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John Hancock Mutual Life Insurance Co. v. Harris Trust & Savings Bank: Guaranteed Benefit Policy Exclusion Holds No Guarantee For Insurers From ERISA's Fiduciary Standards

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This case came before the Supreme Court of the United States to decide whether the fiduciary obligations of the Employee Retirement Income Security Act of 1974 ("ERISA") apply to an insurance company's annuity contracts, or whether they were within the guaranteed benefit policy exclusion.[1] The defendant-petitioner, John Hancock Mutual Life Insurance Co. and the plaintiff-respondent, Harris Trust & Savings Bank, acting as trustee for a Sperry Rand Corp. Retirement Plan, were parties in a participating group annuity titled Group Annuity Contract No. 50 ("GAC50").[2] In participating group annuity contracts, deposits made to secure retiree benefits are placed with the insurer's general corporate assets instead of applied to the immediate purchase of annuities.[3] The deposits can then be removed from the general account and converted into guaranteed benefits for the policy's retirees.[4] GAC50's assets were likewise made part of Hancock's general account with assets and liabilities recorded in two accounts for bookkeeping purposes.[5] In return for this arrangement, Harris received a pro rata portion of the investment gains and losses stemming from Hancock's general account.[6] Upon request, Hancock would convert GAC50 assets and guarantee all benefits to the specified retiree(s).[7] The liability would be recorded by adding an amount set by Hancock to the "Liabili-

1. John Hancock Mut. Life Ins. Co. v. Harris Trust & Sav. Bank, 114 S. Ct. 517 (1993).
2. *Id.* at 521.
3. *Id.*
4. *Id.*
5. *Id.* at 522. Assets were recorded in the "Pension Administration Fund" and the liabilities were recorded in "Liabilities of the Fund." *Id.*
6. *Id.*
7. *Id.*

ties of the Fund."[8] This method of conversion would continue as long as the minimum operating level (105% of the Pension Administration Fund) was maintained.[9] Funds in excess of the Minimum Operating Level were referred to as "free funds."[10] Harris had access to the free funds and used them for two purposes.[11] The primary use of the free funds was to pay additional benefits to retirees with no obligation for Hancock to pay except when free funds existed.[12] The parties specifically referred to these payments as "non-guaranteed benefits."[13] Hancock also allowed Harris to transfer free funds in rollover procedures without incurring any penalties.[14] When Hancock stopped allowing these functions, Harris, without any access to the free funds, filed suit.[15] In July 1983, in the United States District Court for the Southern District of New York, Harris alleged that Hancock was managing plan assets and was, therefore, subject to fiduciary standards in its administration of GAC50 under ERISA.[16] Hancock countered that ERISA's fiduciary standards did not apply to GAC50 because the contract fell within the guaranteed benefit policy exclusion[17] (29 U.S.C. § 1101(b)(2)(B)) exempting guaranteed benefit policies from plan assets.[18] ERISA defines a guaranteed benefit policy as an insurance policy or contract to the extent it provides for benefits guaranteed by the insurer.[19] In September 1989, the district court granted Hancock's motion for summary judgment on the ERISA claims, holding that Hancock was not a fiduciary with respect to any portion of GAC50.[20] Harris appealed, and the United States Court of Appeals for the Second Circuit reversed in part, holding that even though GAC50 provides for guarantees with respect to one portion of the benefits, it does not provide for guarantees to all benefits derived from the free funds portion of the

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8. *Id.* A part of the contract allowed these rates to be altered by Hancock. *Id.* at 522 n.3.
9. *Id.* at 522.
10. *Id.* at 521.
11. *Id.* at 522.
12. *Id.*
13. *Id.*
14. *Id.*
15. *Id.* From June 1982 to 1988, there were no conversions requested or any free funds removed. This lack of interruption resulted in a dramatic increase in free funds. *Id.*
16. *Id.* at 523.
17. *Id.*
18. *Id.*
19. *Id.*
20. Harris Trust & Sav. Bank v. John Hancock Mut. Life Ins. Co., 722 F. Supp. 998 (S.D.N.Y. 1989).

