couple with no dependents is entitled to receive up to \$20,700 free of taxation: $\$12,600 + (2 \times \$4,050) = \$20,700$. The tax-free amount increases by \$4,050 for each dependent the married couple has.

¹⁶⁴ I.R.C. § 1 (2014).

¹⁶⁵ I.R.S. Rev. Proc. 2015-53 § 3, Table 3.

¹⁶⁶ *Id.*

¹⁶⁷ I.R.S. Rev. Pro. 2015-53 § 3, Table 1

¹⁶⁸ *Id.*

to lower income tax rates. For example, according to Drs. Panis and Brien's study of the California and Illinois programs, most targeted workers (61% in California and 59% in Illinois) were in tax brackets of 0% or 10% compared to 42% of the comparison group in California and 40% of the comparison group in Illinois.¹⁶⁹ Moreover, less than 13% of targeted workers in California and less than 14% of targeted workers in Illinois were in 25% or higher tax brackets compared to 30.4% of the comparison group in California and 28% of the comparison group in Illinois.¹⁷⁰ According to a Connecticut study, about half of Connecticut workers not covered by an employer-sponsored pension are not required to pay income taxes because their earnings are too low.¹⁷¹

c. Tax Rates for Younger Workers Covered by the State Automatic Enrollment IRA Programs are Likely to Increase Over Time

In the United States, as in many countries, wages tend to increase with age.¹⁷² Thus, the wages of the younger workers covered by the state automatic enrollment IRA programs are likely to increase over time. Because tax rates increase as wages increase, the younger workers covered by the programs are likely to face higher tax rates over time.

Whether the younger workers covered by the state automatic enrollment IRA programs will face higher tax rates in retirement depends, of course, on their income at retirement as well as the prevailing tax rates at the time of their retirement. At least some younger workers covered by the state automatic enrollment IRA programs are likely to have higher incomes at retirement than in their early years of coverage by the state automatic enrollment IRA programs and thus are likely to face higher tax rates in retirement.

¹⁶⁹ Panis & Brien, *supra* note 154, at 7, 13.

¹⁷⁰ *Id.*

¹⁷¹ *Connecticut Report to Legislature, supra* note 118, at 12-13 (extrapolating from 2010 census data).

¹⁷² Pnina Alon-Shenker, *Nonhiring and Dismissal of Senior Workers: Is It All about the Money?*, 35 COMP. LAB. L. & POL'Y J. 159, 172-73 (2014) (noting that "[b]ecause the linkage between work experience and age is strong, wages often increase at least indirectly with age"); Christine Jolls, *Hands-Tying and the Age in Discrimination Employment Act*, 74 TEX. L. REV. 1813, 1815 (1996) (noting that "higher pay based on age – wholly apart from productivity or seniority at a particular firm – seems to be a fairly robust empirical fact about our economy.").

2. Interaction between Characteristics of Workers Covered by Programs and Difference in Timing of Taxation

As discussed above,¹⁷³ if tax rates remain constant, from an economic standpoint, individuals should be indifferent as between a traditional and Roth IRA. On the other hand, if they face lower tax rates in retirement, they would be better off with a traditional IRA, and if they are subject to higher tax rates in retirement, they would be better off with a Roth IRA.

Given the relatively low income tax rates to which most workers covered by state automatic enrollment IRA programs are subject and the fact that the workers tend to be younger and thus likely to earn higher wages over the course of their careers, most workers covered by the state automatic enrollment IRA programs are likely to face either the same or higher income tax rates in retirement. This suggests that most workers should be either indifferent as to the type of default IRA or prefer a Roth IRA.

If the economic impact of the timing of taxation were the sole factor to be taken into account in selecting a default IRA, it seems that a Roth IRA should be the default IRA because more workers enrolled in a state automatic enrollment IRA program are likely to benefit from a Roth IRA than from a traditional IRA. As discussed above, however, the timing of taxation is not the sole difference between traditional and Roth IRAs. There are other distinctions between traditional and Roth IRAs.

3. Interaction between Characteristics of Workers Covered by Programs and Difference in Income Limits

As discussed above,¹⁷⁴ income limits apply in a different fashion to traditional and Roth IRAs. Specifically, the income limits prohibit individuals from contributing to a Roth IRA once they reach the limits while they prohibit an individual from deducting contributions to a traditional IRA once they reach the limits. Moreover, the income limits on the deductibility of contributions to traditional IRAs only apply if the individual and/or his or her spouse is covered by an employer-sponsored pension.

Focusing on the applicability of income limits to Roth IRAs, the Connecticut Retirement Security Board recommended to the Connecticut legislature that traditional IRAs serve as the default IRA because the income

¹⁷³ See *supra* Section IV(A).

¹⁷⁴ See *supra* Section IV(B)(1).

limits applicable to Roth IRAs make them more administratively complex.¹⁷⁵ Specifically, the Board “recommend[ed] a Traditional IRA as a default over a Roth IRA, because the Roth IRA adds administrative complexity. With a Roth IRA, the program would need to determine which participants were eligible for a Roth on a tax basis, and those employees that are auto-enrolled may be penalized if they were ineligible for a Roth.”¹⁷⁶ The BCCRR, on the other hand, contends that the distinction in income limits points toward selecting a Roth IRA rather than a traditional IRA. According to the BCCRR, the income limits applicable to Roth IRAs are more straightforward and easier for individuals to understand than the income limits for traditional IRAs; the traditional limits may be confusing for workers going in and out of a state system because they only apply if the worker and/or his or her spouse is covered by an employer-sponsored pension plan.¹⁷⁷

Undoubtedly, income limits apply to traditional IRAs in a different fashion than to Roth IRAs. That distinction, however, should not drive the choice of default IRAs. The income limits only apply to individual taxpayers with earnings equal to or greater than \$117,000 and to married taxpayers filing jointly with earnings equal to or greater than \$184,000. Because the workers covered by state automatic enrollment IRA programs tend to have lower incomes, few workers are likely to be subject to these limits.¹⁷⁸ Indeed, according to the Connecticut Retirement Security Board less than 10% of the population subject to the Connecticut program would exceed the individual limit.¹⁷⁹ Selecting the default IRA based on the income limits would be a bit like having the tail wag the dog.

¹⁷⁵ *BCCRR Connecticut Report*, *supra* note 118, at 10-11. The Connecticut Board, however, recognized that access to accumulated savings might be important to participants and recommended that the legislature give the implementing Board the final authority to select the default IRA. *Id.*

¹⁷⁶ *Id.* at 11.

¹⁷⁷ *Id.* at 10.

¹⁷⁸ It is, of course, possible for a low-income worker to be married to a high-income worker so that the family income of a low-income worker exceeds the limit. The needs of such individuals, however, should not drive the choice of default IRAs. Higher-income families are in a better position to get tax advice than lower-income families.

¹⁷⁹ *Connecticut Report to Legislature*, *supra* note 118, at 14.

4. Interaction between Characteristics of Workers Covered by Programs and Difference in Contribution Limits

As discussed above,¹⁸⁰ the contribution limits for traditional and Roth IRAs are nominally identical for workers under age 70 ½. Specifically, workers under the age of 50 may contribute up to \$5,500 while workers between the ages of 50 and 70 ½ may contribute up to \$6,500. Effectively, however, the Roth IRA limit is higher than the traditional limit because the Roth limit is an after-tax limit while the traditional limit is a before-tax limit.

The BCCRR has pointed to the effectively higher limit for Roth IRAs as a reason in favor of selecting the Roth IRA as the default IRA.¹⁸¹ Specifically because the Roth IRA limit is an after-tax limit, workers may have more retirement income on an after-tax basis with a Roth IRA than with a traditional IRA.¹⁸²

Undoubtedly, workers subject to a positive income tax rate in retirement will have higher after-tax income in retirement if their IRA distributions are from a Roth IRA that is not subject to income tax than if they are from a traditional IRA that is subject to income tax. For most workers, however, that difference is not due to the effective difference in the contribution limits but instead is due to the fact that Roth contributions are subject to tax when made while contributions to traditional IRAs are not subject to tax until distributed.

Few workers are likely to be constrained by the \$5,500 contribution limit applicable to both traditional and Roth IRAs. Currently, the three states that have established a default contribution rate have set that rate at three percent.¹⁸³ Only workers with income equal to or in excess of \$183,333 would have default contributions of \$5,500 at a contribution rate of three percent. Even if the default contribution rate were increased to six percent, only workers with income equal to or in excess of \$91,667 would have default contributions of \$5,500.

Arguably, a Roth IRA is superior to a traditional IRA because a Roth IRA effectively requires workers subject to positive income tax rates to contribute more to their IRA. In essence, workers subject to positive tax

¹⁸⁰ See *supra* Section IV(B)(2).

¹⁸¹ BCCRR *Connecticut Report*, *supra* note 118, at 10-11; BCCRR *Oregon Memo*, *supra* note 84, at 2.

¹⁸² *Id.*

¹⁸³ See CAL. GOV'T CODE § 100032(h); 820 ILL. COMP. STAT. § 80/60(c); 2016 Conn. Acts No. 16-29 § 1(3).

rates are effectively contributing more to a Roth IRA than a traditional IRA because with a Roth IRA not only are they contributing the nominal contribution to the Roth IRA but they are also effectively contributing the taxes by paying the tax in the year of contribution rather than the year of distribution.

Given the relatively low incomes of most workers targeted by state automatic enrollment IRAs, however, state automatic enrollment IRA programs do not need to be structured as Roth IRAs to increase contributions and thus retirement savings. Rather, default contribution rates can simply be set higher. Indeed, consultants and analysts typically recommend default contribution rates higher than the three percent rate in place in the current programs.¹⁸⁴

For the few workers willing and able to contribute more than \$5,500 in pre-tax dollars to a state automatic enrollment IRA, the Roth IRA may be the better default IRA due to the difference in contribution limits. For the majority of workers who are likely unable and unwilling to make the maximum contribution, however, the difference in contribution limits is simply irrelevant. Just as income limits should not drive the choice of a default IRA, contribution limits should not drive the choice of a default IRA.¹⁸⁵

5. Interaction between Characteristics of Workers Covered by Programs and Excise Tax on Pre-Age 59 ½ Distributions

As discussed above,¹⁸⁶ individuals may make income-tax-free and excise-tax-free withdrawals of contributions to Roth IRAs at any time. In contrast, not only are distributions from traditional IRAs subject to income tax, but distributions prior to age 59 ½ are generally subject to a ten percent excise tax. Only pre-age 59 ½ distributions of earnings on contributions to Roth IRAs are potentially subject to a ten percent excise tax.

