A Timely Analysis of Legal Developments

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10th Circuit Puts Another Nail in the Coffin for Cash Balance Plan Litigation

By Susan Hoffman

It's been a roller coaster ride for cash balance plans during the past 20 years or so – first the darlings of the benefits world, then the devil incarnate. Now, are they again the savior of the defined benefit plan or have they been rendered largely irrelevant? And what of all of the frightful litigation – is it over, or are we still suffering through the agonies of these cases? On August 11, 2011, the Tenth Circuit issued its decision in *Tomlinson v. El Paso Corporation*, addressing most of the issues that remain and again finding in favor of the plan sponsor.[1]

What Is a Cash Balance Plan?

A cash balance plan is a defined benefit plan, which means that the benefit is defined pursuant to a formula, the employer contributes to a trust fund that is designed to accumulate sufficient funds to pay the promised benefits, and the participant receives the promised benefits regardless of the investment performance of the trust fund. The employer guarantees the trust fund's sufficiency, and, if the employer is unable to pay any trust fund shortfall, the federal Pension Benefit Guaranty Corporation guarantees the benefit up to a statutory maximum.[2]

In a traditional defined benefit plan, a participant's annual retirement benefit is based on a benefit factor (either a fixed dollar amount or a percentage of average or final average compensation) multiplied by the participant's years of service at retirement. In a cash balance plan, the participant's benefit is stated as a cash balance as of any given date, but the cash balance is a nominal bookkeeping account, rather than a separate account within the trust fund. El Paso's cash balance plan is typical – the cash balance includes:

- An opening balance – usually the prior benefit converted to a lump sum value (in the case of a conversion from a traditional defined benefit plan)[3] – newly hired employees start with zero;
- Annual "pay credits" equal to a percentage multiplied by the participant's earnings for the current year;[4]
- "Interest credits" equal to the cash balance for the prior year, multiplied by an interest factor reflecting current interest rates.

The participant's annual pension benefit is the actuarially-equivalent annuity that can be "purchased" by the cash balance. Unlike a defined contribution plan, however, the interest credited to the participant's cash balance is not subject to the risks of investment fluctuations. The employer guarantees the payment of accrued benefits just as the employer guarantees the benefits under any defined benefit plan. The cash balance plan works like a defined contribution plan where the employer guarantees the rate of return (with the Pension Benefit Guaranty Corporation acting as the back-up guarantor, just as in all other defined benefit plans).

Just as cash balance plans act like defined contribution plans with a guaranteed return, the benefit accrual pattern of a cash balance plan also acts like a defined contribution plan – the benefit accrues evenly throughout the employee's employment. Converted to an annuity at age 65, the annuity that can be purchased for a younger employee with a given contribution is much higher than the benefit that can be purchased for an older employee receiving the same contribution – primarily because the younger employee's "account" will have many more years to earn compound interest before being drawn down at retirement to fund the annuity. The *El Paso* plaintiffs argued that because the annuity was lower for an older employee than for a younger employee with the same salary and years of service, the accrued benefit violated the Age Discrimination in Employment Act's (ADEA) prohibition against a reduction in the rate of benefit accrual based on age.

Another feature of the El Paso cash balance plan was a transition feature that allowed older employees to keep their "old" formula for five years after the conversion date – they could retire with the higher of the old formula or the cash balance. Once the five-year period ended, the cash balance was usually less valuable for longer term employees than the now-frozen benefit, resulting in a number of years in which the employees would not earn any additional retirement benefits until the cash balance caught up to the frozen benefit. This phenomenon is known as "wearaway." The plaintiffs argued that the wearaway provision violated the ADEA because it affected only older employees, and that it resulted in a technical violation of the Employee Retirement Income Security Act's (ERISA) anti-backloading rules – a requirement that a future accrual rate cannot be higher than an earlier accrual rate (since the rate is zero in a year subject to wearaway, any future accrual is by definition higher).

Finally, as in many of the other cash balance cases, the plaintiffs argued that El Paso violated the notice requirement of section 204(h) of ERISA – if the cash balance design resulted in a significant reduction in the rate of benefit accrual, ERISA requires specific notice prior to the effective date, and the plaintiffs asserted that improper notice was given. They also argued that the summary plan description (SPD) and other notices inadequately described the wearaway feature.

The Age Discrimination Problem

The plaintiffs in *El Paso* claimed that the cash balance design violated two ADEA provisions. Section 4(i) makes it unlawful for an employer to maintain a defined benefit plan that permits "the cessation of an employee's benefit accrual or the reduction of the rate of an employee's benefit accrual, because of age." And section 4(a) generally prohibits discrimination against employees over age 40 on account of age.