contract.[21] Consequently, the guaranteed benefit policy exclusion did not cover GAC50's free funds since Hancock did not guarantee any of the benefit payments or fixed rates of return but subjected them to fluctuation based on Hancock's investment performance.[22] The Supreme Court granted certiorari to resolve a split among the Courts of Appeals as to the meaning of the guaranteed benefit policy exclusion.[23] The main issue before the Court was whether fiduciary standards in ERISA apply to an insurance company in relation to certain annuity contracts.[24] In a six to three decision, Justice Ginsburg wrote for the majority and Justice Thomas, joined by Justice O'Connor and Justice Kennedy, dissented.[25] The Supreme Court affirmed the Second Circuit.[26] The Court held a group annuity contract did not qualify for ERISA's guaranteed benefit policy exclusion regarding free funds above the amount necessary to provide guaranteed benefits and subject to the insurer's discretionary management.[27] Absent the exclusion, this subjects the insurer to ERISA's fiduciary obligations with regard to such funds.[28]

Under ERISA, the obligations of a fiduciary are to discharge its duties with respect to a plan solely in the interests of the participants and their beneficiaries and for the exclusive purpose of providing benefits to the same.[29] A person is a fiduciary with respect to an employee benefit plan "to the extent he exercises any discretionary authority or control respecting management or disposition of such plans or its assets."[30] An ERISA guaranteed benefit policy is an insurance policy or contract to the extent that such policy or contract provides for benefits the amount of which is guaranteed by the insurer.[31] Such term includes any surplus in a separate account but excludes any other portion.[32] A definition for guaranteed benefit contract has never been a part of the insurance

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21. Harris Trust & Sav. Bank v. John Hancock Mut. Life Ins. Co., 970 F.2d 1138, 1143 (2d Cir. 1992).

22. *Id.* at 1144.

23. 114 S. Ct. at 521.

24. *Id.* A fiduciary under ERISA generally covers the management of plan assets for which ERISA does not give any comprehensive definition. Therefore, since Congress did not intend for the Guaranteed Policy Exclusion to include plan assets, the Court must determine it's meaning. *Id.*

25. *Id.*

26. *Id.* at 517.

27. *Id.*

28. *Id.*

29. 114 S. Ct. at 523.

30. *Id.* (quoting 29 U.S.C. § 1002(21)(A)).

31. *Id.* at 524.

32. *Id.*

industry lexicon so the actual meaning must come from ERISA itself.[33] This issue is one that has only been discussed a few times with results prior to this Supreme Court decision stemming from four Circuit Court opinions which were all basically in disagreement.[34] The four cases are: *Peoria Union Stock Yards Co. Retirement Plan v. Penn Mutual Life Insurance Co.*,[35] *Mack Boring & Parts v. Meeker Sharkey Moffitt*,[36] *Associates in Adolescent Psychiatry, S.C. v. Home Life Insurance Co.*,[37] and the present case of *Harris Trust & Savings Bank v. John Hancock Mutual Life Insurance Co.*[38] In *Peoria*, the United States Court of Appeals for the Seventh Circuit became the first federal court of appeals to consider whether an insurer's general account activities implicated ERISA's fiduciary obligations as well as the first to consider the scope of the exemption of section 401(b)(2).[39] In that case, the insurer sold a defined benefit plan in which they guaranteed the rate of return on the insured's contributions for three years.[40] The Seventh Circuit determined that, in certain circumstances, general account assets could qualify as plan assets and thus subject an insurer to ERISA's fiduciary obligations.[41] Implicitly relying on analysis of securities law to support their section 401(b)(2) analysis,[42] the Seventh Circuit held that the Penn Mutual-Peoria contract was not a guaranteed benefit policy because the words "guaranteed benefit" were meant to refer to the rate of return credited by the insurer, and the percentage guaranteed was too small to support the conclusion that the benefits were guaranteed.[43] The Seventh Circuit revisited the section 401(b)(2) issue once again in the *Associates* case in which the purchasers of a defined benefit plan sued their insurer under ERISA.[44] The insurer in *Associates* declared

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33. *Id.* at 524 n.4.

34. Prentice Hall Law and Business, *Supreme Court Explains When Assets of an Insurance Company's General Account are Plan Assets*, 2 No. 6 ERISA LITIG REP. 3 (1993).

35. 698 F.2d 320 (7th Cir. 1983).

36. 930 F.2d 267 (3d Cir. 1991).

37. 941 F.2d 561 (7th Cir. 1991).

38. The case was initially brought before United States District Court for the Southern District of New York, 722 F. Supp. 998 (S.D.N.Y. 1989). Upon appeal, the case went to the United States Court of Appeals for the Second Circuit, 970 F.2d 1138 (2d Cir. 1992).