¹⁸⁴ See, e.g., *Overture Financial LLC*, *supra* note 26, at 7 (recommending five percent default rate); *Connecticut Report to Legislature*, *supra* note 118, at 22 (recommending six percent default rate).

¹⁸⁵ In addition, the fact that workers may only contribute to a Roth IRA after age 70 ½ should not drive the choice of the default IRA. The state automatic enrollment IRA programs are intended to promote retirement savings for workers without access to an employer-sponsored pension. The vast majority, if not all, of the workers covered by the state automatic enrollment IRA programs are likely to have retired by age 70 ½.

¹⁸⁶ See *supra* Section IV(B)(3).

The BCCRR pointed to this difference in the imposition of excise taxes, which it referred to as a “penalty,” as its first justification for recommending the Roth IRA as the default IRA. According to the BCCRR, a Roth IRA “provides a balance between retention and liquidity for a population that may need to access its funds for emergencies.”¹⁸⁷ Even the Connecticut Board, which recommended the traditional IRA as the default IRA, recognized that the default IRA “must balance targeting asset accumulation and an income replacement ratio for retirement with creating a situation where an individual cannot access capital and potentially incurs high cost debt or experiences significant financial stress as a result.”¹⁸⁸

As the Connecticut Board and the BCCRR recognize, penalty-free access to retirement savings is likely to be very important to the population covered by the state automatic enrollment IRA programs. Penalty-free access to retirement savings, however, is a double-edged sword. On the one hand, the availability of penalty-free access to retirement savings may encourage workers to participate in a state automatic enrollment IRA program¹⁸⁹ and thus encourage workers to save more for retirement.¹⁹⁰ On the other hand, penalty-free access to Roth contributions makes it easier for workers to withdraw their retirement savings and thus can lead to retirement savings “leakage” with workers having less retirement savings when they reach retirement age.¹⁹¹

Undoubtedly, the ten percent excise tax on pre-age 59 ½ distributions would likely discourage early withdrawals from retirement savings vehicles and thus promote retirement savings. Nevertheless, it hardly seems fair or appropriate to impose this tax penalty, which serves as

¹⁸⁷ *BCCRR Connecticut Report*, *supra* note 118, at 10.

¹⁸⁸ *Connecticut Report to Legislature*, *supra* note 118, at 14.

¹⁸⁹ The state automatic enrollment IRA programs do not require workers to affirmatively elect to participate in the programs. They do, however, permit workers to opt out. The presence of penalties on withdrawals may result in more workers electing to opt out of participation.

¹⁹⁰ *Cf.* U.S. DEP'T OF TREAS., GENERAL EXPLANATION OF THE ADMINISTRATION'S FISCAL YEAR 2004 REVENUE PROPOSALS 119 (2003) (stating that ten percent excise tax on early distributions from IRAs “discourage[s] many taxpayers from making contributions because they are concerned about the inability to access the funds should they need them.”).

¹⁹¹ *Cf.* Norman P. Stein & Patricia E. Dilley, *Leverage, Linkage, and Leakage: Problems with the Private Pension System and How They Should Inform the Social Security Debate*, 58 WASH. & LEE L. REV. 1369, 1402-07 (2001) (discussing the problem of leakage from qualified employer-sponsored pension plans).

a quid pro quo for the favorable tax treatment accorded retirement savings,¹⁹² to low-income workers who receive little or no tax benefit from the favorable tax treatment accorded IRAs.¹⁹³ As the BCCRR has noted, “[c]onsidering the population targeted, the possibility of a newspaper story – about a family paying a ten percent penalty to use money in their account to repair their roof – could be fatal to this initiative.”¹⁹⁴

In light of the fact that state automatic enrollment IRA programs tend to cover lower-income workers who receive little to no income tax benefit from the favorable tax treatment accorded IRAs, it appears that a Roth IRA, which minimizes the exposure to excise taxes on pre-age 59 ½ distributions, is a more appropriate default IRA than a traditional IRA.

6. Minimum Distribution Rules

As discussed above,¹⁹⁵ minimum distribution rules apply to traditional IRAs but generally do not apply to Roth IRAs. Specifically, the minimum distribution rules require that beginning at age 70 ½, the entire amount of a traditional IRA be distributed over the life expectancy of the individual (or over the lives of the individual and a designated beneficiary). Minimum distribution rules only apply to Roth IRAs after the death of the individual who established the Roth IRA.

The distinction between the application of the minimum distribution rules to traditional IRAs and Roth IRAs is only relevant to individuals who do not wish to begin receiving distributions from their IRAs once they reach age 70 ½. Because the state automatic enrollment IRA programs target lower-income workers, few workers covered by the state programs are likely to object to receiving minimum distributions once they reach age 70 ½. Thus, the distinction in the application of the minimum distribution should not play much of a role in the selection of a default IRA.¹⁹⁶

¹⁹² See, e.g., *supra* Section IV(B)(3).

¹⁹³ The favorable tax treatment accorded retirement savings has been described as an “upside down subsidy” because it offers higher-income individuals subject to higher income tax rates with greater tax benefits than lower-income workers subject to lower income rates. See, e.g., Karen Burke & Grayson McCouch, *Lipstick, Light Beer and Back-Loaded Savings Accounts*, 25 VA. TAX REV. 1101, 1127-28 (2006) (using terminology).

¹⁹⁴ *Id.*

¹⁹⁵ See *supra* Section IV(B)(4).

¹⁹⁶ The BCCRR recognizes that the distinction in the application of minimum distribution rules is likely to be less important to low-income workers. *BCCRR*

D. RECOMMENDATION

Overall, it appears that a Roth IRA is a more appropriate default IRA than a traditional IRA.

The most important factor pointing toward the selection of the Roth IRA as the default IRA is the fact that pre-age 70 ½ withdrawals of contributions to Roth IRAs are not subject to a ten percent excise tax, or penalty, while pre-age 70 ½ withdrawals of contributions to traditional IRAs may be subject to a ten percent excise tax. Although the excise tax is consistent with the goal of discouraging early distributions of retirement savings so as to ensure that retirement savings are used for retirement purposes, it does not seem fair or appropriate to impose a tax penalty on workers who receive little to no tax benefit from IRAs. Thus, the most appropriate default IRA is the Roth IRA which exposes workers to the least risk of an excise tax on early distributions.

The second factor pointing toward the selection of the Roth IRA as the default IRA is the difference in the timing of taxation of traditional and Roth IRAs. Because workers covered by state automatic enrollment IRAs tend to be younger and have lower wages, most workers should be either indifferent as to the type of default IRA or prefer the Roth IRA.

Arguably, the differences in contribution limits and application of minimum distribution rules also point in favor of a Roth IRA. Those differences, however, should not play much, if any, role in the selection of a default IRA; the differences only impact relatively high-income workers, a small subset of workers covered by the state programs. Similarly, the difference in income limits, which could support either type of IRA depending on one's point of view, is not relevant for most workers covered by a state automatic enrollment IRA program.

V. CONCLUSION

Although state automatic enrollment IRA programs are created by state law, they are not independent of federal law. In order for workers covered by state automatic enrollment IRA programs to receive favorable federal income tax treatment, the IRAs under these programs must satisfy the requirements set forth in I.R.C. §§ 408(a) and 408(c). As currently structured, the state laws expressly satisfy some, but not all, of these requirements. Prior to final implementation, the programs will need to be

Oregon Memo, *supra* note 85, at 2; *BCCRR Connecticut Report*, *supra* note 118, at 11.

adjusted to ensure that all of the requirements are incorporated and expressly satisfied.

In enacting a state automatic enrollment IRA program, a state must select a default IRA. To date, the states have not been uniform in their choice. Some states have selected the traditional IRA while others have selected the Roth IRA. In light of the populations targeted by state automatic enrollment IRA programs and the difference in rules applicable to traditional and Roth IRAs, it appears that the Roth IRA is the more appropriate default IRA for a state automatic enrollment IRA program.

THE PENSION MIS-SELLING SCANDAL, THE SEC, AND THE FIDUCIARY STANDARD

JOHN A. TURNER*

A growing literature has documented the low quality of financial advice that many people receive because of conflicts of interest that many financial advisers have. The Council of Economic Advisers has found that bad advice from financial advisers concerning rollovers from 401(k) plans to IRAs costs U.S. workers \$17 billion a year. When a similar situation occurred in the United Kingdom, the situation was termed the “pension mis-selling scandal.” British financial market regulators levied billions of pounds in fines on financial service providers to compensate pension participants for the bad advice they had received. This paper argues that a pension mis-selling scandal is occurring in the United States. Despite the fiduciary duty of financial advisers, and the task of the SEC to enforce that fiduciary responsibility, the SEC has taken no action to protect pension participants relating to advice to roll funds over from low-fee 401(k) plans to IRAs, which generally charge higher fees. Even in the case of advice to roll funds over from the extremely low-fee Thrift Savings Plan for federal government workers (which charges less than 3 basis points), the SEC has taken no action. This paper compares the pension mis-selling scandal in the United Kingdom to the situation in the United States concerning pension rollovers to IRAs. The paper then compares the regulatory response of financial market regulators in the United Kingdom to that of the SEC. The main findings of this paper are the apparent view of the SEC that fees in the context of pension rollovers are not an important issue, and the related finding that there has been a lack of action by the SEC concerning pension mis-selling in the United States. These findings are both consistent with the hypothesis of regulatory capture of the SEC. Because the fiduciary standard of the SEC is weak, extending it to broker-dealers will have limited effect.

*I received helpful comments from participants at the Fifth Annual National Benefits and Social Insurance Conference at the University of Connecticut, from participants at a seminar of the Savings and Retirement Foundation in Washington, DC, and from Benjamin Jones.

*“The mission of the U.S. Securities and Exchange Commission is to protect investors. . . .”*¹

I. INTRODUCTION

The Securities and Exchange Commission (SEC) has the job of protecting U.S. investors in financial markets.² One way it does that is to regulate the services provided by Registered Investment Advisers (RIAs). RIAs have a fiduciary duty to provide advice that is in the best interest of their clients.³ However, one problem clients encounter is called “hat switching.”⁴ With “hat switching,” an adviser sometimes acts as an RIA with a fiduciary duty, and sometimes acts as a broker-dealer, with a suitability duty, which is a lower standard. Broker-dealers are regulated by the Financial Industry Regulatory Authority (FINRA). Under the suitability standard, advice, rather than being in the best interest of the client, must merely be suitable for the client, given the client’s age, income and assets, risk preferences, and other factors.⁵ For this and other reasons, it may be difficult for clients to determine what standard of regulatory protection, if any, applies to the advice they are receiving.⁶ The SEC has been considering extending its fiduciary standard to broker-dealers.⁷

RIAs advise some workers relating to their pensions, which for many people are their primary or only form of financial market investment. While only 13.8 percent of households directly held stocks in 2013, 49.2 percent of households held retirement accounts, primarily Individual

¹ U.S. SEC. AND EXCH. COMM’N, *What We Do* (2016), <https://www.sec.gov/about/whatwedo.shtml>.

