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## Much Ado About the Meaning of "Benefit Accrual": The Issue of Age Discrimination in Hybrid Cash Balance Plan Qualification Is Dying but Not Yet Dead, 40 J. Marshall L. Rev. 867 (2007)

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# MUCH ADO ABOUT THE MEANING OF “BENEFIT ACCRUAL”: THE ISSUE OF AGE DISCRIMINATION IN HYBRID CASH BALANCE PLAN QUALIFICATION IS DYING BUT NOT YET DEAD

BARRY KOZAK\* AND JOSHUA WALDBESER\*\*

In the world of qualified retirement plans,<sup>1</sup> there are only two choices for a for-profit employer to deliver retirement benefits to its employees: through a defined contribution plan,<sup>2</sup> or through a defined benefit plan.<sup>3</sup> They look, act (and yes, smell) different, and the rules in the Internal Revenue Code (“I.R.C.” or “Code”) and ERISA that attach to and govern qualified plans are sometimes

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1. A qualified plan is a retirement plan that meets all of the requirements of 26 U.S.C. § 401(a), as amended, such that the sponsoring employer will get an immediate tax deduction for contributions made to the plan under 26 U.S.C. § 404(a), the participants and beneficiaries of the plan will not generally pay taxes on their retirement benefits until actually received under 26 U.S.C. § 402(a), and since the assets generally need to be invested in a trust that is tax-exempt under 26 U.S.C. § 501(a), no income taxes are paid in the interim.

2. See basically identical definitions at 26 U.S.C. § 414(i) and § 3(34) of The Employee Retirement Income Security Act of 1974 (“ERISA”), P.L. 93-406, 88 Stat. 829 (codified in scattered sections of 29 U.S.C.).

3. See basically identical definitions at 26 U.S.C. § 414(j) and ERISA § 3(35).

quite different for defined contribution plans than for defined benefit plans. One of those important differences is how Congress seeks to prevent age discrimination in qualified plans with what appear to be stricter rules for defined benefit plans than for defined contribution plans.

A cash balance plan<sup>4</sup> is a hybrid plan that has been developed over time by attorneys, actuaries, accountants, and other benefits professionals to mimic the individual account aspects of defined contribution plans while remaining grounded with the guaranteed component of the defined benefit plan (here, the investment earnings and the annual contribution credits are usually guaranteed).<sup>5</sup> Therefore, since benefits are not based *solely* on the accumulation of contributions, forfeitures and fund earnings, the plan is by definition a defined benefit plan and not a defined contribution plan.

This cash balance design enjoyed great viability and growth in the mid 1980s through the mid 1990s in the absence of any specific rules, and its plan sponsors and administrators attempted to comply with the qualification rules applicable to all defined benefit plans. Then the lawsuits began, and some of the loudest cries were about age discrimination.<sup>6</sup> Congress finally endorsed the cash balance design in the Pension Protection Act of 2006<sup>7</sup> ("PPA") by carving out a special rule that allowed cash balance plans to meet the age-discrimination requirements, but did so only on a prospective basis. Around the same time, existing cash balance plan sponsors found a welcome ally in the influential and economically savvy Seventh Circuit<sup>8</sup> in their defense against age discrimination claims arising from past events. However, while the news of late has been generally favorable for the general concept of a cash balance plan, significant pockets of potential liability continue to fester. The holding of the Seventh Circuit in *Cooper v. IBM Personal Pension Plan*<sup>9</sup> is limited in application to

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4. Before 2006, a common plan design that was a hybrid between a defined benefit plan and defined contribution plan was referred to as a cash balance plan. As discussed below, the legal name now assigned is either "statutory hybrid plan" or "applicable defined benefit plan" (the authors will use the former term in this Article where appropriate in lieu of cash balance plan).

5. For a discussion of the various advantages of, and reasons behind the explosive growth of cash balance plans, see generally Barry Kozak, *The Cash Balance Plan: An Integral Component of the Defined Benefit Plan Renaissance*, 37 J. MARSHALL L. REV. 753 (2004).

