REGULATION

# ERISA FIDUCIARY DUTY AND OTHER LEGAL CONSIDERATIONS IN CASH BALANCE PLAN CONVERSIONS

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When converting a traditional defined benefit pension plan to a cash balance pension plan, certain legal issues may arise under the Employee Retirement Income Security Act of 1974, as amended (ERISA) and the Internal Revenue Code of 1986, as amended (the Code).

A cash balance pension is a defined benefit plan that resembles a defined contribution plan in that the employee's promised benefits are stated in terms of an account balance (although the account is hypothetical and is used only to conceptualize the amount of benefits the employee has accrued). Cash balance plan accounts typically consist of employer contributions that are a percentage of participants' compensation (called "pay credits") and interest earned on those contributions (called "interest credits"). The interest credits are typically set at a specified rate, thereby protecting participants from investment risk and effectively promising a specified benefit at normal retirement age (unlike a defined contribution plan).

Cash balance pension plans enjoyed a dramatic rise in the 1980s and 1990s, in part due to their relatively simple administration and ability to provide plan sponsors with more certainty in terms of funding liability (as compared to traditional defined benefit plans using final average earnings or similar benefit formulas). They also provide participants with more clarity in terms of the amount of their ultimate retirement benefit. Unfortunately, as the number of cash balance pension plans rose, so too did the frequency of litigation surrounding the conversion to cash balance pension plans.

## BASES FOR LITIGATION

As a general matter, an employer's decision to convert a traditional defined benefit plan to a cash balance plan isn't subject to ERISA's fiduciary standards. This is because the act of establishing or amending a pension plan is a corporate act, or "settlor" function, and not a fiduciary act. As a result, except with respect to notice and disclosure issues, it's unlikely that a plan sponsor would be found to have breached ERISA's fiduciary duty standards when establishing the terms of a cash balance conversion, including determining how participants' opening account balances are established.

Consequently, cash balance claims generally challenge the structure of the cash balance plan itself or, in some cases, the adequacy and accuracy of participant communications. Specifically, litigation with respect to cash balance plans has generally centered around three issues—age discrimination, "whipsaw" claims, and inaccurate and misleading disclosure regarding plan terms and benefits.

*Age Discrimination.* Age discrimination claims have been primarily based on two legal theories—the "rate of benefit accrual" theory and the "wear-away" theory. Under the "rate of benefit accrual" theory, plaintiffs have argued that the cash balance structure is inherently discriminatory against similarly situated older employees because the amount of pay credits credited to younger employees' accounts for any year would earn more interest credits than older employees' accounts on the same amount of pay credits, simply because younger employees have more years to earn interest credits.

The second theory advanced by plaintiffs in cash balance age discrimination cases involves the concept of "wear-away." Wear-away occurs when the value of the employee's accrued benefit under the traditional defined benefit plan formula exceeds the opening balance of the employee's hypothetical account under the cash balance plan. In this situation, a participant's accrued benefit may not increase for a number of years until the new cash balance benefit, including any opening balance, grows to be larger than (*i.e.*, "wears-away") the frozen accrued benefit under the traditional benefit plan.

*"Whipsaw" Claims.* In a cash balance plan, the pension amount to be distributed to a participant is calculated by projecting the participant's hypothetical account balance to normal retirement using the plan's interest credit rate and converting the projected account balance to an annuity based on the plan's annuity conversion factor. The annuity is then reconverted back to a lump sum and discounted to the present value using the rate set forth in Code Section 417(e). Under the whipsaw theory, participants allege that when the plan interest rate that is applied to project their hypothetical account balances to normal retirement (*i.e.*, the "projected rate") is higher than the Code Section 417(e) discount rate used to determine the present-value lump-sum, payment of an amount equal to the hypothetical account balance is less than it should be based on the present-value lump-sum. Participants also allege that using a projected rate that is less than the plan's stated interest credit rate results in an impermissible forfeiture of accrued benefits.

*Inaccurate and Misleading Disclosure.* Participants who believe that they have been adversely affected by a conversion have alleged that the plan fiduciaries breached their fiduciary duties by failing to accurately disclose the allegedly negative impact the conversion would have on older workers.

## EFFECT OF PPA ON CASH BALANCE LITIGATION

The Pension Protection Act of 2006 (PPA) provides a safe harbor for cash balance plans from the antidiscrimination provisions of ERISA, the Code, and the Age Discrimination in Employment Act (ADEA), and largely eliminated age discrimination and whipsaw claims prospectively, from June 29, 2005.

In order to meet the PPA antidiscrimination safe harbor, a participant's accrued benefit under the cash balance plan must be at least as great as that of any similarly situated younger individual—an individual who is identical in every respect, including period of service, compensation, position, date of hire, work history, etc., except age—who is or could be a participant in the plan. In addition, the PPA prohibits the use of wear-away provisions previously used in many defined benefit plan conversions. As a result, if a traditional defined benefit plan is converted to a cash balance plan, a participant's accrued benefit must be the sum of (1) his or her accrued benefit determined before the conversion, plus (2) the benefit accrued for years of service after the conversion.

The PPA also contains a provision intended to eliminate the effects of whipsaw. Under the PPA, a cash balance plan may pay out to an employee a lump-sum distribution equal to the participant's hypothetical account balance. However, in order to meet the antidiscrimination requirements, the PPA requires that the plan use an interest credit rate that is not greater than a market rate of return (although the plan may provide for a minimum rate of return or a rate of return that is the greater of a fixed or variable rate of return).

## LEGAL ISSUES POST-PPA

*Cases Involving Years Prior to PPA Effective Date.*
Although the PPA changes described above are made effective for plan years beginning on or after June 29, 2005, the PPA specifically left resolution of age discrimination as well as whipsaw issues under prior law to the courts.