² *Id.*

³ Peter Lazaroff, *The Difference Between Fiduciary and Suitability Standards*, FORBES (Apr. 6, 2016), <http://www.forbes.com/sites/peterlazaroff/2016/04/06/the-difference-between-fiduciary-and-suitability-standards/#4d42e9a735bf>.

⁴ John A. Turner & Dana M. Muir, *The Market for Financial Advisors* 13-45 (Olivia S. Mitchell & Kent Smetters, eds., 2013).

⁵ Lazaroff, *supra* note 3.

⁶ Angela A. Hung et al., *Investor and Industry Perspectives on Investment Advisors and Broker-Dealers*, RAND INST. FOR CIV. JUST. (2008) https://www.sec.gov/news/press/2008/2008-1_randiabdreport.pdf.

⁷ John Manganaro, *Optimizing Your Practice to Capture Rollovers, Plan Adviser* (Mar. 28, 2014) http://www.planadviser.com/Optimizing_Your_Practice_to_Capture_Rollovers.aspx.

Retirement Accounts (IRAs) and 401(k) plans.⁸ When employees with a 401(k) plan, or with a similar type of defined contribution plan, terminate employment, they generally have the options of leaving the money in the retirement fund of the former employer, cashing out the account, transferring the money to the plan or another employer, or transferring the money to an Individual Retirement Account (IRA).⁹

Because many people lack financial sophistication, when they change jobs or retire they seek the advice of investment advisers about how to invest the assets in their employer-sponsored retirement accounts.¹⁰ Because of the way the adviser is compensated, the advice that yields the adviser the most income is not always the best advice for the client. According to one adviser, "...you come to believe what is in your interest to believe; your objectivity and professional judgment is always at risk of being compromised if you put yourself in a conflicted situation where your interests are not 100% aligned with your client's."¹¹

Financial advisers who earn fees based on the amount of assets they manage may advise rolling over pension assets into an IRA because that will yield greater income for the adviser. The situation of financially illiterate clients interacting with advisers who have a conflict of interest generally creates the potential for an agency problem, in which the agent or adviser may not act in the best interest of the client.¹²

⁸ Jesse Bricker et al., *Changes in U.S. Family Finances from 2010-2013: Evidence from the Survey of Consumer Finances*, 100 FED. RES. BULL. 4 (Sept. 2014), <http://www.federalreserve.gov/pubs/bulletin/2014/pdf/scf14.pdf>.

⁹ U.S. DEP'T OF LAB., EMP. BENEFITS SEC. ADMIN. PRIV. PENSION PLAN BULL., ABSTRACT OF 2013 FORM 5500 ANN. REP. (2015), <https://www.dol.gov/sites/default/files/ebsa/researchers/statistics/retirement-bulletins/2013pensionplanbulletin.pdf>.

¹⁰ Annamaria Lusardi & Olivia S. Mitchell, *The Economic Importance of Financial Literacy: Theory and Evidence*, 25 J. OF ECON. LITERATURE 1, 5-44 (Mar. 2014), <http://www.aeaweb.org/articles.php?doi=10.1257/jel.52.1.5>; David M. Abbey & Brian Reid, INV. CO. INST., *The Role of IRAs in U.S. Households' Saving for Retirement 2014*, http://www.ici.org/pdf/15_ici_omb_data.pdf.

¹¹ Christopher Carosa, *Exclusive Interview: Clark Blackman II Says SEC Fiduciary Fix 'Not Tough Stuff'; Proposed DOL Fiduciary Rule a "Band-Aid"*, FIDUCIARYNEWS (Dec. 15, 2015), <http://www.fiduciarynews.com/2015/12/exclusive-interview-clark-blackman-ii-says-sec-fiduciary-fix-not-tough-stuff-proposed-dol-fiduciary-rule-a-band-aid/>.

¹² John A. Turner, Bruce W. Klein, & Norman P. Stein, *Financial Illiteracy Meets Conflicted Advice: The Case of Thrift Savings Plan Rollovers*, 3 J. RETIREMENT 47 (2016).

In advising a client on whether to roll funds over to an IRA, an RIA has a conflict of interest, even if the adviser charges by the hour, rather than by assets under management. If the adviser advises the client to stay with the 401(k) plan, the adviser will receive a one-time fee for that advice. But if the adviser advises the client to roll funds over to an IRA that he or she manages, the adviser will receive a continuing stream of advisory fees, which can be as much as two percent of assets under management,¹³ though more generally they are around one percent.¹⁴ Thus, the adviser's incentive to advise a client to roll over his or her 401(k) plan to an IRA can be substantial. Employees often wrongly assume that they are receiving objective advice, that they have fiduciary protection concerning the advice they receive, and that the adviser has their best interests at heart. One survey found that 42 percent of investors thought that broker-dealers have a fiduciary duty to their clients, which is incorrect.¹⁵

This paper raises an issue that when it occurred in the United Kingdom was called the "pension mis-selling scandal."¹⁶ It presents the case that pension mis-selling has occurred in the United States as well. The paper applies the economic theory of agency to analyze the regulation of the market for financial advice by the SEC. It does so by focusing on pension rollovers to IRAs. It compares the role of the SEC in protecting pension participants in the United States when they receive bad advice from financial advisers to the actions taken by British financial market regulators following the pensions mis-selling scandal in the United Kingdom.

The paper is structured as follows. First, it discusses the literature relating to financial advice and regulatory protections. Second, it documents that pension rollovers play a key role in the U.S. retirement income system, causing IRAs to have more assets than either 401(k) plans or defined benefit plans. Third, it presents evidence that these rollovers are often not in the best interest of workers, in part because of the higher fees attached to IRAs, but also because of the loss of fiduciary protections. Fourth, it discusses an extreme example of bad advice, which relates to rollovers from the Thrift

¹³ *Id.*

¹⁴ *Intro: Average Financial Advisor Fees in 2016: Full Details on Advisory & Investment Management Fees (Comparison)*, ADVISORYHQ (2016), <http://www.advisoryhq.com/articles/financial-advisor-fees-wealth-managers-planners-and-fee-only-advisors/#Percentage-AUM>.

¹⁵ Hung et al. *supra* note 6, at 10.

¹⁶ Sue Ward, *Personal Pensions in the UK, the Mis-Selling Scandal and the Lessons to be Learnt* 139-146 (Gerard Hughes & Jim Steward eds., 2000).

Savings Plan for federal government workers, a plan that charges extremely low fees of less than 3 basis points. Fifth, it compares the lack of action by the SEC with the regulatory response of the U.K. financial markets regulators. It also presents evidence that the SEC has not considered fees charged for rollovers to be an important issue, despite a Council of Economic Advisers study indicating that bad advice about making pension rollovers is costing U.S. pension participants \$17 billion a year. Last, the paper draws conclusions concerning the protection the SEC provides to U.S. pension investors.

II. LITERATURE

Three approaches have been taken in law to deal with conflicts of interest: (1) prohibition, (2) disclosure, and (3) the fiduciary standard. With prohibition, conflicts of interest are not allowed. With disclosure, conflicts of interest are allowed, but the adviser must disclose these conflicts of interest. With the fiduciary standard, conflicts of interest may be allowed, but the adviser is prohibited from acting on them.¹⁷

The law and economics literature discusses the role of a fiduciary standard as one way of dealing with the “agency problem”: a problem in which the agent has a conflict of interest and superior knowledge, and it is difficult for the client to assess the advice of the agent.¹⁸ Because of low levels of financial literacy among pension participants, financial advisers (the agents) have superior knowledge over pension plan participants. To deal with the potential for bad advice, with the fiduciary standard, the agent is supposed to act solely in the best interest of the client. However, clients have a lack of financial sophistication and thus are unable to evaluate the quality of the advice they receive. For this reason, they play a weak role in helping regulators enforce the financial market regulations that supposedly protect them.

A fourth approach in public policy for dealing with conflicts of interest is to provide financial education that leads to financial literacy. Presumably, financially literate investors will be less susceptible to bad advice.

People who are not financially literate often are not able to evaluate the quality of advice they receive. The Australian financial markets regulator did a study that rated the quality of financial advice that people received. Out

¹⁷ Turner & Muir, *supra* note 4.

¹⁸ Robert H. Sitkoff, *The Economic Structure of Fiduciary Law*, 91 B.U. L. REV. 1039, 1041-55 (2011).

of 64 cases reviewed, it found that only two people received what it considered to be high-quality financial advice. The majority (37 people) received adequate advice, while a significant minority (25 people) received poor quality advice—i.e., advice that was inappropriate for their situation.¹⁹ Yet in the Australian study, most people who received poor advice thought that they had received good advice.²⁰ This phenomenon makes it difficult for regulators to counteract poor quality advice.

Turner, Klein, and Stein document that some advisers with a fiduciary duty are advising participants in the Thrift Savings Plan for federal government workers to roll their funds over to higher-fee IRAs.²¹ The Thrift Savings Plan charges the lowest fees of any 401(k)-type plan in the United States, less than three basis points per year.

This paper documents that the SEC has not taken a role in protecting American pension participants concerning pension mis-selling, whereas the British financial regulators have stepped in and done so. The literature relating to the pension mis-selling scandal in the United Kingdom is discussed later.

One possible explanation for the inaction of the SEC is “regulatory capture.” Regulatory capture refers to the regulated industry so influencing the regulator that the regulator does a poor job in protecting the public. Woodward and Etzioni discuss the issue of the regulatory capture of the SEC.²² Gadinis presents evidence as to the weak enforcement of cases by the SEC against large banks and brokerage firms.²³ The article demonstrates a

¹⁹ Peter Kell, *The Future of Financial Advice Post FOFA* (2012), [http://www.asic.gov.au/asic/pdf/lib.nsf/LookupByFileName/Future-of-advice-post-FoFA.pdf/\\$file/Future-of-advice-post-FoFA.pdf](http://www.asic.gov.au/asic/pdf/lib.nsf/LookupByFileName/Future-of-advice-post-FoFA.pdf/$file/Future-of-advice-post-FoFA.pdf).

²⁰ *Id.*

²¹ Turner, Klein & Stein, *supra* note 12 at 47.