39. Scott v. Rozmus, Comment, *Insurers Beware: General Account Activities May Subject Insurance Companies to ERISA's Fiduciary Obligations*, 88 NW. U. L. REV. 803, 811-12 (1994).

40. *Peoria*, 698 F.2d at 321-22.

41. Rozmus, *supra* note 39, at 811.

42. *Id.*

43. *See supra* note 34, at 3.

44. *Associates*, 941 F.2d at 568.

the applicable interest rates on its contract in advance of the year.[45] The court reasoned that by giving advance notice of the applicable rate, the contract provided a sufficient guarantee of return since the contract holder could decide not to transfer new funds to the policy or "take its money and go elsewhere."[46] By finding the contract to be a guaranteed benefit policy, the court distinguished *Peoria*.[47] In both of these decisions, however, despite being the first to confront ERISA's section 401(b)(2), the Seventh Circuit reached its results with only casual consideration of the section's scope.[48] In *Mack Boring*, however, not only did the United States Court of Appeals for the Third Circuit take a more extensive look at the scope of 401(b)(2), it rejected the reasoning of *Peoria* as well.[49] The court considered the language, legislative history, judicial and administrative interpretations of section 401(b)(2), and the definition of plan assets to conclude that the insurer was not a fiduciary under ERISA.[50] The court determined that the term "provides for" was to be interpreted as "make available" and since the policy made available fixed payment annuities for all the participants in the underlying plan, it was a guaranteed benefit policy.[51] The critical question according to *Mack Boring* is whether it is possible to use the policy's accumulated funds to purchase fixed payout annuities.[52] As long as the contract has provisions which, at some point in the future, allow payment of guaranteed benefits to plan participants, the contract is a guaranteed benefit policy.[53] On the way to this result, however, the court in *Mack Boring* followed the reasoning of the United States District Court for the Southern District of New York in *Harris Trust v. John Hancock*.[54] In that case, the district court held assets in the insurer's general account were not plan assets.[55] This part of the district court's holding, however, was reversed on appeal by the Second

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45. *See supra* note 34, at 3.

46. *Id.*

47. Rozmus, *supra* note 39, at 815.

48. *Id.* at 816.

49. *Mack Boring*, 930 F.2d at 271.

50. Rozmus, *supra* note 39, at 816.

51. *See supra* note 34, at 3.

52. *Mack Boring*, 930 F.2d at 273. This was the approach of Justice Thomas' dissenting opinion in *Hancock*. 114 S. Ct. at 535 (Thomas, J., dissenting) An insurance policy "provides for benefits the amount of which are guaranteed" when its terms make provisions for fixed payments to plan participants and their beneficiaries that will be guaranteed by the insurer. *Id.*

53. *Id.*

54. Rozmus, *supra* note 39, at 817. Mack Boring said the approach used by the New York District Court was more logical than the one taken by Peoria. 930 F.2d at 271.

55. *Hancock*, 722 F.Supp. at 998

Circuit. The court in *Mack Boring* did, however, acknowledge that the phrase "to the extent" had a limiting effect on the scope of section 401(b)(2).[56] This set the table for the Second Circuit Court of Appeals to introduce a totally new line of analysis in which a higher level of emphasis is placed on the words "to the extent."[57] The court reasoned "to the extent" meant there must be group annuity contracts that provided guaranteed benefits in part as well as non-guaranteed benefits.[58] Through this new line of reasoning, the court found the contract provided no guarantee of benefit payments or fixed rates of return since both were dependent on the performance of Hancock's investments.[59] As a result, the court held the free funds were plan assets[60] and the insurer should be subject to fiduciary responsibility.[61] The Second Circuit expressly approved the analysis of *Peoria* thereby rejecting *Mack Boring*.[62]

In this case, the first issue the Supreme Court addressed was whether Hancock was an ERISA fiduciary with respect to GAC50.[63] To do this, the Court looked at the statute as a whole as well as the policy behind the statute.[64] When a general policy is qualified by an exception, the Court "usually read[s] the exception narrowly in order to preserve the primary operation of the policy."[65] ERISA's primary purpose is protection since "[the] security of millions of employees and their dependents are directly affected by [employee benefit plans]."[66] Hence, "safeguards [should] be provided with respect to the establishment, operation, and administration of [these] plans."[67] So, with words of limitation present in the guaranteed benefit policy exclusion in contrast with other areas without any qualifications,[68] the Court viewed Congress' intent to be a narrow application of the exemption.[69] Therefore, the exemption is available to insurance contracts that provide for guaranteed benefits; however, it is only to the extent that the

