IN THE UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

HAROLD E. SHEPLEY JR., *et al.*,

Plaintiffs-Appellees,

v.

NEW COLEMAN HOLDINGS, INC., *et al.*,

Defendants-Appellants,

.

AMERICAN ACADEMY OF ACTUARIES and
AMERICAN SOCIETY OF PENSION ACTUARIES,

Amici Curiae.

Appeal No. 98-7519

BRIEF OF *AMICI CURIAE* AMERICAN ACADEMY OF ACTUARIES AND THE AMERICAN SOCIETY OF PENSION ACTUARIES IN SUPPORT OF DEFENDANTS-APPELLANTS

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The American Academy of Actuaries and the American Society of Pension Actuaries submit this brief as *amici curiae*, pursuant to the Rules of the United States Court of Appeals for this Circuit. This brief is being filed with the consent of the parties.

STATEMENT OF INTEREST OF *AMICI CURIAE*

The American Academy of Actuaries (the "Academy") is a nonprofit professional association established in 1965 to provide a common membership organization for actuaries of all specialties (including pension and health) practicing in the United States. The Academy's membership exceeds 13,000 actuaries nationwide. To articulate its purpose and guide its activities into the next century, the Academy in 1994 adopted the following Mission Statement:

> To ensure that the American public recognizes and benefits from (1) the independent expertise of the actuarial profession in the formulation of public policy, and (2) the adherence of actuaries to high professional standards in discharging their responsibilities.

Mission Statement, *Strategic Plan 1995-2000 of the American Academy of Actuaries* (1994).

The American Society of Pension Actuaries ("ASPA") is a nonprofit professional society whose members provide actuarial, administrative, consulting and other services for approximately one-third of the qualified pension plans in the United States. ASPA's mission is to educate retirement plan professionals and to preserve and enhance the private pension system as part of the development of a cohesive and coherent national retirement income policy. ASPA was established to:

> advance actuarial science as applied to pension plans, promote high professional and ethical standards among its membership, facilitate the assembly of pension actuaries and consultants for the discussion of professional matters, and inform the public of the nature of the profession of the pension actuary and consultant.

Article I, Name and Purpose, *Bylaws of the American Society of Pension Actuaries*.

The Academy and ASPA have adopted a common Code of Professional Conduct to govern the professional ethics of their members. The Code provides, among other things, that an actuary must comply with applicable standards of practice whenever he or she provides professional services. In the United States, the applicable standards are the *Actuarial Standards of Practice* adopted by the Actuarial Standards Board, a committee created by the bylaws of the Academy. Members who breach the Code by failing to comply with the *Actuarial Standards of Practice* may be publicly reprimanded, or suspended or expelled from membership.[1]

The Academy regularly provides unbiased expertise to state legislatures, regulatory

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[1] To be eligible to provide actuarial services to employee benefit plans governed by the Employee Retirement Income Security Act ("ERISA"), 29 U.S.C. §§ 1101 *et seq.*, an actuary must be licensed by the Joint Board for the Enrollment of Actuaries (the "Joint Board") of the United States Departments of Labor and the Treasury. The Joint Board has adopted its own regulations to govern the professional conduct of enrolled actuaries. *See* 20 C.F.R. § 901.20. Nearly all enrolled actuaries are members of the Academy, ASPA or both, and thus are subject to oversight not only by the Joint Board, but also by the Academy and/or ASPA.

agencies and Congress on the actuarial implications of regulatory and legislative proposals involving insurance, health care and retirement income security.[2] ASPA, too, provides legislators and regulators with expert advice on the nation's pension system.[3] The Academy and ASPA also participate as *amici curiae* in court cases with significant actuarial implications.

Together, ASPA and the Academy are uniquely situated to provide the Court with the professional perspective of actuaries who provide services to ERISA plans. Our members are expert in the calculation of liabilities and benefits under defined benefit plans, and can advise the Court concerning the typical expectations of employers and plan participants under these plans.