²² SUSAN E. WOODWARD, REGULATORY CAPTURE AT THE U.S. SECURITIES AND EXCHANGE COMMISSION in JAMES R. BARTH, R. DAN BRUNBAUGH, JR., & GLENN YAGO, EDS., *RESTRUCTURING REGULATION AND FINANCIAL INSTITUTIONS*, (The Milken Institute Series on Financial Innovations and Growth, Kluwer Academic Publishers 2000), <http://books.google.com/books?hl=en&lr=&id=mAHsmzdUbsIC&oi=fnd&pg=PA99&dq=regulatory+capture+of+the+SEC&ots=IL-K2zHvG3&sig=cRYeKtvws3yHw9EdiAWpsiPjkHk#v=onepage&q=regulatory%20capture%20of%20the%20SEC&f=false>; Amitai Etzioni, *The Capture Theory of Regulations – Revisited*, 46 *SOC'Y* 319 (2009), <http://www2.gwu.edu/~ccps/etzioni/documents/A400%20Society,%20Capture.pdf>.

²³ Stavros Gadinis, *The SEC and the Financial Industry: Evidence from Enforcement Against Broker-Dealers*, 67(3) *BUSINESS LAWYER* 679 (2012), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1333717.

systematic lack of action against individual violators in high-profile cases. As far as we are able to determine, the SEC has never filed a case concerning advice about pension rollovers, despite those rollovers sometimes involving large increases in fees.

The International Organisation of Pension Supervisors (IOPS 2015) argues that pension mis-selling is more likely to occur in countries with relatively little regulation on competition in financial markets. For the purposes of our paper, whether or not the inaction by the SEC is due to regulatory capture is a secondary issue. The main issue is the failure of the SEC to act to deal with pension mis-selling in the United States.

III. PENSION MIS-SELLING IN THE UNITED STATES

The Council of Economic Advisers (CEA) has quantified the cost of pension mis-selling in the United States. It finds that conflicted advice costs participants in IRAs \$17 billion a year.²⁴ That amount comprises not only excess fees but also lower investment returns compared to what investors would have received in net rates of return had they not been advised to roll their funds over to an IRA. Thus, pension mis-selling is one reason for the shortfall of retirement savings in the United States. A large amount of this loss, and the underlying reason for why it is occurring, relates to the higher fees earned by the financial services industry.

Supporting the conclusions of the CEA, a recent study in 2015 by Munnell, Aubrey and Crawford finds that IRAs tend to receive net rates of return that are about 1 percentage point less than those of employer-provided defined contribution plans, such as 401(k) plans.²⁵ This result is largely due to a difference in fees, but it is also due to differences in asset allocation. A higher percentage of assets in IRAs is invested in money market funds, which would seem to be a poor investment choice for retirement savings.

The CEA estimate takes into account increased trading costs and increased administrative fees compared to a 401(k) plan, but it does not factor in that a person in an IRA is more likely to pay a financial adviser for

²⁴ EXEC. OFF. OF THE PRESIDENT, COUNCIL OF ECON. ADVISERS, *The Effects of Conflicted Investment Savings* (2015), http://www.whitehouse.gov/sites/default/files/docs/cea_coi_report_final.pdf.

²⁵ Alicia H. Munnell, Jean-Pierre Aubrey & Caroline V. Crawford, *Investment Returns: Defined Benefit vs. Defined Contribution Plans*, CTR. FOR RET. RES. AT B.C., Issue Brief no. 15-21 (Dec. 2015), http://crr.bc.edu/wp-content/uploads/2015/12/IB_15-21.pdf.

ongoing investment management services than a person in a 401(k) plan. Thus, in that respect, it understates the loss.

The bad advice, as well as being costly in the aggregate, is costly at the individual level. A person who receives advice from a financial adviser who has a conflict of interest in advising that person to roll over a 401(k) account to an IRA at retirement will lose, on average, an estimated 12 percent of his or her savings when those savings are drawn down over 30 years—not taking into account fees charged by investment advisers.²⁶

Bad outcomes as a result of bad financial advice generally require a combination of three factors operating simultaneously. First, the pension participant has a low level of financial literacy—in particular, not understanding the importance of the difference in fees between different financial products. Second, the financial adviser has a conflict of interest in that the advice that yields him the most income is not the best advice for the pension participant. Third, the regulatory protections are weak or the enforcement of regulations is weak.

Even bad advice needs to be supported by some argument. One of the main arguments financial advisers make for rolling over a 401(k) pension account to an IRA is that the IRA holder has a much larger range of investment options.²⁷ However, a substantial literature demonstrates that the cognitive costs of greater choice can lead to worse savings and retirement investment choices.²⁸ The evidence presented by Munnell, Aubrey, and Crawford concerning IRA investments in money market funds supports the idea that the larger range of options does not necessarily have a positive effect.²⁹ In addition, Shen and Turner demonstrate that the small number of

²⁶ EXEC. OFF. OF THE PRESIDENT, COUNCIL OF ECON. ADVISERS, *supra* note 24.

²⁷ Turner, Klein & Stein, *supra* note 12.

²⁸ See Nava Ashraf, Dean Karlan & Wesley Yin, *Tying Odysseus to the Mast: Evidence from a Commitment Savings Product in the Philippines*, 121(2) Q.J. OF ECON. 635 (2016), <http://www.jstor.org/stable/pdf/25098802.pdf>; Brigitte C. Madrian & Dennis Shea, *The Power of Suggestion: Inertia in 401(k) Participation and Savings Behavior*, 116(4) Q.J. OF ECON. 1149, 1180-1182 (2001), <http://www.jstor.org.ezproxy.lib.uconn.edu/stable/pdf/2696456.pdf>; Fabian Duarte & Justine Hastings, *Fettered Consumers and Sophisticated Firms: Evidence from Mexico's Privatized Social Security System*, Yale U. Dep't of Econ. (Oct. 2009) (unpublished manuscript), http://www.nber.org/aging/rrc/papers_files/orrc09-04/orrc09-04.pdf; Justine Hastings & Lydia Tejada-Ashton, *Financial Literacy, Information and Demand Elasticity: Survey and Experimental Evidence from Mexico* (NBER Working Paper No. 14538, 2008), <http://www.nber.org/papers/w14538.pdf>. (Choi et al. 2006, 2007)

²⁹ See Munnell, Aubrey & Crawford, *supra* note 25, at 6.

options in the Thrift Savings Plan for federal government workers, the military, and members of Congress (five basic options) permit a high degree of portfolio diversification.³⁰ Furthermore, section 404(c) of ERISA requires that 401(k) plans must provide a sufficient range of choices to pension participants to allow them to select an adequately diversified portfolio.³¹

IRAs are the largest type of pension plan in the United States, having overtaken 401(k) plans. Rollovers are the primary source of funding for IRAs, as relatively few people contribute to IRAs.³² In a rollover, the person receives a check from the pension plan of a former employer, then deposits the check with the IRA. In a transfer, the pension plan sends the check directly to the IRA. We follow common practice and refer to both as rollovers.

Because of the importance of the rollover decision, many people seek financial advice. One survey finds that 61 percent of the people with rollover IRAs received advice from a financial adviser before making the rollover.³³ This compares to 38 percent of families who reported obtaining information about investing from bankers, brokers, or other sellers of financial services, and 31.3 percent of families who reported obtaining information from lawyers, accountants, or other financial advisers.³⁴ Thus, rollovers are a financial decision in which advice is particularly prevalent.

The frequency of rollovers is surprising because studies have documented the tendency for pension participants to exhibit inertia.³⁵ Inertia

³⁰ Sally Shen & John A. Turner, *Analyzing the Quality of Financial Advice: Do Conflicted Advisers Tell Half Truths?* (Pension Pol. Ctr., Working Paper May 2016), <http://www.busman.qmul.ac.uk/newsandevents/EventDocuments/BFWG%20Conference%20Papers%202016/177059.pdf>.

³¹ Employee Retirement Security Act of 1974, Pub. L. No. 93-406, §404(c), 88 Stat. 829 (codified in part at 29 U.S.C. (2015)).

³² David M. Abbey & Brian Reid, INV. CO. INST., *The Role of IRAs in U.S. Households' Saving for Retirement 2014*, http://www.ici.org/pdf/15_ici_omb_data.pdf.

³³ *Id.*

³⁴ Jesse Bricker et al., *Changes in U.S. Family Finances from 2010-2013: Evidence from the Survey of Consumer Finances*, FED. RES. BULL. 100(4) (Sept. 2014), <http://www.federalreserve.gov/pubs/bulletin/2014/pdf/scf14.pdf>.

³⁵ John Manganaro, *Optimizing Your Practice to Capture Rollovers*, Plan Adviser, (March 28), http://www.planadviser.com/Optimizing_Your_Practice_to_Capture_Rollovers.aspx; See also James J. Choi et al., *Defined Contribution Pensions: Plan Rules, Participant Choices, and the Path of Least Resistance* 16, 67-113 (2002). But see Leslie A. Muller & John A. Turner, *The Persistence of Employee 401(k) Contributions Over a Major Stock Market Cycle: The Limited Power of Inertia* 3, 51-65 (2013).

would cause participants to leave their 401(k) accounts with their former employers because that is the “path of least resistance.” The rollover trend is inconsistent with participant inertia because it requires an action by participants. Most analysis in behavioral economics concerning retirement focuses on why people do not do something—they do not annuitize, some do not participate in 401(k) plans offering an employer match or, if they do participate, do not contribute sufficiently to receive the maximum matching contribution. However, the study of why clients make rollovers involves the opposite tendency—a question of why people are doing something.

Because of concerns that rollovers are being driven by faulty advice, the Department of Labor (DOL), the SEC, and FINRA have all considered regulatory action,³⁶ and in 2016 the DOL released major new regulations concerning financial advice received by pension participants.³⁷ The SEC indicated that it would make examining rollovers a priority for 2014, and would focus on investment advisers who encourage people to roll funds over to investments with higher fees.³⁸ However, two years later, the SEC still has taken no action.

A. FEES

From an economics perspective, fees are an important issue in pension rollovers—not just the fees of the investment products, but also the advisory fees of fiduciary advisers advising participants to roll over their funds to accounts the adviser would manage. In 20 years, a fee of 50 basis points (0.5 percent) reduces a portfolio with a 4 percent annual return by \$10,000 compared to a fee of 25 basis points, while the reduction is \$30,000 if the fee is 100 basis points.³⁹

In comparing the fees of IRAs and 401(k) plans, the question is not whether an IRA can be constructed that provides lower fees than 401(k) plans. Rather, the question is whether the IRAs that people actually have

³⁶ See Manganaro, *supra* note 35.

³⁷ U.S. DEP'T OF LABOR, *Fact Sheet: Department of Labor Finalizes Rule to Address Conflicts of Interest in Retirement Advice, Saving Middle Class Families Billions of Dollars Every Year*, <https://www.dol.gov/agencies/ebsa/about-ebsa/our-activities/resource-center/fact-sheets/dol-final-rule-to-address-conflicts-of-interest-pdf>.