6. As discussed below, class-action plaintiffs concurrently allege age discrimination violations of both ERISA and the Age Discrimination in Employment Act of 1967 ("ADEA"), P.L. 90-202, 81 Stat. 602.

7. P.L. 109-280, 120 Stat. 780 (Aug. 17, 2006) [hereinafter "PPA"].

8. *Cooper v. IBM Personal Pension Plan*, 457 F.3d 636 (7th Cir. 2006), cert. Denied 127 S. Ct. 1143 (Jan. 16, 2007).

9. *Id.*

its own subordinate jurisdictions, and adoption of its rationale (and result) by other courts has been a mixed bag — some on board, some not, some having yet to be heard.<sup>10</sup> This Article will analyze the remaining legal issues, including age-discrimination claims for cash balance plans in existence before June 29, 2005.

First, this Article will explain how a statutory hybrid plan with a cash balance design works. Second, this Article will explore the age-discrimination prohibitions for all defined benefit plans prior to the PPA, outline the prospective changes made by the PPA, and then provide a comprehensive analysis of *Cooper's* strengths and weaknesses as precedent. Third, this Article will highlight the non-age discrimination issues remaining unresolved and still being litigated for older cash balance plans. Finally, this Article will summarize the advantages and disadvantages of the cash balance plan design after the changes made by the PPA. The authors hope that this Article will demonstrate that, going forward, employers that want to provide retirement benefits through a qualified plan having the guarantees of a defined benefit plan but has the look and feel of a defined contribution plan will be able to accomplish their business goals through a statutory hybrid plan with a cash balance design.

### I. WHAT IS A HYBRID PLAN?

Even after the amendments made by the PPA, only two mutually exclusive types of qualified retirement plans exist: defined contribution plans and defined benefit plans. Before the PPA (and subsequently Notice 2007-6) provided specific legal terms, consultants referred to hybrid plan designs combining attributes of defined contribution and defined benefit plans as "cash balance plans," "pension equity plans," "defined lump sum plans," "personal account plans," "life cycle plans," or "cash account plans." Going forward, however, the actual legal term for any hybrid design is either "applicable defined benefit plan"<sup>11</sup> or "statutory hybrid plan."<sup>12</sup> For purposes of this Article, they will be referred to as "statutory hybrid plans." Regardless of the labels given these hybrid pension plans, however, they are now absolutely, without question, a subset of defined benefit plans, and a thorough understanding of a defined benefit plan is required before advising a client on a hybrid design.<sup>13</sup>

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10. See *infra* Part II(B).

11. Sections 701(a)(2) and (b)(2) of the PPA adds new sections at ERISA § 203(f) and 26 U.S.C. § 411(a)(13), respectively.

12. I.R.S. Notice 2007-6, 2007-3 I.R.B. 272.

13. For a more comprehensive discussion of the difference between defined benefit plans and defined contribution plans, see Barry Kozak, *Cash Balance Plans: Still a Good Program if We Look to the Logic From Eaton and BankBoston Rather than from IBM*, 11 J. OF PENSION BENEFITS 29, 29-36

A defined contribution plan is an individual account plan where benefits at retirement are based *solely* on the accumulation of contributions, forfeitures, and earnings within the individual account.<sup>14</sup> A defined benefit plan is any qualified plan that is not a defined contribution plan.<sup>15</sup> Therefore, if a plan either does not have individual accounts, or if it has individual accounts, but the benefits are not based *solely* on the accumulation of the account, then by legal definition the plan is a defined benefit plan, regardless of how the plan is drafted, administrated, or communicated.