Moreover, our members have a professional interest in this case. The lower court defined "overpayments" to include only contributions paid into the plan by the employer, and excluded surplus funds generated by the successful investment of plan assets. This definition conflicts with generally-accepted actuarial practice as set forth in the *Actuarial Standards of Practice* published by the Academy's Actuarial Standards Board and, we believe, reflects a fundamental

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[2] For example, the Academy recently testified before the Social Security Administration concerning the merits of raising the retirement age. "Witnesses Debate Merits of Raising Retirement Age," *BNA's Daily Report for Executives* (Feb. 27, 1998). The Academy has also addressed proposals to modify ERISA in the national press. *E.g.*, "Full Funding Limit Increase Not Enough to Make Defined Benefit Plans More Popular," *BNA's Daily Tax Report* (Aug. 26, 1997); "Removing Restrictions on Pension Savings a Risky Plan," *USA Today* (April 17, 1998).

[3] ASPA recently proposed that the U.S. Department of Labor establish a program to permit plan sponsors voluntarily to correct errors without the threat of legal action or onerous penalties. "ASPA: No Reprisals in Fixing Error," *Pension & Investments* (Sept. 15, 1997); "Establish Program for Fiduciary Breach Correction: ASPA," *Employee Benefit Plan Review* (Oct. 1997). ASPA also argued to the U.S. Senate against including in the Budget Reconciliation Act of 1997 a "spousal consent" provision that could have prevented plan participants from ever receiving their benefits if their spouses would not cooperate or could not be found. "Pension Professionals Help Remove 'Spousal Consent' Provision from Budget Bill," *REJI/Corridor Real Estate Journal* (Aug. 22, 1997).

misunderstanding of actuarial techniques for calculating sponsor contribution requirements for defined benefit plans. If the lower court's reasoning were affirmed, members of the Academy and ASPA who calculate sponsor contribution requirements for defined benefit plans would be faced with the unacceptable alternative of either violating the published standards of practice of the actuarial profession, or practicing in apparent contravention of common law. Accordingly, the members of the Academy and ASPA have a substantial interest in this case.

SUMMARY OF ARGUMENT

In defining "overpayments" to include only sponsors' contributions to defined benefit plans (excluding investment income attributable to plan assets), the lower court ignored the fundamental nexus between investment income and sponsor contribution requirements. When an actuary calculates a sponsor's required contribution to a defined benefit plan, the actuary is expressly directed by the standards of practice of the actuarial profession to consider how much investment income the plan's assets are likely to generate, and to adjust the sponsor's contribution to reflect that expected income. If actuaries are to meet their professional obligations, they cannot draw the artificial distinction between investment income and sponsor contribution requirements that the lower court's opinion appears to require.

Moreover, the lower court's analysis unrealistically assesses the ease of projecting investment income from plan assets. Contrary to the lower court's apparent perception, even the most skilled and conscientious actuary cannot predict with perfect accuracy what the investment income of a plan will be in any given year. Actuaries, therefore, typically recommend that sponsors contribute conservatively to defined benefit plans to ensure adequate funding to pay all expected benefits. The lower court's decision, if affirmed, will at the very least discourage

sponsors from following their actuaries' advice, and could lead sponsors to terminate or underfund their defined benefit plans to the ultimate detriment of plan participants.

ARGUMENT

I. The Lower Court's Decision Is Contrary to Generally-Accepted Actuarial Practice

From the actuarial perspective, the critical flaw in the lower court's decision rests in its attempt to distinguish sponsor contributions from investment income when defining an "overpayment." Analyzing the plan documents, the lower court concluded that the plan sponsor could only recover surplus that constituted an "overpayment." The lower court reasoned:

> It is undisputed that the surplus assets in the Plan resulted from a high return on monies invested in the Plan, not from excess money contributed to the fund. ...The Court finds that a return on an investment does not constitute an 'overpayment.' ...Thus, the 1984 Plan allows for reversion of funds resulting from overpayments; but not other funds.

Shepley v. New Coleman Holdings Inc., slip op at 13 (S.D.N.Y. Docket No. 95 Civ. 447 (DAB)) (internal citations omitted).

The lower court appears to have believed that a sponsor's contributions to a defined benefit plan are made independent of investment income. That belief is mistaken. A defined benefit plan of the sort at issue in this case has only two sources of income to satisfy the plan's obligations to participants: sponsor contributions and investment income. Actuaries who calculate sponsor contribution requirements for defined benefit plans do so with express reference to the plan's anticipated investment earnings. One federal court described the process of calculating the sponsor's contributions to a typical defined benefit plan as follows:

> Because the Salaried Plan provides defined benefits to participants

> and because Stevens [the plan sponsor] is its sole contributor, Stevens bears the risk of the Salaried Plan's actuary investment experience relative to actuarial predictions. ... If the actuarial predictions for investment returns are lower than actual experience in a given year, Stevens is then required to make larger contributions to the Salaried Plan in subsequent year. ... If, on the other hand, actuarial predictions prove too high, Stevens is permitted to decrease its contributions in subsequent years.