³⁸ Fred Reish et al., *FINRA's Reminder About Rollovers: News to Many*, RET. INCOME TEAM NEWSLETTER, http://files.drinkerbiddle.com/files/ftpupload/MemosandNewsletters/Retirement-Income-Team-Newsletter_Article-2.pdf.

³⁹ U.S. SEC. AND EXCH. COMM'N, *How Fees and Expenses Affect Your Investment Portfolio*, https://www.sec.gov/investor/alerts/ib_fees_expenses.pdf.

generally charge lower fees than the 401(k) plans they formerly had. In aggregate, fees are lower in 401(k) plans than in IRAs. In 2014, fees were 58 basis points for an asset-weighted average of 401(k) plans and 74 basis points for the asset-weighted average of equity mutual funds held in IRAs.⁴⁰

Some workers changing jobs or retiring may be able to reduce the fees they pay by moving from a 401(k) plan to an IRA. Such a worker may be in a 401(k) plan with no low-fee options. For example, the 401(k) plan for the nonprofit firm Demos in 2012 did not offer any investment options with an expense ratio of less than 70 basis points.⁴¹ A worker may also face higher fees if he has several small accounts than if he rolls over those accounts into a single account, such as an IRA or a subsequent employer's 401(k) plan. For example, some accounts charge fixed fees for small account balances.

Thus, a rollover may be good advice in some circumstances, but it generally is not.⁴² Most 401(k) participants are in large plans, but a minority are in small plans. In 2013, 9.8 million participants were in plans with less than 100 participants, while 54.7 million participants were in plans with 100 or more participants.⁴³ Fees tend to be higher in smaller 401(k) plans than in larger ones. A study of 401(k) fees has found that, because of economies of scale, plans with more total assets and with more assets per participant tend to have lower fees.⁴⁴ Thus, on the basis of fees, a rollover to an IRA is more likely to be beneficial if it comes from a 401(k) plan that has a small number of employees and that has relatively small account balances.

⁴⁰ Abbey & Reid, *supra* note 31.

⁴¹ ROBERT HILTONSMITH, *THE RETIREMENT SAVINGS DRAIN: THE HIDDEN & EXCESSIVE COSTS OF 401(K)S* 5 (2012).

⁴² Nancy Anderson, *7 Reasons Not To Rollover Your Orphan 401(K) To An IRA*, FORBES (2012), <http://www.forbes.com/sites/financialfinesse/2012/07/10/are-your-401k-investments-worth-their-cost/>; See also John A. Turner and Bruce W. Klein, *Retirement Savings Flows and Financial Advice: Should You Roll Over Your 401(k) Plan?*, *Benefits Quarterly* 30: Fourth Quarter (2014), 42-54. The fees in these two studies are not directly comparable. The fees in the 401(k) plan study are plan averages, while the mutual fund fees are weighted by assets. Thus, the mutual funds study is overweighted for large accounts, compared to a participant based statistic, while the plan statistics are over weighted for small plans, compared to a participant based statistic.

⁴³ U.S. DEP'T OF LAB., EMP. BENEFITS SECURITY ADMIN., *PRIV. PENSION PLAN BULLETIN, ABSTRACT OF 2013 FORM 550 ANNUAL REPORTS* (2015), <https://www.dol.gov/sites/default/files/ebsa/researchers/statistics/retirement-bulletins/2013pensionplanbulletin.pdf>.

⁴⁴ INV. CO. INST. AND DELOITTE, *DEFINED CONTRIBUTION/ 401(K) FEE STUDY* (2009), http://www.ici.org/pdf/rpt_09_dc_401k_fee_study.pdf.

Fees vary considerably across 401(k) plans. One study found that 10 percent of the 130 plans in the study had an “all-in” fee, which includes administrative fees, of 0.37 percent of assets or less, while 10 percent had an “all-in” fee of 1.71 percent or more, with an average of 0.72 percent.⁴⁵ In an update of that study, 10 percent of the 525 plans surveyed had an “all-in” fee of 0.28 percent of assets, while 10 percent had an “all-in” fee of 1.38 percent of assets.⁴⁶ These statistics compare to an average fee for equity mutual funds for retail investors of 0.79 percent (79 basis points) and 0.62 percent (62 basis points) in bond funds.⁴⁷

Some 401(k) plans offer very low fee options that are not available to participants in IRAs. In particular, some plans provide options that are institutionally priced rather than retail priced. Institutional pricing is the reduced pricing that sponsors of defined benefit plans have, which is sometimes extended for some investment options to participants in the 401(k) plan of the employer. For example, an institutionally priced equity index fund that a plan sponsor’s defined benefit plan uses could charge fees as low as 6 basis points to 401(k) plan participants of that plan sponsor. In some 401(k) plans, the plan sponsor pays the administrative fees, whereas in an IRA those fees are the individual’s responsibility. According to the consulting firm AonHewitt, “[w]ithin the defined contribution system, plan participants not only generally have access to high-quality investment options at reasonable prices (through lower-cost institutional fund products such as collective trusts and separate account vehicles), but also benefit from fiduciary protections. Workers cannot obtain these benefits individually in the retail market.”⁴⁸ The “retail market” refers to the IRA market and the market for private savings. Institutional shares account for 43 percent of the equity mutual funds held in 401(k) plans.⁴⁹

The financial incentives for financial firms to advise their clients to make rollovers are substantial. Even firms that manage clients’ 401(k) investments often advise their clients to roll those funds over to an IRA when

⁴⁵ *Id.* at 6.

⁴⁶ DELOITTE CONSULTING, INSIDE THE STRUCTURE OF THE DEFINED CONTRIBUTION/401(K) PLAN FEES: A STUDY ASSESSING THE MECHANICS OF THE “ALL-IN” FEE (2011), http://www.ici.org/pdf/rpt_11_dc_401k_fee_study.pdf.

⁴⁷ INV. CO. INST., TRENDS IN THE EXPENSES AND FEES OF MUTUAL FUNDS, 2011 (2012), <http://www.ici.org/pdf/per18-02.pdf>.

⁴⁸ AON HEWITT, LEAKAGE OF PARTICIPANTS’ DC ASSETS: HOW LOANS, WITHDRAWALS, AND CASHOUTS ARE ERODING RETIREMENT INCOME (2011), http://www.aon.com/attachments/thought-leadership/survey_asset_leakage.pdf.

⁴⁹ INV. CO. INST., *supra* note 47, at 17.

they retire or leave their employers because the firms can make more money managing IRAs. Not only do financial advisers encourage rollovers, but so do record keepers for 401(k) plans that also provide mutual funds. These record keepers advise participants who no longer work for the employer sponsoring the plan to roll their funds over to an IRA, which the record keepers would then manage.⁵⁰

The fees for IRA participants may also include fees for financial advice because many people are not financially sophisticated and feel as if they need assistance in managing their accounts, especially when faced with the large number of options available to IRA participants. One large provider of financial advice charges fees of 1.5 percent for advisory services for account balances up to \$500,000 on top of the investment fees the mutual funds in the account charge.⁵¹

As an example of bad advice, National Public Radio (“NPR”) documented the case of a woman who was advised to roll over her 401(k) plan to an IRA. The adviser told her that the rollover would not result in her paying any extra fees. When NPR analyzed her financial documents relating to the rollover, it found that the adviser had invested her money into mutual funds that charge load fees of 5.75 percent, causing her to lose nearly 6 percent of her retirement savings.⁵²

IV. THRIFT SAVINGS PLAN (TSP) ROLLOVERS TO IRAS

Financial advisers are advising clients to roll funds over from good, low-fee defined contribution plans to higher-fee IRAs. The case of the Thrift Savings Plan is a particularly dramatic example. The TSP is a 401(k)-type defined contribution plan for federal government workers, the military, and members of Congress. The TSP is the largest pension fund, in terms of assets,

⁵⁰ John A. Turner & Kathy K. Perry, *Protecting Pension Participants: Communications Concerning Pension Rollovers From Record Keepers* (2016).

⁵¹ U.S. GOV'T ACCOUNTABILITY OFF., GAO-13-30, 401(K) PLANS LABOR AND IRS COULD IMPROVE THE ROLLOVER PROCESS FOR PARTICIPANTS 36 (2013).

⁵² Chris Arnold, *When Fees Attack: Rolling Over A 401(k) Can Trigger Big-Time Charges*, KUNC (Nov. 20, 2015), <http://www.kunc.org/post/when-fees-attack-rolling-over-401k-can-trigger-big-time-charges#stream/0> (Noting a “load” fee is a sales charge or commission charged to an investor for buying or redeeming shares in a mutual fund. The fee may be a one-time charge or an annual charge).

in the United States.⁵³ Its assets are more than 10 times as large as the largest private-sector defined contribution plan, which is sponsored by IBM.⁵⁴

The TSP charges extremely low fees—the lowest fees of any plan in the United States. In 2015, the fees for all the TSP funds, including the international stock fund and the target date funds, were 2.9 basis points or less.⁵⁵ The fees in 2013 were less than one-twentieth the average cost of a stock index fund and less than one-thirtieth the average cost of target date funds.⁵⁶ In 2014, the TSP fees compared to 83 basis points as the participant-weighted average for a survey of 401(k) plans, 58 basis points for the asset-weighted average of 401(k) plans, and 74 basis points for the asset-weighted average of equity mutual funds held in IRAs.⁵⁷ A survey by Morningstar, an investment research firm based in Chicago, finds that the asset-weighted average of all mutual funds, excluding money market funds and funds of funds (FOFs), such as target date funds, was 64 basis points in 2014.⁵⁸ For passively managed funds it was 20 basis points, and for actively managed funds it was 79 basis points.⁵⁹ That study finds that over time, investors on average have moved to lower-fee funds, which is the reverse of what happens when TSP participants roll over their accounts to an IRA.⁶⁰ The TSP's fees are low primarily because of its large size, but in part because some administrative costs are borne directly by the federal government, and in part because, as an employer-sponsored plan, it does not engage in advertising.⁶¹

⁵³*The world's 300 largest pension funds – year end 2013*, WILLIS TOWERS WATSON (September 2014), <http://www.towerswatson.com/en/Insights/IC-Types/Survey-Research-Results/2014/09/The-worlds-300-largest-pension-funds-year-end-2013>.

⁵⁴*The Economics of Providing 401(k) Plans: Services, Fees, and Expenses*, 21 ICI RESEARCH PERSPECTIVE 1 (2015).

⁵⁵*Fund Comparison Matrix*, THRIFT SAVINGS PLAN (2016), <https://www.tsp.gov/InvestmentFunds/FundsOverview/comparisonMatrix.html>.

