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The SECURE Act Reduces—But Does Not Eliminate—Litigation Risk of Offering Annuities in 401(k) Plans

On December 20, 2019, President Trump signed into law the Setting Every Community Up for Retirement Enhancement (SECURE) Act,[1] the most important retirement legislation since the Pension Protection Act of 2006. One of the most significant features of the SECURE Act is an amendment to Section 404 of ERISA,[2] which sets forth the duties of plan fiduciaries, to add a "safe harbor" for the offering of annuities in retirement plans. This article discusses why the safe harbor was added, what it does, and what it means for ERISA fiduciaries going forward.

WHY CONGRESS ADDED A SAFE HARBOR

Although annuities offer a guaranteed stream of retirement income payments for life, very few retirement plans currently offer them. According to the Employee Benefit Research Institute, less than 10% of 401(k) plans offer annuities, despite 75% of 401(k) participants saying that they are interested in using them. One reason for this disconnect is the concern about fiduciary liability. In particular, plan fiduciaries worry that they will be sued for breach of fiduciary duty—potentially decades after selecting an annuity—if the provider becomes unable to pay.[3]

While the Department of Labor issued a "safe harbor" regulation for selecting and monitoring annuity providers for defined contribution plans in 2008,[4] many employers felt that the regulation was unclear on the scope of a fiduciary's obligations (among other things, the regulatory safe harbor only applied if the fiduciary "appropriately conclude[d]" that an insurer could make all future payments). The statutory safe harbor added to Section 404 by the SECURE Act attempts to provide that clarity.

WHAT THE SAFE HARBOR DOES

The SECURE Act amends Section 404 of ERISA to add a "safe harbor for annuity selection."[5] This safe harbor provides that a fiduciary will be deemed to have met their duty of prudence if they:

- engage "in an objective, thorough, and analytical search for the purpose of identifying insurers from which to purchase" annuity contracts[6];
- consider both the insurer's financial capability to meet its obligations and "the cost (including fees and commissions) of the" annuity contract "in relation to the benefits and product features of the contract and administrative services to be provided under such contract"[7]; and
- conclude both that (i) "at the time of selection, the insurer is financially capable of satisfying its obligations under" the annuity contract and (ii) that "the relative cost of the" annuity contract "is reasonable."[8] The safe harbor also provides that this should not be construed as requiring a fiduciary to select the lowest cost annuity contract.[9]

Perhaps most importantly, the safe harbor further provides that if a fiduciary obtains written representations from an insurer that the insurer is in compliance with specific regulatory requirements, then the fiduciary will have appropriately considered whether the insurer is "financially capable of satisfying its obligations under" the annuity contract.[10] Unless the fiduciary has reason to think the insurer is not so capable, it can conduct this review and obtain representations from the insurer on an annual basis.[11]

If a fiduciary complies with the requirements of the safe harbor, the fiduciary will not be liable "for any losses that may result to the participant or beneficiary due to an insurer's inability to satisfy its financial obligations under the terms of the contract."[12]

WHAT DOES THE SAFE HARBOR MEAN FOR ERISA FIDUCIARIES GOING FORWARD

The SECURE Act's safe harbor gives fiduciaries broad protection against the risk of an annuity provider later becoming insolvent. Accordingly, so long as fiduciaries comply with the safe harbor's requirements, they can significantly reduce the long-tail fiduciary risk that has kept annuities out of most defined contribution plans. But that does not mean offering annuities is risk-free. Some of the principal remaining risks are:

- ***Fiduciaries must conduct an "objective, thorough, and analytical search***." The protection of the safe harbor—including the protection against liability for an insolvent insurer—only applies if the fiduciary "engages in an objective, thorough, and analytical search" to identify annuity providers. This language evokes the "prudent process" standard that governs plan investment selection under ERISA generally. Accordingly, if fiduciaries wish to benefit from the protections of the new safe harbor, they will need to make sure that their initial search for providers is rigorous, uses objective criteria, and is well-documented.
- ***Fiduciaries must conclude that "the relative cost" of the annuity contract is "reasonable."*** While the safe harbor gives specific instructions on how a fiduciary should evaluate an insurer's financial stability, it gives much less detail on how a fiduciary should decide the relative cost of an annuity, and whether that cost is "reasonable." High-cost investment options in defined contribution plans have been a constant source of ERISA class action litigation over the past decade. Fiduciaries can expect that annuity products, many of which are already criticized for being expensive, will be a prime target for similar lawsuits if they are not selected carefully and pursuant to a prudent process.
- ***Fiduciaries must meet their duty of loyalty and avoid prohibited transactions***. Relatedly, fiduciaries cannot forget their duty of loyalty to the plan and obligation to avoid prohibited transactions. While the

> SECURE Act's safe harbor gives broad protection for fiduciaries in the event an annuity provider becomes insolvent, its protection from other types of claims—like an annuity being too expensive or poor performing—is more limited. Specifically, the safe harbor provides that fiduciaries who conduct the appropriate selection process have satisfied their duty of *prudence*—it does not say the same thing about their duty of loyalty. This means that fiduciaries might still be exposed to claims that they disloyally selected a subpar annuity product, even if they complied with the safe harbor. Similarly, the safe harbor does not apply to prohibited transaction claims under Section 406 of ERISA.[13]

* * *

The SECURE Act is designed to remove a major legal roadblock to the offering of annuities in defined contribution plans. But while fiduciaries can take comfort that it is now less likely they will be sued over an insolvent annuity provider, offering annuities still poses the same fiduciary risks that most other investments do. As with any other investment decision, fiduciaries should make sure to conduct a thorough and objective selection and monitoring process, and to document that process in writing.

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1 Pub. L. No. 116-94 (2019).
2 29 U.S.C. § 1104.
3 See Brookings Institute, When income is the outcome: Reducing regulatory obstacles to annuities in 401(k) plans, July 2019, available at https://www.brookings.edu/wp-content/uploads/2019/07/ES_201907_IwryGaleJohnJohnson.pdf.
4 See 29 C.F.R. § 2550.404a-4.
5 SECURE Act § 204.
6 29 U.S.C. § 1104(e)(1)(A) (as amended).
7 Id. § 1104(e)(1)(B).
8 Id. § 1104(e)(1)(C).
9 Id. § 1104(e)(3).
10 Id. § 1104(e)(2).
11 Id. § 1104(e)(4).
12 Id. § 1104(e)(5).
13 29 U.S.C. § 1106.