In addressing claims like these, the courts have focused on one seemingly-simple question: What does the ADEA mean by "rate of benefit accrual?" The plaintiffs argue that the term "rate of benefit accrual" refers to the portion of a participant's age-65 annuity that is earned each year. If the pay crediting rate is the same for employees at every age, the dollars added to a younger employee's cash balance account will buy a higher age-65 annuity than the dollars added to an older employee's cash balance account, even though the two might have the same compensation.

The defendants observe that the statutes do not define the term "rate of benefit accrual" and that the term "accrued benefit" has various meanings in different places in the Internal Revenue Code (the Code) and ERISA. Because the participant's benefit in a cash balance plan is based on the cash balance, defendants argue that it is appropriate to look only at the annual increase in the cash balance, which is identical for all participants. They also note that the age-65 annuity is relevant only if the participant leaves the benefit in the plan until age 65, which rarely occurs in a cash balance plan. Since the younger employee receives the same lump sum at termination of employment (regardless of age) as an older employee with similar compensation and service, the rate of benefit accrual is the same.

In *Cooper v. IBM Personal Pension Plan*[5] the district court held that the IBM cash balance plan violates the ADEA rule because the rate of benefit accrual – stated as the annual addition to the participant's age-65 annuity benefit – was smaller for older participants than for younger participants. The decision was reversed by the Seventh Circuit in memorable language referring to the law as requiring testing of the "inputs" to the benefit rather than the "output" received at retirement. In *Register v. PNC Financial Servs. Group, Inc.*,[6] the Third Circuit followed the lead of the Seventh Circuit and held that cash balance plans do not violate the age discrimination prohibitions in ERISA and the ADEA, based on "inputs" rather than "outputs." And then the Second, Sixth and Ninth Circuits followed suit.[7] The Tenth Circuit in *El Paso* had no trouble adopting the "inputs" analysis.

The plaintiffs then turned to their claim under ADEA section 4(a)(1), claiming that because the wearaway affected only older employees, and because the accrued benefit was higher for younger employees than for older employees with similar compensation, the plan violates the ADEA's general prohibition against discrimination on account of age with respect to any individual's "compensation, terms, conditions, or privileges of employment." The Tenth Circuit similarly rejected these claims, holding that section 4(i) is the only provision in the ADEA that regulates benefit accrual. In the words of the Tenth Circuit, "compliance with § 4(i) satisfies § 4, period." Then, the court noted that the wearaway was a result of treating the older workers *better* than the younger workers – there would be no wearaway if they had been not allowed to continue their old benefit formula for five years during the transition period. Therefore, there was no violation of section 4(a) resulting from the wearaway.

Backloading

The anti-backloading rules are contained in section 411(b) of the Code and in section 204(b)(1) of ERISA, and are designed to prevent an employer from evading the vesting rules by "loading" benefit accruals into the later years of a participant's service. For example, if the participant accrues only 1% of his or her ultimate retirement benefit in each of the first 20 years, and then 20% of the ultimate benefit in each of the next four years, the employer has essentially imposed a 20-year vesting rule on 80% of the retirement benefit. The anti-backloading rules prevent this abuse by requiring the plan to satisfy any one of three available rules that generally require either front-loading of benefits or a smooth benefit accrual throughout an employee's service.

In Notice 96-8, the IRS observed that cash balance plans generally will only be able to satisfy the 133 1/3% test set forth in section 204(b)(1)(B) of ERISA, which requires the rate of benefit accrual in any given year *after* each tested year to be no greater than 133 1/3% of the rate of benefit accrual for any earlier year *after* the tested year. If the employee is required to remain employed in order to receive interest credits, the interest credits on the already-accrued cash balances would be considered to be part of the future years' benefit accruals. Since the benefit accrual rate would then increase exponentially as the participants' cash balances increased, this design would violate the backloading rule. But if interest credits are earned without regard to future employment, so long as the participant does not withdraw his or her accrued benefit, the IRS would consider the "right" to future interest credits to be part of the benefit accrued in each year. In other words, each year's pay credit would carry within it the inherent right to receive future interest credits. Under that scenario, a cash balance plan generally will not violate the backloading rules (unless the interest credit is very small), as long as any increase in pay credits (for older or longer-service workers) satisfies the 133 1/3% rule (taking into account interest credits built into the pay credit).