56. *Mack Boring*, 930 F.2d at 271.
57. *See supra* note 34, at 3.
58. *Id.*
59. *Hancock*, 970 F.2d at 1143-45.
60. *Id.* at 1138.
61. *Id.* at 1144.
62. *Id.*
63. 114 S. Ct. at 523.
64. *Id.*
65. *Id.* at 524-25 (citing Commissioner v. Clark, 489 U.S. 726, 739-40 (1989)).
66. *Id.* at 524 n.5.
67. *Id.*
68. *Id.* at 524.
69. *Id.*

contract guarantees the benefits.[70] Applying this to GAC50 deposits, the Court found that the deposits must have been obtained solely for the issuance of an insurance policy that provides guaranteed benefits, and the exemption would apply only to the extent of that guarantee.[71] The Court then addressed Hancock's primary argument that Congress reserved the primary responsibility for regulating the insurance industry to the states.[72] ERISA's fiduciary standards could not apply since they would be in direct conflict with state law requiring an insurer to consider the interests of, and maintain equity among, all of its policy holders.[73] Since ERISA would have insurers act solely in the interest of participants and their beneficiaries for the exclusive purpose of providing benefits to the same, ERISA must yield to state law requirements.[74] The evidence Hancock used to support its objection was the McCarran-Ferguson Act[75] which states that "no Act of Congress shall be construed to invalidate, impair or supersede any law enacted by any state for the purpose of regulating the business of insurance."[76] However, the Court rejected this claim finding: (1) the McCarran-Ferguson Act does not apply to Acts specifically relating to the business of insurance such as ERISA and the guaranteed benefit policy exclusion[77]; (2) the preemption clause of ERISA would cause state laws governing insurance to yield when they relate to any employee benefit plan[78]; and (3) a Senate draft of ERISA, which would have provided a blanket exclusion to all general account assets from fiduciary obligations was not adopted by Congress.[79] Consequently, when the two entities cannot work in harmony, the federal law controls.[80] The Court next determined the extent to which GAC50 qualified for the guaranteed benefit policy exclusion. To determine whether a contract qualifies as a guaranteed benefit policy, each component of the contract has to be examined.[81] The Court looked to past cases[82] to determine that a

70. *Id.*
71. *Id.*
72. *Id.* at 525.
73. *Id.*
74. *Id.*
75. *Id.*
76. *Id.*
77. *Id.*
78. *Id.* at 525-26. Even though ERISA contains a savings clause that seems to conflict with the preemption clause, no decision of the Supreme Court had ever applied the saving clause to supersede a provision of ERISA itself. *Id.* at 526 n.9.
79. *Id.* at 526. The Court stated that they would not be directed by the discarded draft over the one that was adopted. *Id.*
80. *Id.* at 527.
81. *Id.*

guarantee exists only if the policy allocates investment risk to the insurer.[83] If the risk lies with the policy holder, then it is not guaranteed and the exemption only applies to the extent the policy provides for guaranteed benefits.[84] The Court found this to be the case when an insurer provides a genuine guarantee of an aggregate amount of benefits payable to retirement plan participants and their beneficiaries, which Hancock did with certain GAC50 benefits not part of the controversy.[85] As to the free funds, however, the insurer must guarantee a reasonable rate of return on those funds as well as provide a way to convert them into guaranteed benefits at rates set by the policy.[86] The Court found GAC50 did not guarantee a reasonable rate or provide any real guarantee that benefits in any amount would be payable from the free funds.[87] Hancock argued the Court should follow the Third Circuit[88] and interpret ERISA's exclusion to apply to contracts as long as guaranteed benefits are possible at some point in the future.[89] The Court rejected this argument stating that reading ERISA in this manner would allow for an overly broad application of the exemption which was not the intended purpose of the exclusion.[90] More significantly, the Court stated that, with no guarantee regarding either the amount of benefits or the conversion price, Harris was undeniably at risk and, therefore, that part of GAC50 did not qualify for ERISA's guaranteed benefit policy exclusion.[91] Hancock argued finally that the Court should follow the Department of Labor's ("DOL")[92] view that ERISA's fiduciary obligations do not apply to assets held in the general account by the insurer under contracts like GAC50.[93] This objection, however, was rejected as well. The Court found: (1) since the interpretive bulletin expressing this view did not mention its applicability to the guaranteed benefit policy exclusion, it lacked the scope Hancock

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82. The Court looked specifically to SEC v. Variable Annuity Life Ins. Co. of America, 359 U.S. 65 (1959) and SEC v. United Life Benefit Life Ins. Co., 387 U.S. 202 (1967). 114 S. Ct. at 527.