Common defined contribution plan types include a profit sharing plan, a money purchase plan, a 401(k) cash or deferred arrangement, and an employee stock ownership plan. A participant in any of these defined contribution plans easily understands the value of his or her benefits in the plan because the benefit statement will show the ending account balance as of the prior valuation date, contributions and forfeitures added to the account during the current valuation period, and the appreciation in market value. This easily understood value of benefits at any time is the key characteristic to a hybrid plan design: employers can provide a guaranteed defined benefit promise by communicating it to the employee as an immediate account instead of an annuity payable at normal retirement age.<sup>16</sup>

In a statutory hybrid plan, the accounts that are created through the plan design are hypothetical or notional accounts that are not truly individual accounts, as that term is used for defined contribution plans. In addition, a guaranteed interest rate is generally credited to these hypothetical accounts (even if it is a floating market rate). Thus, falling outside of the legal requirement for defined contribution plans that benefits must be based *solely* on the accumulation of account. For these reasons, and because Congress said so through the PPA, statutory hybrid plans are defined benefit plans and must comply with all of the rules associated with defined benefit plans described elsewhere in the Code and in ERISA.

Basically, a statutory hybrid plan established after the effective date of the PPA expresses the accrued benefit<sup>17</sup> as a

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(2004).

14. 26 U.S.C. § 414(i) (emphasis added).

15. 26 U.S.C. § 414(j).

16. 26 U.S.C. § 411(a)(7)(A)(i) requires an employee's accrued benefit under a defined benefit plan to be expressed in the form of an annual benefit commencing at normal retirement; whereas 26 U.S.C. § 411(a)(7)(A)(ii) requires an employee's accrued benefit under a defined contribution plan to be expressed in the form of the balance of an employee's account (at any point in time).

17. Under the PPA, the term accrued benefit is still used, but for purposes of determining the accrued benefit in a statutory hybrid plan, it must be the

balance in a hypothetical account or as an accumulated percentage of final average compensation subject to the following rules<sup>18</sup>. First, in order to comply with the age discrimination rules (discussed in Part II of this Article), any participant's accrued benefit must be equal to or greater than any similarly situated younger person's accrued benefit.<sup>19</sup> Second, the interest crediting rate cannot be greater than a market rate defined through regulations<sup>20</sup>; it could be a guaranteed rate that is equal to the greater of a fixed or variable rate, but if it is a variable rate, then upon termination it must equal the average of the rates of returns for the prior five years. Third, the hypothetical account balance may *not* be subject to the minimum lump sum rules for other defined benefit plans under I.R.C. § 417(e). Fourth, accrued benefits must be fully vested within three years of service. Finally, if a traditional defined benefit plan is converted into a statutory hybrid plan, then the preserved benefit from the old plan must be added to all new accruals from the new plan.

## II. PREVENTING AGE DISCRIMINATION IN QUALIFIED PENSION PLANS

### A. *General Age Discrimination Rules*

All qualified plans must comply with multiple requirements,<sup>21</sup> including prohibitions against age discrimination. The drafters of ERISA adopted different standards (as amended by the OBRA<sup>22</sup>) for preventing age discrimination in defined contribution plans and defined benefit plans. In defined contribution plans, the plan document must contain provisions that allocate any contributions into the plan among the various participant accounts. As described later, this relates to input (i.e., how much money goes into the respective individual accounts). The level of allocations (i.e., input) is dictated by the Code as to the maximum annual addition<sup>23</sup> and as to the prohibition against discrimination in favor

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benefit accrued to date. In Notice 2007-6, Treasury introduces the term "accumulated benefit," which is only applicable in statutory hybrid plans and means the accrued benefit that has been accrued to date.

18. 26 U.S.C. § 411(b)(5), as amended by the PPA.

19. *See infra* Part II.