⁵⁶*Vanguard Target Retirement Funds*, VANGUARD (2014), <https://investor.vanguard.com/mutual-funds/target-retirement/#/>.

⁵⁷DELOITTE, *INSIDE THE STRUCTURE OF DEFINED CONTRIBUTION/401(K) PLAN FEES: A STUDY ASSESSING THE MECHANICS OF THE 'ALL-IN' FEE 28* (2011); See generally, *The Role of IRAs in U.S. Households' Saving Retirement, 2014*, 21 ICI RESEARCH PERSPECTIVE 1 (2015).

⁵⁸MICHAEL RAWSON & BEN JOHNSON, *2015 FEE STUDY: INVESTORS ARE DRIVING EXPENSES RATIOS DOWN 1* (2015).

⁵⁹*Id.*

⁶⁰*Id.*

⁶¹Boccia Romina, *Q&A: Should All Americans Join the Same Retirement Plan as Congress?*, THE DAILY SIGNAL (May 15, 2014) <http://dailysignal.com/2014/05/15/qa-americans-join-retirement-plan-members-congress/>.

Despite the TSP's extremely low fees, some participants are being advised to roll their TSP funds over to managed investment accounts in IRAs, sometimes resulting in as much as a seventy-fold increase in fees (from 3 basis points to 230 basis points). A survey of TSP participants who made a withdrawal in 2013 found that an estimated 16,400 participants (about one-third of those making withdrawals) withdrew all or part of their TSP account because they were advised by their financial adviser to do so.⁶² A telephone survey study that asked financial advisers for advice concerning TSP rollovers found that advisers generally advised the callers to make a rollover, despite the very low fees in the TSP. That advice on average cost participants approximately \$20,000 in present value of increased fees.⁶³

V. UNITED KINGDOM—THE PENSION MIS-SELLING SCANDAL⁶⁴

The United Kingdom also has had experience with people being advised to roll over from good, employer-provided pension plans to higher-fee individual account pension plans. That episode is known in the U.K. as the “pension mis-selling scandal.”⁶⁵ The “pension mis-selling scandal” is the term used in the United Kingdom to refer to the situation in which many people were advised to switch their pension plans from employer-provided defined benefit pension plans to individual account pensions in instances where those changes were in the financial interest of the adviser, but with little effort made to determine whether the advice was suitable for the client.

In 1988, a regulatory change expanded eligibility for personal pensions from just the self-employed to all employees. This change presented financial service providers with an opportunity. As part of a deregulation of financial products, individuals were permitted to choose personal pensions instead of participating in the earnings-related part of social security (SERPS—the State Earnings-Related Pension Scheme) or in employer-provided plans that had been used for “contracting out” of that part of social security.

⁶² AON HEWITT, *supra* note 48.

⁶³ Turner, Klein & Stein, *supra* note 12.

⁶⁴ In the U.K., it is spelled “mis-selling”. See Dana Muir, *Regulation and Personal Pensions*, in PERSONAL CHOICE IN THE PROVISION OF RETIREMENT INCOME: MEETING THE NEEDS OF OLDER PEOPLE? (Gerard Hughes & Jim Stewart eds., 2009).

⁶⁵ Ward, *supra* note 16.

Firms responded by rewarding new, untrained sales forces with sales incentives to capture market share. These incentives were awarded for making direct sales of financial products to consumers who were unfamiliar with those financial products. Insurance salesmen targeted groups like nurses and steelworkers who were in good defined benefit plans but who were nonetheless encouraged to roll those plan funds over to personal pensions that provided lower benefits.⁶⁶ These factors created an environment in which aggressive sales practices thrived.⁶⁷

The mis-selling of personal pensions from 1988 to 1994 resulted in the regulatory review of sales of pension products to almost 2 million customers and in extensive regulatory change. During that six-year period, people had been encouraged by financial services companies and advisers, and through a large advertising campaign by financial services companies, to switch their pension arrangements from employer-sponsored defined benefit plans to individual account plans, only to end up receiving lower benefits as a result.⁶⁸

Due to reports of advisers not complying with regulatory standards in the sale of personal pensions, in 1992 the government regulator, the Securities and Investments Board (SIB), reviewed a sample of the records associated with personal pension sales and found that only 9 percent substantially complied with regulatory rules.⁶⁹ The SIB later became part of a new agency called the Financial Services Authority (FSA), which has since been replaced by the Financial Conduct Authority. The SIB commissioned a study of industry practices that found “widespread regulatory compliance failure”.⁷⁰

The British media were highly critical of the insurance companies involved in the mis-selling scandal. The BBC reported that Prudential (U.K.), which it cited as one of the worst offenders in the mis-selling scandal, had set aside £1.1 billion to pay for claims related to the scandal. This implicit admission of guilt followed an earlier statement by the company’s CEO in 1994 expressing “total reassurance” that Prudential was not guilty of

⁶⁶ *Id.*

⁶⁷ Richard Nobles & Julia Black, *The Privatization Process: Pensions Mis-selling – The Lessons for Regulating Privatised Social Security*, 64 BROOK. L. REV. 933 (1998); TREASURY SELECT COMMITTEE, NINTH REPORT, 1997-98, H.C. 712-I (UK).

⁶⁸ *Pension Mis-selling*, PENSIONS ADVISORY SERV. (2009), <http://tools.pensionsadvisoryservice.org.uk/common-areas-of-concern/pension-mis-selling>.

⁶⁹ Nobles & Black, *supra* note 67.

⁷⁰ Marina Milner & Keith Syrett, *Personal Pensions and the Financial Services Authority: New Chapter or Same Old Story?*, 51(2) N. Ir. Legal Q. 141 (2000).

pension mis-selling. In 2002, the BBC reported that more than one million customers would receive compensation for being victims of pension mis-selling and the total cost would be at least £11.8 billion, with the financial market regulator taking disciplinary action against 346 firms.⁷¹

The concern with mis-selling focused on the sale of personal pensions, by both insurance companies and independent financial advisers, to employees who then opted out of an employer-provided pension plan. Two factors caused employer-provided pension plans to be better arrangements than personal pensions for most individuals. First, employers typically contributed to plans they sponsored but did not contribute to personal pensions. Second, the benefits formula of an employer-provided plan typically was more generous than the investment growth in a personal pension.⁷²

Nobles and Black attribute pensions mis-selling in the U.K. to failures both by regulators and by the firms involved in mis-selling.⁷³ They argue that until the 1992 SIB audit, regulators failed to focus their efforts on personal pensions as a product line. Instead the regulators suffered from a lack of expertise with personal pensions, which represented a new line of financial products.⁷⁴ The regulators established review processes that tended to focus at the firm level and on the activities of the internal firm monitors. In a government inquiry into the cause of mis-selling, the FSA indicated that the multiple regulators experienced coordination problems in determining the responsibilities of the different regulators.⁷⁵

In 2006, the FSA took further action to deal with investment product mis-selling, with those new rules coming fully into force in 2012. Despite the existence of a best-interest or fiduciary standard—meaning the adviser must act in the best interest of the client—continued problems with investment mis-selling were observed, leading to the implementation of the new rules. Previously, financial advisers receiving commissions for making recommendations concerning pensions to clients had an obligation to make recommendations in the best interest of the client, but it had become clear that, because of commissions that caused a conflict of interest for the advisers, this approach was not working. These regulatory changes improved the transparency of fees and eliminated the practice of mutual funds and

⁷¹ *Pensions Scandal Costs £11.8 Billion*, BBC (June 27, 2002), <http://news.bbc.co.uk/2/hi/business/2070271.stm>.

⁷² TREASURY SELECT COMMITTEE, *supra* note 67.

⁷³ Nobles & Black, *supra* note 67.

⁷⁴ *Id.*

⁷⁵ TREASURY SELECT COMMITTEE, *supra* note 67.

other financial intermediaries paying commissions to advisers that recommend their products.⁷⁶

These rules in the United Kingdom thus differ from the approach taken in the U.S. Department of Labor regulations of 2016, discussed later, which do not prohibit advisers from receiving commissions, so long as they act in the best interest of their clients.⁷⁷ The United Kingdom previously had taken the approach used by the U.S. Department of Labor but found that the incentives embedded in that approach were sufficiently strong—and presumably the enforcement sufficiently weak—to cause that approach to not provide adequate protection for pension participants.

The new U.K. rules require advisers to receive their income solely by charging their clients fees for their services. This approach reduces conflicts of interest that advisers have with respect to the choice of financial products to sell. It has the further advantage of making the compensation advisers receive more transparent. This reform was enacted because the receipt of commissions has been viewed as a root cause of the pension mis-selling scandal in the United Kingdom.

The U.K. pension mis-selling scandal was much more visible to participants and plan sponsors than the scandal in the United States, where, despite the CEA's report, so far is largely invisible. In the United Kingdom, the scandal involved a switch from defined benefit plans with clearly determinable benefits to defined contribution plans that were required to provide benefits as annuities. Initial concern about the situation was expressed by plan sponsors, with that concern leading to a study by the financial regulator, which ultimately documented mis-selling.⁷⁸

The SIB, the U.K. financial markets regulator at the time, issued guidance to participants, stating that “it is nearly always best for you” to stay with your employer's plan rather than rolling those funds over into an individual account plan.⁷⁹ While such advice would probably also apply in the United States, the U.S. regulators have not given that advice.

⁷⁶ Fin. Conduct Auth., *Post-implementation review of the Retail Distribution Review* (2014).

⁷⁷ See U.S. DEP'T. OF LABOR, EMP. BENEFITS SEC. ADMIN., *Fact Sheet: Department of Labor Finalizes Rule to Address Conflicts of Interest in Retirement Advice, Saving Middle Class Families Billions of Dollars Every Year*, <https://www.dol.gov/agencies/ebsa/about-ebsa/our-activities/resource-center/fact-sheets/dol-final-rule-to-address-conflicts-of-interest> (2016).

⁷⁸ Ward, *supra* note 16.

⁷⁹ SEC. AND INV. BD. (UK), *Pension Opt Outs, A Factsheet for People Thinking of Opting Out of an Employer's Scheme* (1994).

The situation in the United States involves a switch from defined contribution plans to IRAs, in which the comparison with the former plan's benefits is difficult for participants to make because it is not as clear what they would have received had they stayed in the former plan. Perhaps as a consequence, there appear to be no complaints by people about bad advice they have received encouraging a rollover to an IRA. If participants were aware of the importance of fees in determining financial outcomes, the comparison would not be so difficult, but with the low level of financial literacy of many people, many participants do not understand the importance of fees.

A lesson from the experience of the United Kingdom is that the financial service industry may take advantage of unsophisticated pension participants in selling them expensive pensions when more suitable, lower-fee pensions are available to them. Pension participants need regulatory protection.