Lynch v. J.P. Stevens & Co., Inc., 758 F. Supp. 976, 982 (D. N.J. 1991) (internal citations omitted). Thus, as the *Lynch* court recognized, the level of a sponsor's contributions is inextricably linked to the investment returns achieved by the plan, increasing or decreasing depending upon the plan's investment success.

Actuaries must calculate sponsor contribution requirements in the manner described by the *Lynch* court if they are to comply with the Actuarial Standards Board's *Actuarial Standard of Practice No. 4*, "Measuring Pension Obligations," Doc. No. 046 (1993) ("*ASOP No. 4*"). *ASOP No. 4* "sets forth generally accepted actuarial principles and practices for measuring pension obligations," and applies to a wide range of actuarial tasks, including "funding of defined benefit pension plans." *Id*. at ¶¶ 1, 2(a). When determining a sponsor's required contribution to a defined benefit plan, the actuary must select a number of assumptions concerning the plan, including an assumption about investment return. *Id*. at ¶ 5.2.4(a)(2). The standard expressly recognizes that the sponsors required contribution cannot be calculated without reference to the investment return assumption: "[t]he valuation of assets, the investment return assumption, the determination of the actuarial present values, and the intended use of the calculations are interdependent, and one cannot be considered in isolation from the others." *Id*. at ¶ 5.2.6. Moreover, the standard requires the actuary to consider the reasonableness of each assumption

both individually and in the aggregate, so that the other assumptions cannot fairly be evaluated without reference to the investment return assumption. *Id*. at ¶ 5.2.4(b).

Further guidance is provided to the actuary by the Actuarial Standards Board in *Actuarial Standard of Practice No. 27*, "Selection of Economic Assumptions for Measuring Pension Obligations," Doc. No. 053 (1996) ("*ASOP No. 27*"). This standard provides guidance to the actuary in selecting economic assumptions ("primarily investment return, discount rate and compensation scale"), and applies to "the selection of economic assumptions to measure obligations under any defined benefit pension plan that is not a social insurance program" (such as Social Security). *Id*. at ¶¶ 1, 1.2. Thus, *ASOP No. 27* also recognizes the critical importance of projecting investment income as an element of determining the sponsor's required contribution to a defined benefit plan.

The published standards of practice of the actuarial profession expressly direct the actuary to estimate investment income as a mandatory step in determining a sponsor's required contribution to a defined benefit plan. If the plan assets ultimately generate more income than the actuary anticipates, the sponsor's required contribution will be lower, and any excess funds contributed by the sponsor based on the actuary's original estimate will constitute an "overpayment." For an ongoing plan, any excess sponsor contribution are recovered through lower future contributions. However, if the plan terminates before the adjustment of future contributions to account for prior excess contributions is complete, the plan will have excess assets (as occurred in this case).

The purpose of a defined benefit plan is to provide participants with the security of a specified, anticipated benefit -- but not with an unexpected windfall derived from excess assets.

Chait v. Bernstein, 835 F.2d 1017, 1026 (3rd Cir. 1987); *accord*, *Washington-Baltimore Newspaper Guild v. Washington Star Co.*, 555 F. Supp. 257, 261 (D.D.C. 1983), *aff'd mem.*, 729 F.2d 863 (D.C. Cir. 1984). Tying the sponsor's required contribution to the investment income assumption is an appropriate actuarial technique to ensure that defined benefit plans will be fully, but not excessively, funded, because that technique takes into account all of the assets available to the plan to pay expected benefits and does not artificially segregate any segment of the plan assets.[4] The lower court's analysis is inconsistent with generally-accepted actuarial practice, and should be rejected.

II. The Lower Court's Decision Unrealistically Assesses the Ease of Projecting Plans' Investment Income

As the lower court recognized, ERISA requires that qualified plans be administered in accordance with the terms and conditions set forth in the plan documents. *Shepley*, *supra*, slip op. at 8, *citing Curtiss-Wright Corporation v. Schoonejongen*, 514 U.S. 73 (1995). If the plan documents provide that participants are to receive a defined benefit, the plan (and therefore, the sponsor) must provide that benefit, regardless of whether the plan assets generate sufficient investment income to cover the defined benefit. Lower investment returns generate the need for higher sponsor contributions. *Lynch, supra*.