20. Notice 2007-6 provides some safe harbors, pending future guidance.

21. See the list of requirements in 26 U.S.C. § 401(a).

22. The Omnibus Budget Reconciliation Act of 1986, Pub. L. No. 99-509 (Oct. 21, 1986).

23. Under 26 U.S.C. § 415(c), the maximum total allocation (the sum of all employer contributions, including elective salary deferrals into a 401(k) plan, all forfeitures from other participants who terminate employment and who are not fully vested in their account balances, and any additional employee contributions) may not exceed \$40,000, as adjusted by "Cost of Living Adjustments" (\$45,000 under the 2007 published adjustments).

of “Highly Compensated Employees” (“HCEs”).<sup>24</sup> Additionally and of more relevance to this Article, defined contribution plans comply with the age-discrimination rules as long as “allocations to the employee’s account are not ceased, and the rate at which amounts are allocated to the employee’s account is not reduced, because of the attainment of any age.”<sup>25</sup> The terms “allocations” and “amounts . . . allocated to the employee’s account” are clear and deliberate references to the amount of the annual contribution made to a plan by the employer on an employee’s behalf, meaning that age discrimination testing focuses on the input to the plan or annual increase in a participant’s account balance.

On the other hand, in defined benefit plans, the plan document must contain provisions that determine the benefits to be paid upon retirement from the general pool of plan assets. As described later, this relates to output (i.e., how much money will be paid from the plan to participants and beneficiaries, regardless of how the plan’s liabilities are funded along the way<sup>26</sup>). The level of benefit payments (i.e., output) is dictated by the Code as to the maximum annual distribution<sup>27</sup> and as to the prohibition against discrimination in favor of HCEs.<sup>28</sup> The age-discrimination rules for defined benefit plans are more complicated than those for defined contribution plans, and the complexity and ambiguity has led to the age-discrimination litigation in cash balance plans. For example, a major difference between the age-discrimination rules for defined benefit plans and defined contribution plans is that the former requires a two-prong approach while the latter implements a single-prong approach.

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24. Under 26 U.S.C. § 401(a)(4), the annual additions for each participant are divided into their respective annual salaries for an “Allocation Rate,” and the complicated rules under Treasury regulations require the plan to demonstrate that the allocation rates for the participants classified as HCEs are not excessively greater than the Allocation Percentages for all of the remaining non-HCEs.

25. 26 U.S.C. § 411(b)(2)(A); 29 U.S.C. § 1054(b)(2)(A)).

26. 26 U.S.C. § 412 and 29 U.S.C. § 1082 require a mathematician certified by the Joint Board for the enrollment of actuaries to determine the proper annual contributions that the sponsoring employers need to deposit.

27. Under 26 U.S.C. § 415(b), the maximum annual benefit (payable in a life annuity for a person between ages sixty-two and sixty-five with ten years of credited participation in the plan, and adjusted otherwise) may not exceed \$160,000, as adjusted by “Cost of Living Adjustments” (\$180,000 under the 2007 published adjustments).

28. Under 26 U.S.C. § 401(a)(4), the annual benefits for each participant are compared to their respective average salaries and are expressed as an “Accrual Rate,” and the complicated rules under Treasury regulations require the plan to demonstrate that the normal and most valuable accrual rates for the participants classified as HCEs are not excessively greater than the Accrual Rates for all of the remaining non-HCEs.

Although the issue of age discrimination in cash balance plans involves numerous economic and policy considerations, the entire controversy hinges on the proper construction of the term "benefit accrual." And the controversy stems from the following statutory language. First, the language reads, "*accrued benefit* may not decrease [or be reduced] on account of increasing age or service."<sup>29</sup> However, the additional age-discrimination requirement of the very next subparagraph refers to situations where "an employee's *benefit accrual* is ceased, or the *rate of an employee's benefit accrual* is reduced, because of the attainment of any age."<sup>30</sup> Thus, Congress used different terms in two consecutive subparagraphs, defined only one of the terms, and used a subheading that makes understanding the second provision even more complex.<sup>31</sup>

Plaintiffs (i.e., disgruntled plan participants that believe they are being unfairly treated in a cash balance plan design compared to their similarly situated younger co-workers) and defendants (i.e., the employers who adopt a cash balance plan design) have fought over these intersecting terms and meanings for over a decade now, and although Congress seems to have clarified the age-discrimination issues after June 29, 2005, the laws as they existed prior to the enactment of the PPA remain unclear.