VI. THE SEC

This section considers the regulatory oversight provided by the Securities and Exchange Commission (SEC) related to fees charged in connection to pension rollovers, reasons why that oversight appears to be weak, and the views of the SEC concerning the level of fees charged by advisers as a fiduciary or regulatory issue.

A. THE SEC AND THE FIDUCIARY STANDARD

As a result of the conflict of interest of financial advisers, government has stepped in through the SEC to regulate financial advice in order to protect the interests of investors. This regulation involves imposing a fiduciary standard, which requires that the advice be the best advice for the client.⁸⁰ However, over time broker-dealers have increasingly provided advice, but the SEC has not required that they register as RIAs.⁸¹

⁸⁰ Unless otherwise indicated, we are referring to the SEC fiduciary standard. Different organizations have different fiduciary standards, as discussed later in the paper. The SEC standards are not as stringent as standards found in ERISA and the IRC. In particular, the SEC generally permits self-dealing transactions that would largely be prohibited under ERISA and the IRC, as long as the Registered Investment Adviser (RIA) fully discloses the conflict to the client.

⁸¹ Michael Kitces, *Is the SEC Failing to Enforce the 'Solely Incidental' Advice Exemption for Broker-Dealers Under the Investment Advisers Act of 1940?*, NERD'S EYE VIEW AT KITCES.COM (Jan. 12, 2015), <https://www.kitces.com/blog/is-the-sec->

In 2008, the SEC first considered updating its fiduciary standard. Christopher Cox, chairman of the SEC at the time, has stated that updating the standard “is harder than perhaps it ought to be.” He noted, “There are enormous interests at stake here.” The 2016 chairwoman of the SEC, Mary Shapiro, has stated that the SEC has had “hundreds of meetings” and that a task force is working on a proposed rule, but that its efforts only resulted in a study.⁸²

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 requires the SEC to undertake a study of the adequacy of consumer protections regarding financial advice. The study is to assess whether there should be a uniform standard of conduct for broker-dealers and RIAs. In 2011, the SEC staff released that report, *Study on Investment Advisers and Broker-Dealers*.⁸³ The report recommended extending the fiduciary standard that applies to investment advisers to include broker-dealers. However, the SEC has not acted on those recommendations, even though more than five years have passed since the report was released. In March 2015, the SEC indicated that it would move toward a uniform standard for broker-dealers and RIAs, but it has provided no indication of the time frame in which it would do that.⁸⁴

The Consumer Federation of America has noted that despite years of entreaties from consumer advocates, the SEC has done nothing to protect investors in this area. It has failed to propose, let alone finalize, new rules.⁸⁵ While rule-making in this area is not required by the Dodd-Frank Act, rule-

failing-to-enforce-the-solely-incident-al-adv-ice-exemption-for-broker-dealers-under-the-investment-advisers-act-of-1940/.

⁸² Hazel Bradford, *Former SEC Chairmen Call on Agency to Adopt Fiduciary Rule*, PENSIONS & INVESTMENTS (Oct. 6, 2015), http://www.pionline.com/article/20151006/ONLINE/151009909/former-sec-chairmen-call-for-agency-to-adopt-fiduciary-rule?newsletter=defined-contribution-digest&issue=20151006&utm_campaign=P%26I+Defined+Contribution+Digest&utm_medium=email&utm_source=Newsletters.

⁸³ U.S. SEC. AND EXCH. COMM’N, *Study on Investment Advisers and Broker-Dealers* (2011), <https://www.sec.gov/news/studies/2011/913studyfinal.pdf>.

⁸⁴ *Examining the SEC’s Agenda, Operations and FY 2016 Budget Request: Hearing before H. Comm. on Fin. Serv.*, 114th CONG. 1 (2015) (statement of Mary Jo White, Chair of the SEC).

⁸⁵ *Preserving Retirement Security and Investment Choices for all Americans: Joint Hearing Before the Capital Mkts. and Gov’t Sponsored Enters. Subcomm. and the Oversight and Investigations Subcomm. of the H. Fin. Servs. Comm.*, 114th Cong. (2015) [hereinafter *Hearing*] (written testimony of Barbara Roper, Director, Investor Protection Consumer Federation of America).

making in other areas is required, and as of December 31, 2015, the SEC had failed to meet Dodd-Frank deadlines on 22 percent of its required rules.⁸⁶

The SEC has been criticized in other contexts for its deference to the industry it regulates. For example, it has been criticized for its handling of the bankruptcies of Enron in 2001 and of Lehman Brothers in 2008, and for its handling of the Bernie Madoff Ponzi scheme (which cost investors \$50 billion) in 2009.⁸⁷

The SEC regulates RIAs, holding them to a fiduciary standard. The literature on the regulation of RIAs often focuses on the problem called “hat switching,” where an adviser will sometimes act as a broker-dealer, with a suitability standard, and sometimes act as a RIA, with a fiduciary standard for conduct.⁸⁸ While the “hat switching” problem is a serious problem, it is not the main problem with respect to advice concerning pension rollovers. The main problem is the lack of action by the SEC.

B. THE SEC, THE FIDUCIARY STANDARD, AND FEES

The SEC appears to consider fees charged by advisers to not be an important issue in the context of pension rollovers. On its website, the SEC provides information as to the options a person has when changing jobs. It provides information on the option of rollovers from a 401(k) plan to an IRA, but it does not mention that the person should consider the level of fees in the new plan versus the old plan.

It also fails to mention that the person generally has the option of leaving the money in the 401(k) plan of his or her former employer, thus biasing the person’s decision toward the other options, including a rollover to an IRA. It further biases the decision by noting that for the rollover to an IRA, but not for other options, your money “can continue to grow over time, giving you more income to live on in retirement.”

We sought to obtain further information from the SEC concerning its views on the importance of fees in the rollover decision. To assess the SEC’s views on the fiduciary standard and the importance of fees, we asked the SEC through its online contact portal the following question: “If a

⁸⁶ DAVIS POLK REGULATORY, DODD-FRANK PROGRESS REPORT: FOURTH QUARTER (2015), http://prod.davispolk.com/sites/default/files/Q4_2015_Dodd-Frank_Progress_Report.pdf.

⁸⁷ Quentin Fottrell, *10 Things the SEC Won’t Tell You*, MARKETWATCH, (Nov. 29, 2012), <http://www.marketwatch.com/story/10-things-the-sec-wont-tell-you-1320000352729>.

⁸⁸ See e.g., Turner & Muir, *supra* note 4.

Registered Investment Adviser advises a client to roll over his or her 401(k) account to an IRA that the adviser would manage, are the management fees charged by the adviser taken into account when analyzing whether this advice meets the fiduciary standard?" The SEC declined to provide an answer to the question, replying that it does not answer hypothetical questions.

We then presented an actual situation where someone was advised to roll funds over from the TSP by an adviser that charges a management fee of 200 basis points, which raised the fees paid by that individual by more than 70 times. The SEC again declined to provide an answer, saying that it does not comment on specific cases and that we should consult with an attorney. In addition, we filed a complaint with the SEC concerning that particular case, but the SEC never responded to the complaint.

It appears that the SEC does not take into account the fees charged by advisers when considering whether the advice of the adviser meets the fiduciary standard, as long as the adviser has clearly disclosed the fees. That approach considerably weakens the protection provided by the fiduciary standard. An adviser can thus provide advice that is clearly not in the best interest of the client if fees are taken into account, so long as the adviser discloses the fees.

Thus, merely by disclosing the fees, an adviser can satisfy the fiduciary requirement of acting in the best interest of the client. To give a specific example, an adviser can advise rolling over assets from the TSP, which charges fees of less than 3 basis points, to a plan managed by the adviser that charges 200 basis points for the management fee, and that advice can meet the standard of being in the best interest of the client if the adviser discloses the fees.

The SEC thus places considerable reliance on the disclosures of financial advisers. Surveys of investors, however, indicate that most investors find the disclosures of financial advisers to be difficult to understand. Investors also feel that financial advisers do not spend sufficient time helping them understand the disclosures.⁸⁹

The SEC has taken a weak position on other issues relating to fees. For example, in 2012, as required by the Dodd-Frank Act, the SEC released new rules to protect investors concerning income and asset thresholds at which advisers could charge performance-based fees.⁹⁰ However, it greatly

⁸⁹ Hung, *supra* note 6.

⁹⁰ U.S. SEC. AND EXCH. COMM'N, SEC TIGHTENS RULES ON ADVISORY PERFORMANCE FEE CHARGES (2012), <http://www.sec.gov/News/PressRelease/Detail/PressRelease/1365171487308>.

weakened the effect of those rules by grandfathering in all persons affected by the old rules.

The SEC has announced that it intends to propose a new fiduciary rule that would extend its current fiduciary rule to broker-dealers, perhaps as early as April 2017.⁹¹ While this would be a step in the right direction, its fiduciary standard is so weak that it would not provide much protection for pension participants or other investors.

C. EXPLANATIONS FOR WEAK OVERSIGHT

The SEC's Office of Compliance Inspections and Examinations has enforcement authority. However, because of a decrease in the number of staff in that office owing to a reduction in congressionally approved funding, the number of examinations has declined, presumably resulting in a weakening of enforcement by the SEC.⁹² Furthermore, the Consumer Federation of America points out that even when a fiduciary duty applies, the SEC has shown little inclination to enforce it.⁹³

Because of the large amount of money at stake for financial advisers, they have attempted to influence the regulators. Such influence is sometimes referred to when it is successful as "regulatory capture" or "regulatory influence." One way the SEC may be influenced is through the "revolving door" of government. Former SEC employees must file post-government employment statements if they plan to represent a client before the Commission within two years of leaving the SEC. The Project on Government Oversight (POGO) filed a Freedom of Information Act (FOIA) request for all post-employment statements filed by former SEC employees between 2006 and 2010. It found that between 2006 and 2010, 219 former SEC employees filed 789 post-employment statements indicating their intent to represent an outside client before the Commission.⁹⁴ The Dodd-Frank Act raised salaries at the SEC, and at other federal financial regulatory agencies, compared to those at other agencies in the federal government, in order to attract and retain qualified staff at the financial regulatory agencies. For

⁹¹ Mark Schoeff Jr., *SEC plans to propose fiduciary rule next April*, PENSIONS & INVS., (May 19, 2016), http://www.pionline.com/article/20160519/ONLINE/160519849/sec-plans-to-propose-fiduciary-rule-next-april?utm_campaign=saxo_rss&utm_medium=rss&utm_source=rss02_rss.

⁹² U.S. SEC. & EXCH. COMM'N, *supra* note 83.