The plaintiffs in *El Paso* ignored this analysis to focus only on the wearaway effect, and argued that because the accrual rate of a participant in his wearaway period is zero, once the wearaway ends and the cash balance becomes greater than the frozen benefit, the accrual rate by definition exceeds 133 1/3% of zero. The plaintiffs supported their argument by citing Revenue Ruling 2008-7 and Treasury Regulation section 1.411(b)-1(a). The IRS recognized that the backloading regulation ignores accrual rates under a pre-amendment formula in testing accrual rates after a plan amendment. But the regulation also says that when benefits are accrued under a "greater of" provision (with reference to two different formulas), the benefits are tested under both formulas, whichever is applicable at any given time. Therefore, when there is an amendment converting a final average pay plan to a cash balance plan, and some participants (as in *El Paso*) are allowed to continue to accrue under the old formula for some period of time while accumulating cash balance credits, the wearaway at the end of the double-accrual period will (in the view of the IRS) result in a backloading violation when the wearaway period ends and benefits again start accruing under the cash balance formula.

In the Ninth Circuit's *Hurlic* decision, the same issue was raised. Noting that the IRS view essentially punishes employers for being generous to older workers (by allowing them to continue to accrue benefits under the old formula for a limited period of time), and that it clearly was not a situation that abused the vesting requirements of ERISA (the basis for the anti-backloading rules), the Ninth Circuit held that the IRS interpretation was not entitled to deference and therefore the plan did not violate ERISA. In *El Paso*, the Tenth Circuit found the Ninth Circuit's opinion to be far more persuasive than the IRS's (and for the same reasons). The Tenth Circuit also noted that the IRS had declined to make Revenue Ruling 2008-7 applicable to the tax status of plans before January 1, 2009. The Tenth Circuit refused to apply an IRS rule that the IRS had itself refused to apply.

Notice Requirements

As with many of the other cash balance cases, the Tenth Circuit held that the pre-1999 version of section 204(h) of ERISA only required that El Paso notify its participants of the fact of the amendment, its contents, and the effective date. Unlike some other courts, the Tenth Circuit did not seem concerned that the notice was given before the actual date of the adoption of the plan amendment (which was a technical requirement of the pre-1999 version of the statute). The court disagreed with the Ninth Circuit's determination in *Hurlic* that section 204(h) required explicit warning of the wearaway feature, and in any event found that there was enough specificity in the El Paso notice to let participants know what their new formula would be, that it was not as good as the old formula, and that in some instances there would be a reduction in the rate of future benefit accruals. The court also rejected plaintiffs' creative argument that because the wearaway ended after 1999, the "new" version of section 204(h) was applicable and required new, more explicit notice under the revised version of section 204(h).

Finally, the Tenth Circuit dismissed plaintiffs' claims that the SPD was inadequate because it did not include specific information about the wearaway period and the benefit reductions. The court found that a wearaway provision was a consequence of the change of the plan's benefit formula, and does not have to be explicitly disclosed as long as the benefit formula is disclosed. Because the SPD did explain the manner of conversion and the new benefit formula, there was no disclosure violation and therefore the court did not have to reach the question of whether any failure to disclose the wearaway provision resulted in "actual harm" to plaintiffs (as required by the Supreme Court's recent decision in *CIGNA Corp. v. Amara*[8]).

Conclusion

Between the now-unanimous decisions of the Courts of Appeals upholding cash balance plans against ADEA challenges, and the new ERISA provisions explicitly blessing cash balance designs, it is expected that plaintiffs' lawyers will find these cases considerably less attractive..

Susan Hoffman is a Shareholder in Littler Mendelson's Philadelphia office. If you would like further information, please contact your Littler attorney at 1.888.Littler, info@littler.com, or Ms. Hoffman at shoffman@littler.com.

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[1] Darren Nadel, a Shareholder in Littler Mendelson's Denver office, successfully represented El Paso Corporation.

[2] Under ERISA, a retirement plan is either an individual account plan or a defined benefit plan. An individual account plan provides only the contributions credited to the participant's account, adjusted for actual earnings and losses. Because the cash balance plan effectively guarantees the earnings in the form of interest credits, the cash balance plan is not an individual account plan. See ERISA § 3(34) and § 3(35).

[3] In some cash balance conversions, the heritage plan benefit is frozen, and the cash balance starts at zero. This is the design that is favored by the Pension Protection Act's rules on conversions after June 29, 2005. ERISA § 204(b)(5)(B)(ii).

[4] The pay credit increases as the participant ages and earns additional service.

[5] 274 F. Supp. 2d 1010 (S.D. Ill. 2003), *reversed*, 457 F.3d 636 (7th Cir. 2006), *cert. denied*, 127 S. Ct. 1143 (2007).

[6] 477 F.3d 56 (3d Cir. 2007).

[7] *Hirt v. Equitable Retirement Plan*, 533 F.3d 102, 107-108 (2d Cir. 2008); *Drutis v. Rand McNally & Co.*, 499 F.3d 608 (6th Cir. 2007); *Hurlic v. Southern Cal. Gas Co.*, 539 F.3d 1024 (9th Cir. 2008).

[8] 131 S. Ct. 1866 (2011).