In defined benefit plans, the normal retirement benefit is the "greater of the early retirement benefit under the plan, or the benefit under the plan commencing at normal retirement age,"<sup>32</sup> which is the ultimate benefit promised to the employee if he or she continues to work for the sponsoring employer until attaining normal retirement age,<sup>33</sup> assuming the plan document is not amended. At any point in time, if the participant's employment is terminated or if the plan document is amended, he or she has earned an accrued benefit that generally may not be reduced by plan amendment or termination.<sup>34</sup> Specifically, an accrued benefit in a defined benefit plan is "the accrued benefit determined under the plan and, [subject to some statutory requirements,] expressed

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29. See 26 U.S.C. § 411(b)(1)(G) (emphasis added); 29 USC § 1054(b)(1)(G)) (emphasis added).

30. 26 U.S.C. § 411(b)(1)(H)(i) (emphasis added); 29 U.S.C. § 1054(b)(1)(H)(i) (emphasis added).

31. The heading of I.R.C. § 411(b)(1)(H) is "Continued accrual beyond normal retirement age," but as is discussed in some of the opinions, the heading may or may not be relevant.

32. 26 U.S.C. § 411(a)(9); 29 U.S.C. § 1002(22).

33. Under 26 U.S.C. § 411(a)(8), and 29 U.S.C. § 1002(24) the normal retirement age is the earlier of the plan's defined normal retirement date, or the later of attaining age sixty-five or the 5th anniversary of a participant's participation in the plan.

34. 26 U.S.C. § 411(d)(6); 29 U.S.C. § 1054(g).



in the form of annual benefit commencing at normal retirement age."<sup>35</sup>

Unfortunately, the parade of legal definitions stops there, and Congress neglected to provide a definition of "benefit accrual." As applied to a traditional defined benefit plan, the term "benefit accrual," and thus, application of the statute, is ostensibly straightforward. Since, by definition, benefits under such an arrangement are expressed as guaranteed annuity payments beginning at retirement age, it is only intuitive that the term "benefit accrual" would refer to the increases in the amount of these expected annuity payments that a participant continuously earns throughout service with her employer.<sup>36</sup> For example, if the traditional defined benefit plan document provides a normal retirement benefit of one percent of a participant's average salary for each year of service, and a particular participant is expected to work for twenty-five years until retirement, then his expected monthly benefit at retirement is twenty-five of his average monthly salary. However, if he quit or was fired today after only working for seven years, his accrued benefit today would be seven percent of his average monthly salary payable as a monthly annuity starting on his normal retirement date. His accrued benefit one year from today would be eight percent of his salary. Therefore, in the absence of a succinct definition of "benefit accrual," the rate of benefit accrual between this year and next year is arguably the one percent increase in monthly annuity benefits payable at retirement.

For defined benefit plans with cash balance designs, however, this application is more dicey. To understand why, we must first examine how such a hybrid plan functions. Cash balance plan designs allocate value to hypothetical participant accounts<sup>37</sup> that are funded collectively and not actually separated by participant and are based on a system of credits usually set at an annual percentage of an employee's pay (i.e. pay credit), with the entire

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35. 26 U.S.C. § 411(a)(7)(A)(i); 29 U.S.C. § 1002(23)(A). In a defined contribution plan, the accrued benefit is "the balance of the employee's account." 26 U.S.C. § 411(a)(7)(A)(ii); 29 U.S.C. § 1002(23)(B).

36. Although there are no statutory provision for determining the rate of benefit accruals in defined contribution plans, for illustration purposes only, since the accrued benefit at any point in time is the balance in the individual's account, it is only intuitive that the rate of benefit accrual, if it ever needed to be determined, would be the increase in account balance from one determination period to the next after ignoring changes due solely to fund earnings.