While plaintiffs had some early success under the age discrimination claims under pre-PPA law, all federal circuit courts of appeal that have addressed the issue have held that the operation of cash balance plans doesn't constitute age discrimination, but is simply a natural consequence of the time value of money [*Hurlic v. Southern California Gas Company*, 539 F.3d 1024 (9th Cir. 2008); *Hirt v. Equitable Ret. Plan for Employees, Managers and Agents*, 533 F.3d 102 (2d Cir. 2008); *Register v. PNC Fin. Servs. Group, Inc.,* 477 F.3d 56 (3d Cir. 2007); *Drutis v. Rand McNally & Co.*, 499 F.3d 608 (6th Cir. 2007); *Cooper v. IBM Personal Pension Plan*, 457 F.3d 636 (7th Cir. 2006)].

These courts have found ADEA compliance on a "contributions" basis (*i.e.*, that the rate of benefit accrual is measured by the pay and interest credits provided each year) and not by the ultimate amount of retirement benefits available at normal retirement age.

And with respect to wear-away claims, those federal circuit courts of appeal that have addressed the issue have held that the occurrence of a wear-away due to a conversion to a cash balance plan does not violate the anti-cutback rules (*Hurlic* at 1033; Register at 70-72). Of course, these holdings only apply to litigation in the jurisdictions of the specific circuit courts. As a result, cash balance plans in other jurisdictions may be subjected to potential litigation based on age discrimination claims under pre-PPA law.

In addition to antidiscrimination issues under ERISA, the Code, and ADEA, plan sponsors will also need to consider state age discrimination laws to the extent not preempted by ERISA. In addition, when converting to a cash balance plan, plan sponsors should be mindful of breach of contract or other similar common law causes of action as well as claims based on the federal common law of promissory estoppel (to the extent not preempted by ERISA).

Thus, while the rejection by federal circuit courts of appeal of the argument that cash balance plans are inherently age discriminatory has significantly reduced the uncertainty surrounding cash balance plans, the issue is far from settled for cases involving years before the effective date of the PPA amendments.

With respect to whipsaw claims, prior to the PPA several courts held that ERISA required plans to follow the procedure described in IRS Notice 96-8 and project participant account balances forward to normal retirement age at the plan's annual interest crediting rate and convert them to an annuity that would then be reconverted to a present-value lump sum using the Code Section 417(e) rates. This would ensure that lump-sum payments weren't less than the present value of the projected annuity [*Berger v. Xerox Corp. Retirement Income Guarantee Plan*, 338 F.3d 755 (7th Cir. 2003); *Esden v. Bank of Boston*, 229 F.3d 154 (2d Cir. 2000); *Lyons v. Georgia-Pacific Corp. Salaried Employees Ret. Plan*, 221 F.3d 1235 (11th Cir. 2000), cert. denied, 532 U.S. 967 (2001)]. Because the whipsaw provision under the PPA applies to distributions made after August 17, 2006, litigation may still arise regarding lump sums paid to employees before the Act was passed (Congressional Research Service Report RS22214, *Cash Balance Pension Plans: Selected Legal Issues*, by Jennifer Staman and Erika Lunder).

*ERISA Fiduciary Issues with respect to Disclosure and Communication.*
While employers are generally free to adopt, modify, or terminate cash balance pension plans for any reason at any time, if employers provide inadequate disclosure to employees or actively mislead employees in connection with such adoption, modification, or termination, ERISA fiduciary issues may arise. Specifically, being deceitful to employees about benefit plan changes is a breach of the employer's fiduciary duties [*Varity Corp. v. Howe*, 516 U.S. 489 (1996)].

With respect to converting a traditional defined benefit plan to a cash balance plan, ERISA fiduciary liability may arise if disclosures relating to the conversion [*e.g.*, ERISA Section 204(h) notice, summary of material modifications, or summary plan description] are inaccurate or misleading. In fact, there continues to be a fair number of cases relating to insufficient or misleading disclosures [See, e.g., *Engers v. AT&T, Inc.*, 2011 WL 2507089 (3d Cir. June 22, 2011); *Tomlinson v. El Paso Corp.*, 653 F.3d 1281 (10th Cir. 2011); *Jensen v. Solvay Chemicals, Inc.,* 625 F.3d 641 (10th Cir. 2010); *Lonecke v. Citigroup Pension Plan*, 584 F.3d 457 (2d Cir. 2009)].

This may be because converting to a cash balance plan and properly notifying participants of the conversion and applicable changes is a complicated process, and mistakes can be made. In addition, plan sponsors may have a tendency to sugar-coat potential (or actual) benefit reductions.

For example, in a recent U.S. Supreme Court case that involved the conversion of a traditional defined benefit plan to a cash balance plan [*CIGNA Corp. v. Amara*, 131 S.Ct. 1866 (2011)] the plan sponsor made certain assurances in the summary plan description that the new cash balance plan would significantly enhance and provide an overall improvement in retirement benefits. The trial court held that the summary plan descriptions were incomplete, inaccurate, and intentionally misleading because they failed to make known certain features that placed a large number of participants in a worse position under the new plan. The Supreme Court, while holding that plan participants may not sue for unpaid benefit payments under the terms of the plan on the basis of misleading or erroneous language in plan summaries, stated that plan participants might be able to obtain a similar result by bringing a suit under ERISA's fiduciary provisions against those responsible for preparing the erroneous summary plan description language.

Thus, in order to guard against potential fiduciary breach claims, plan sponsors should ensure that all plan communication materials regarding a cash balance plan conversion are carefully checked for adequacy and accuracy. In addition, plan sponsors must not only point out the positives in benefit changes, but also the negative impact on participants. PC

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