83. *Id.*

84. *Id.* at 528 (emphasis added).

85. *Id.*

86. *Id.*

87. *Id.*

88. *Id.* at 528-29. Hancock wanted the Court to follow Mack Boring & Parts v. Meeker Sharkey Moffitt, Actuarial Consultants of N.J., 930 F.2d 267 (3d Cir. 1991).

89. *Id.* at 528.

90. *Id.* at 529.

91. *Id.*

92. The DOL has enforcement responsibility for ERISA along with Department of the Treasury. *Id.* at 529-30 n.14.

93. *Id.* at 529.

attempted to give it,[94] and (2) the DOL declined to file a brief in the Second Circuit Court of Appeals when given the opportunity to do so stating the need to fully consider all of the issue's implications.[95] In conclusion, the majority affirmed the Second Circuit's holding that the free funds, in excess of those necessary to provide guaranteed benefits, of a group annuity contract do not qualify for ERISA's guaranteed benefit policy exclusion to the extent that those funds are subject to the discretionary management of the insurer thereby binding the insurer to ERISA's fiduciary obligations.[96]

Absent a change implemented by Congress, the Supreme Court's holding in Hancock finalizes the dispute over ERISA's application of its fiduciary requirements. The test is which party, insurer or insured, bears the allocation of risk.[97] The effects of this decision could be substantial as insurance companies hold more than $332 billion in their general accounts pursuant to group annuity contracts with pension plans.[98] The decision in *Hancock* may usher in a massive wave of litigation over the terms of group annuity contracts similar to GAC50.[99] Potential problems also include the disruptions and costs of the administrative changes companies would be forced to undertake including segregation of plan-related assets into segmented or separate accounts, and reallocation of operating costs to other policy holders,[100] as well as the extremely high costs of lobbying Congress for the changes.[101] Furthermore, since the DOL's stance is at odds with the decision in *Hancock*, unless the courts choose to, the DOL will not be looked to since agency interpretations at odds with the plain language of the statute are not given deference.[102] It would seem the only relief available to insurance companies would be to make changes necessary to conform to *Hancock* or present their views to Congress and hope the statute is adjusted.[103] Until Congress alters the statute, however, each insurance company will have to inspect its products to see which ones, if any, fall outside the guaranteed benefit policy exclusion due to a lack of guaranteed rates of return and conversion mechanisms to buy annu-

94. *Id.* at 530.
95. *Id.* at 531.
96. *Id.* at 529.
97. *Id.* at 532 (Thomas, J., dissenting).
98. *Id.* at 531-32.
99. *See supra* note 34, at 3.
100. 114 S. Ct. at 531.
101. Rozmus, *supra* note 39, at 852-53.
102. *Id.*
103. *Id.*

ities.[104] If insurers take heed, they should be able to avoid future litigation regarding breaches of fiduciary obligations. The most obvious step for insurance companies would be to segregate their assets and allocate certain assets to free funds on specific contracts.[105] Insurance companies can also avoid litigation by amending the group annuity contracts to include a minimum annuity rate guarantee and a minimum guaranteed return.[106] These changes would likely influence a court to find the investment risk lies with the insurer rather than the insured, thereby placing the contract outside the fiduciary scope. Since one of the main points the Court based its decision on was that Hancock could set the annuity purchase rates at whatever level it desired, these changes would work since it would eliminate this element.[107] Overall, the holding of *Mack Boring* would allow ERISA's fiduciary requirements to focus on a limited goal that ERISA could not have been meant to accomplish.[108] An argument will always arise over how the Court looked outside ERISA to cases from the 1930's dealing with the Securities Act of 1933 to reach its result in *Hancock*.[109] Despite the means employed by the Court, the end it reached was the proper one. ERISA was meant to protect the insured not the insurer.

SHANE C. DELEON

104. *See supra* note 34, at 3.
105. 114 S. Ct. at 536 (Thomas, J., dissenting).
106. *See supra* note 34, at 3.
107. *Id.*
108. *Id.*
109. 114 S. Ct. at 534.