37. Unlike defined contribution plans where participants have vested rights in actual individual accounts, the cash balance plan designs a book-keeping entry and divides the pool of plan assets into hypothetical accounts for communication purposes only, but participants have vested rights in the total benefit due to them, and not to these hypothetical accounts.

"account balance" then being increased by a set annual percentage (i.e. interest credit). Thus, a participant with annual pay of \$50,000 in her first year of employment and \$55,000 in her second year would be credited with the following benefits in a hybrid plan with a cash balance design defined as a ten percent pay credit and five percent interest credit:

*Year one:* The participant would be credited with ten percent of her \$50,000 salary, or \$5,000, as a pay credit. Most cash balance plan designs provide the pay credits on the last day of the plan year, so on the last day of her first year as a participant in the plan, her account balance would be \$5,000.

*Year two:* Her beginning balance of \$5,000 would be credited with one year's worth of interest (whether she actually continued working for any part of the year), which totals \$5,250. Then, since she is credited with another year of service, she will receive a pay credit of \$5,500 on the last day of her second year as a plan participant, so her total account balance on the last day of the second year would be \$10,750.

As such, the benefit accrued in any given year by our participant is expressed as an addition to her balance in the hypothetical account, as it would be if this was a defined contribution plan, as opposed to an increase in the size of her expected annuity payments in retirement, the measuring stick for age-discrimination assigned to traditional defined benefit plans. Cash balance plan designs are hybrid, thus, we now see why the proper definition of "benefit accrual" is the very heart of the issue of cash balance qualification: courts will necessarily need to go through layers of statutory construction applications and protocols to give a definition to a term Congress uses once, and only once, and does so without indicating what it meant. And, to add even more complexity, courts, in their statutory construction exercises, also need to dust off those rules that dictate how to interpret a statutory provision where the official subheading inserted by Congress arguably has everything or nothing to do with the actual provision. It is here that our story of age-discrimination litigation in cash balance plans begins.

### *B. The Issue of Age Discrimination in Cash Balance Plans Before PPA*

Recalling that cash balance arrangements are indeed defined benefit plans under ERISA, but in many aspects are communicated as defined contribution plans, the issue of whether or not they are age discriminatory boils down as follows: if, because of their similarity to defined contribution plans, they can be tested for age discrimination like defined contribution plans, then a cash balance plan will not be disqualified as long as the

rate of annual additions to participants' hypothetical account balances do not decrease because of age. On the other hand, if, despite this similarity, they must be tested as traditional defined benefit plans where the focus is on the increase in the amount of expected annuity payments in retirement, then they will fail.<sup>38</sup> Courts have fallen on both sides of this debate, and a further examination of the underlying law, as well as the interpretative and policy justifications of the respective courts, follows.

However, it is first useful to address the question of why cash balance arrangements are doomed to fail age discrimination testing, if the term "benefit accrual" is defined as an expression of the increase in value of expected annuity payments. To answer this question, one need only recall the provision of interest credits to deduce why this type of arrangement will fail under these circumstances. If we take two hypothetical participants, differing in age but not in pay, length of service, or any other variable, in any given year both will receive the same "pay credit" allocation to their respective hypothetical accounts. However, when expressed as the value of an annuity commencing at normal retirement age, the credit is more valuable to the younger worker because she will accumulate more interest credits before reaching age sixty-five. And of course, this dynamic is similarly applicable to an *actual* annuity, even outside the guise of a qualified plan: if two people, differing only in age, both buy an annuity for the same price, and both are to commence payout at any later date, the future payments for the younger individual will inevitably be greater because the issuer will be afforded a greater period of time in which to accumulate investment returns on the equivalent purchase price and date.<sup>39</sup>

Therefore, it becomes clear that the only hope for cash balance qualification is if the term "benefit accrual" actually refers to the contribution made by the employer (i.e., the input) and the plan is thus tested for age discrimination as a defined contribution plan, rather than as a traditional defined benefit plan. But is this interpretation correct? The courts responding in the affirmative have approached the problem from a standpoint of economic logic. They have reasoned that this type of defined benefit plan was not contemplated by ERISA's drafters, and because the plans are in most ways equivalent to a defined contribution plan, they should