⁹³ *Hearing*, *supra* note 85.

⁹⁴ Michael Smallberg, *Revolving Regulators: SEC Faces Ethics Challenges with Revolving Door Project*, POGO (May 13, 2011), <http://www.pogo.org/our-work/reports/2011/fo-fra-20110513.html>.

example, staff at the SEC in 2016 could earn up to \$237,700, depending on where they were working.⁹⁵ The previously mentioned study refers to the period before that change, but the effect of that change is not known at this time.

The SEC is a stand-alone regulatory entity, whereas the Employee Benefits Security Administration, which has responsibility for protecting pension participants, is part of a larger agency, the DOL. This difference in administrative structure may be part of the explanation for why the SEC is weaker than the Employee Benefits Security Administration with respect to independence from industry influence.⁹⁶

D. THE FEC AND THE SEC

The Federal Elections Commission (FEC) may account for part of the explanation for the weak oversight provided by the SEC: it may be due to the election campaign contributions of the financial services industry to members of Congress, who then favor weak oversight by the SEC. Over the 2013–2014 election cycle, the financial services industry spent \$1.4 billion. More than 340 financial service companies and trade associations each spent more than \$500,000 during this period. Of the total spending, \$497 million was spent on contributions to federal candidates and \$908 million was spent on lobbying. The contributions to federal candidates were split unevenly between the two parties, with 63 percent going to Republicans and 37 percent going to Democrats. The financial sector's campaign contributions were more than twice that of any other business sector.⁹⁷ Thus, regulatory capture can occur both at the agency level and at the level of Congress through financing congressional election campaigns.

E. THE SEC AND COMPLAINTS

⁹⁵ U.S. Securities and Exchange Commission, *SEC Pay Structure* (2016), <https://www.sec.gov/jobs/sec-pay.shtml>.

⁹⁶ John A. Turner, Gerard Hughes & Michelle Maher, *An International Assessment of Regulatory Capture and Regulatory Outcomes: The Case of Pension Regulators in Ireland and the United States*, J. OF FIN. REG. AND COMPLIANCE (forthcoming 2017).

⁹⁷ AMERICANS FOR FINANCIAL REFORM, *Updated AFR Report: Financial Sector Lobbying and Campaign Spending Top \$1.4 Billion for 2014 Election Cycle—\$1.9 million a day* (March 18, 2015), <http://ourfinancialsecurity.org/2015/03/afr-report-financial-sector-lobbying-and-campaign-spending-top-1-2-billion-for-2014-election-cycle-1-8-million-a-day/>.

A person receiving bad advice from a financial adviser concerning a rollover could file a complaint with the SEC. The SEC website, however, is not “user-friendly” to pension participants filing a complaint. The link on the SEC website to “Enforcement” would be the most obvious path to follow. But instead, a person must file a complaint under the link to “Education”—that’s if they persist sufficiently in searching through the links on the website to find that link; “Education” would seem to be one of the least likely places to file a complaint. Even after the person has found the right page, it is not set up for easily dealing with complaints concerning advice on pension rollover.

VII. TWO ALTERNATIVE HYPOTHESES

This section briefly considers two alternatives to the hypothesis of regulatory capture as explanations for the weak oversight provided by the SEC. First, the SEC may not consider the issue of pension rollovers to be in its bailiwick, but rather, it may hold that issue to be the responsibility of the DOL. But contrary to that view, some members of Congress have argued that the SEC, not the DOL, should have jurisdiction in this issue.⁹⁸ In addition, opponents of the DOL fiduciary regulations have argued that point in court.⁹⁹ Second, the SEC may feel that if it were to bring cases in this area, it would not prevail in court. Presumably, if the SEC had that opinion it would favor stronger regulations, but it has not taken that position.

VIII. DEPARTMENT OF LABOR REGULATIONS

In the absence of action by the SEC, the DOL in 2016 promulgated a fiduciary rule that provides some protection for private-sector pension participants.¹⁰⁰ The rule explicitly provides fiduciary protection to pension participants for advice from a financial adviser to roll funds over to an IRA.

⁹⁸ John J. Topoleski & Gary Shorter, *Department of Labor’s 2015 Proposed Fiduciary Rule: Background and Issues*, CONGRESSIONAL RESEARCH SERVICE 19 (2015) <https://www.fas.org/sgp/crs/misc/R44207.pdf>.

⁹⁹ Mark Schoeff Jr., *SEC Commissioner: DOL Fiduciary Rule Would Create a ‘Mess’*, INVESTMENTNEWS (2015), <http://www.investmentnews.com/article/20150804/FREE/150809978/sec-commissioner-dol-fiduciary-rule-would-create-a-mess>.

¹⁰⁰ U.S. DEP’T. OF LABOR, EMP. BENEFITS SEC. ADMIN, PRIVATE PENSION PLAN BULLETIN, ABSTRACT OF 2013 FORM 5500 ANNUAL REPORTS 1-2 (2015), <https://www.dol.gov/sites/default/files/ebsa/researchers/statistics/retirement-bulletins/2013pensionplanbulletin.pdf>.

The rule arguably would protect all pension participants, including government employees, when they are advised concerning a rollover to an IRA. Before the DOL promulgated this regulation, Republicans in Congress sought to block it by introducing a bill, the Retail Investor Protection Act, that would prohibit the DOL from finalizing its rule until 30 days after the SEC had finalized a rule.¹⁰¹ The Republicans presumably made this move because they recognized the low probability that the SEC would act.

Despite its inaction, at least one of the SEC's five commissioners has criticized the attempt of the DOL to deal with pension mis-selling.¹⁰² According to a report released by Republicans in the House of Representatives, the SEC opposes the DOL proposed regulation. The DOL has denied the substance of that report, while the SEC has refused to comment on it.¹⁰³

The DOL has been criticized for regulating in an area outside of its expertise, and a lawsuit has been filed against the department arguing that rulemaking in this area should be done by the SEC.¹⁰⁴

The regulations do not protect pension participants from generalized bad advice, such as advertisements that encourage participants to roll over your old 401(k) plan because "the future you envision for yourself matters

¹⁰¹ *Preserving Retirement Security and Investment Choices for all Americans, Joint Hearing of the Capital Markets and Government Sponsored Enterprises Subcommittee and the Oversight and Investigations Subcommittee and the Financial Services Committee*, U.S. HOUSE OF REPRESENTATIVES (Sept. 10, 2015) (Written testimony of Barbara Roper delivered to the Joint Hearing of Capital Markets and Government Sponsored Enterprises Subcommittee and the Oversight and Investigations Subcommittee), http://www.consumerfed.org/pdfs/9-10-15%20CFA%20HFSC%20Hearing%20on%20DOL%20COI%20Rule%20and%20HR1090_Testimony.pdf; John J. Topoleski & Gary Shorter, *Department of Labor's 2015 Proposed Fiduciary Rule: Background and Issues*, CONG. RES. SERV. (2015), <https://www.fas.org/sgp/crs/misc/R44207.pdf>.

¹⁰² Schoeff, *supra* note 99.

¹⁰³ Suzanne Barlyn & Sarah N. Lynch, *U.S. Labor Dept., SEC clashed over retirement advice rule –report*, REUTERS (Feb. 24, 2016, 1:29 PM), <http://www.reuters.com/article/usa-brokers-fiduciary-idUSL2N1630ME>.

¹⁰⁴ Erika Reynoso & Alison Hawkins, *U.S. House Should Protect Americans' Access to Financial Advice*, FIN. SERVICES ROUNDTABLE (Oct. 27, 2015), <http://www.fsroundtable.org/u-s-house-should-protect-americans-access-to-financial-advice/>; Nevin E. Adams, *It's On! Litigation File Challenging DOL Fiduciary Regulation*, NAPA NET (June 6, 2016), <http://www.napa-net.org/news/managing-a-practice/regulatory-compliance/its-on-litigation-filed-challenging-dol-fiduciary-regulation/>.

to us.”¹⁰⁵ That advice generally results in pension participants paying higher fees and having fewer regulatory protections.¹⁰⁶

IX. CONCLUSION

The SEC has not taken any action concerning financial advice to roll over from low-fee 401(k) plans to higher fee IRAs. The lack of action by the SEC stands in stark contrast to the situation in the United Kingdom, where the type of advice people received to roll funds over to substantially higher-fee pensions is considered to be a scandal and was addressed more than a decade ago by the U.K. financial market regulators.

The SEC appears to not consider the fees charged by financial advisers to be an important issue. It does not include fees as an issue in its advice to people considering rollovers from 401(k) plans to IRAs. It has, to our knowledge, never brought a case against a financial adviser concerning fees relating to pension rollovers, even in the extreme case of rollovers from the TSP, which charges less than 3 basis points. The CEA has concluded that bad advice concerning pension rollovers is costing U.S. pension participants \$17 billion, but the SEC thus far has not considered this to be an issue that would warrant action on its part. The CEA study indicates that pension mis-selling, in which financial advisers have advised pension participants to switch from relatively low-fee 401(k) plans to higher-fee IRAs, has occurred on a widespread basis in the United States.

With more responsibility placed on individuals to invest their retirement assets when they leave an employer’s 401(k) plan, workers often rely on investment advisers but are often not well-served by them. In this paper, we compare the regulatory protections pension investors receive in the United Kingdom to those that have been provided by the SEC relating to advice concerning pension rollovers. Although the SEC holds RIAs to a fiduciary standard, and the literature on advice has expressed concern about the weakening of that protection because of the so-called “hat switching” problem, the more serious problem is that the SEC does not apply the fiduciary standard to advice provided by RIAs concerning pension rollovers. While the DOL has promulgated regulations in this area, those regulations

¹⁰⁵ *Have you settled for average with your old 401(k)?*, T. ROWE PRICE (2016) (on file with author).

¹⁰⁶ John A. Turner & Bruce W. Klein, *Retirement Savings Flows and Financial Advice: Should You Roll Over Your 401(k) Plan?*, INT’L SOC’Y OF CERTIFIED EMP. BENEFIT SPECIALISTS: BENEFITS QUARTERLY, (Fourth Quarter 2014).

in 2016 are being challenged in court, in part on the basis that this area should be the responsibility of the SEC.

While we have addressed one aspect of the issue of bad advice concerning pension rollovers, other issues also warrant addressing. For example, the advice contained in the mutual fund industry advertising campaign to “roll over your old 401(k)” is bad advice for many participants and does not come with disclaimers. That advice campaign is treated by the regulators as sales and marketing, rather than advice. Because most participants have encountered this advice many times, and presumably many roll their funds over based on that advice, the protections that this paper indicates are needed may still be weak in that there are no regulations on this type of generalized advice—generally bad advice that comes without disclaimers.

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