If the lower court's reasoning were affirmed, the logical effect would be to award participants the benefits of better-than-expected investment returns (on the theory that those returns were not, nor did they lead to, "overpayments" that the sponsor could recover) while

[4] Moreover, as stated above, members of the Academy or ASPA who fail to comply with the generally-accepted practices published in the *Actuarial Standards of Practice* are subject to discipline up to and including expulsion from membership in the two organizations.

imposing upon sponsors the risks associated with worse-than-expected investment returns. That result would not be equitable because it is virtually impossible to predict investment returns with sufficient precision to prevent sponsor overpayments.

Even the most professional and diligent actuary cannot predict a plan's investment income with absolute certainty. The Actuarial Standards Board has expressly recognized that investment income and other economic assumptions cannot be calculated to a single, indisputable point:

> Because no one knows what the future holds with respect to economic and other contingencies, the best an actuary can do is to use professional judgment to estimate possible future economic outcomes based on past experience and future expectations, and to select assumptions based upon that application of professional judgment. Therefore, an actuary's best-estimate assumption is generally represented by a *range* rather than one specific assumption. The actuary should determine the best-estimate range for each economic assumption, and select a specific point from within that range. In some instances, the actuary may present alternative results by selecting different points within the range.

ASOP No. 27 at ¶ 3.1 (emphasis in original). The standard goes on to provide detailed guidance to help the actuary construct the range from which the investment income assumption is selected. *Id*. at ¶¶ 3.6 - 3.6.5. Having constructed the range, the actuary must pick a reasonable investment income assumption, and must evaluate that assumption to see whether it is consistent with the other economic assumptions selected by the actuary. *Id*. at ¶¶ 3.9, 3.10.

ASOP Nos. 4 and 27 provide a framework for the actuary to select a reasonable investment income assumption, but, as the Actuarial Standards Board warns, "no one knows what the future holds with respect to economic and other contingencies." Even the best estimate of investment return will be inaccurate to some degree and, given sufficient volatility in the investment market, may be vastly different from actual experience. In fact, the investment market

has generated such unusually high returns in recent years that it would be an arguable breach of actuaries' professional standards and the funding requirements of ERISA for an actuary to assume an investment return anywhere near the level of actual returns that have been achieved.

If the actuary wishes to ensure that sufficient assets will be available to satisfy the plan's obligations, the actuary will likely select relatively conservative assumptions that will tend to (initially) maximize the sponsor's contribution requirements and, thereby, prevent the sponsor from inadvertently underfunding the plan. However, if the lower court's reasoning is upheld, sponsors will have reason to fear that, to the extent an actuary's funding recommendation is based upon a conservative investment income assumption, their excess contributions will not be recoverable. At best, this fear may create some incentive for sponsors to minimize their contributions to their defined benefit plans, with the result that those plans may be underfunded and plan participants may not receive their full benefits. Other courts have recognized this risk. *Outzen v. Federal Deposit Insurance Corporation*, 948 F.2d 1184, 1188 (10th Cir. 1991); *Chait*, *supra* at 1026, *citing Wright v. Nimmons*, 641 F. Supp. 1391, 1407 (S.D. Tex. 1986). At worst, this fear could lead sponsors to terminate their defined benefit plans altogether. Either outcome could only harm plan participants.

We also believe that, in most instances, neither plan sponsors nor participants in defined benefit plans expect the participants to receive investment income in excess of their full defined benefits. Participants in a defined *contribution* plan expect the sponsor to make a specified contribution on their behalf, and understand that they assume the risk of investment of the plan's assets. Participants in a defined *benefit* plan, by contrast, expect to receive only the specified benefit required by the terms of the plan, and understand that the sponsor assumes the risk of

investment of the plan's assets. Plan documents may differ (and without commenting on the specific provisions of the plan at issue in this case), but we do not believe it is generally appropriate to interpret plan language in a manner that modifies the participants' expected benefits, and we would urge the Court not to do so here.

CONCLUSION

For the foregoing reasons, the Academy and ASPA respectfully request that the lower court's decision be reversed.

Respectfully submitted,

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