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38. For a discussion of this issue, see generally Edward A. Zelinsky, *The Cash Balance Controversy Revisited: Age Discrimination and Fidelity to Statutory Text*, 20 VA. TAX REV. 557 (2001); Edward A. Zelinsky, *The Cash Balance Controversy*, 19 VA. TAX REV. 683 (2000) [hereinafter Zelinsky, *Controversy*]. *Contra* Richard C. Shea, Michael J. Francese & Robert S. Newman, *Age Discrimination in Cash Balance Plans: Another View*, 19 VA. TAX REV. 763 (2000).

39. See Zelinsky, *Controversy*, *supra* note 38, at 721-22.

thus be subject only to the type of input-based age discrimination requirements of analogous defined contribution plans. Conversely, other courts have shown a more rigid adherence to the black letter law of ERISA, and, citing policy reasons of their own, they have refused to permit cash balance plan to be tested in this manner.

### C. *Litigation of Cash Balance Plan Age-Discrimination Claims*

Several district court decisions, as well as two court of appeals holdings, have, to varying degrees, endorsed cash balance arrangements as being non-age discriminatory pursuant to ERISA's proscriptions. Chronologically speaking, the first favorable court of appeals holding, that of the Seventh Circuit in *Cooper v. IBM Personal Pension Plan*,<sup>40</sup> embodies the common approach taken by the courts that have fallen on this side of the debate, though the authors feel that the legal justification for the *Cooper* holding could have been better developed by the court in its published opinion.

#### 1. *Cooper v. IBM Personal Pension Plan*

On August 7, 2006, the United States Court of Appeals for the Seventh Circuit ruled that a provision of IBM's defined benefit cash balance plan that awarded interest credits to participant accounts did not violate the aforementioned age discrimination prohibitions of Section 204 of ERISA,<sup>41</sup> and reversed the finding of the United States District Court for the Southern District of Illinois.<sup>42</sup> The appeals court analogized the relevant aspects of cash balance plans to defined contribution plans, and thus ruled that, as would be the case in a defined contribution plan, the inescapable fact that younger workers will accumulate greater interest over their relatively longer tenures as employee-participants does not itself amount to an inherently discriminatory practice.

The IBM Personal Pension Plan, which was terminated subsequent to the lower court's unfavorable ruling, had operated (as typical cash balance arrangements do) to allocate value to hypothetical participant accounts through a system of pay credits set at five percent of the employee's gross income and interest credits set at one percent above the rate paid on one-year Treasury bills. Such an arrangement, the Seventh Circuit properly noted, is classified as a defined benefit plan under ERISA because of the

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40. *Cooper*, 457 F.3d 636.

41. *Id.* at 642. Please note that the ERISA provisions are actually codified at Title 29 of the United States Code at § 1001-1467; therefore, ERISA § 204 as referenced in the opinion is codified at 29 U.S.C. § 1054. See *supra* notes 29, 30.

42. *Cooper v. IBM Personal Pension Plan*, 274 F. Supp. 2d 1010, 1022-23 (S.D. Ill. 2003).

guaranteed elements of the pay credits and interest credits, but behaves very much like a defined contribution plan.<sup>43</sup>

The plaintiff class, consisting of older plan participants, brought suit against the plan and its sponsor and argued that the interest credit provision, which had been adopted pursuant to plan amendments effective July 1, 1999, unlawfully discriminated against them in favor of younger workers, who would have the opportunity to accumulate more of these credits over their relatively longer tenures as employee-participants.

Recalling that the theory on which the plaintiffs brought suit is undoubtedly correct *if* the term “accrued benefit” can be defined *only* as an expression of an increase in the size of expected annuity payments commencing at retirement, this litigation can be seen as a terrific “test case” to illustrate how different courts’ interpretations of the term will govern the respective outcomes. On one hand, the district court agreed with the plaintiffs’ theory, and granted summary judgment to the class.<sup>44</sup> The district judge, seeking guidance on the proper construction of the undefined term “benefit accrual,” relied instead on a substitution of the phrase “accrued benefit,” which is defined in ERISA § 3(23)(A) as an amount “expressed in the form of an annual benefit (i.e., an annuity) commencing at normal retirement age.”<sup>45</sup> Predictably, by transposing the terms and thus defining “benefit accrual” as an expression of an annuity payable at age sixty-five, (rather than treating the term as an expression of the annual contribution made on a participant’s behalf) the district court adopted a framework for discrimination testing that the IBM plan could never pass. This, once again, is because the value of an expected annuity commencing at age sixty-five for two otherwise identically-situated participants differing only in age would inevitably favor the younger because of the greater period of interest accrual.

Per the Seventh Circuit, therein lay the error. By replacing the phrase “accrued benefit” with “benefit accrual” and then proceeding to apply the prohibitions of § 204(b)(1)(H)(i) using the substituted term, it held that the lower court had improperly focused on the measure of the benefit a participant would receive as an annuity at retirement, rather than on the amount of the “contribution” allocated to the participant’s account by the employer.<sup>46</sup> The Seventh Circuit disagreed with this approach and

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43. *Cooper*, 457 F.3d at 637.

44. *Cooper*, 274 F. Supp. 2d at 1022-23.

45. 29 U.S.C. § 1001(a)(23)(A). Because identical definitions are found in the Code and in ERISA, it is irrelevant which federal statute is cited by the court.

46. *See Cooper*, 457 F.3d at 639 (stating “[t]hat’s where this litigation went off the rails: a phrase dealing with inputs was misunderstood to refer to

opined that a cash balance arrangement should, for the purposes of non-discrimination compliance, be treated like a defined contribution plan under the circumstances (i.e., focusing on input under § 204(b)(2)(A) rather than output under § 204(b)(1)(H)(i)). In support of this viewpoint, the Seventh Circuit attempted to put forth both policy and legal justifications.

First, despite the categorization of cash balance arrangements as defined benefit plans, the court devoted an appreciable portion of its opinion to demonstrating that these hybrid plans are functionally equivalent to defined contribution plans in at least all aspects that the court regarded as relevant.<sup>47</sup> Thus, the court was able to justify that, by logical extension, sound economic sense would demand that input-based discrimination testing should be the appropriate interpretation of the undefined term "benefit accrual" in a cash balance plan. On this issue, Judge Easterbrook, writing for the panel, noted that the IBM plan did not cease making allocations (or accruals) to the plan or reduce the allocation rate for older participants, and he went on to opine:

The IBM plan does neither of these things and therefore, one would suppose, complies with the statute. If this were a real, rather than a phantom, defined-contribution plan, that much would be taken for granted. Yet if the 5%-plus-interest formula is non-discriminatory when used in a defined-contribution plan, why should it become unlawful because the account balances are book entries rather than cash?<sup>48</sup>

Standing alone, this rationalization would justify the court's ultimate holding in a manner that could be described as shaky at best. While it does present a powerful argument why, economically speaking, a cash balance plan *should* be subject to contribution-based age discrimination testing, it is silent on the legal issue of how ERISA might permit this type of testing for what is undoubtedly a breed of *defined benefit plan*.

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outputs").

47. The court's first statement with respect to this subject is found in only the second sentence of the holding, which reads: "It [the IBM Plan] is almost, but not quite, a defined-contribution plan." *Id.* at 637. In the very same paragraph, Judge Easterbrook addresses the fact that, being a defined benefit plan, there remains risk that the employer will be unable to fully fund all benefit liabilities, but concludes that "otherwise IBM's plan is economically identical to a defined-contribution plan funded the same way and invested in a bond fund that returns 1% above the Treasury rate." *Id.* The authors assume that although the analysis on this point in the opinion was modest, that the court fully understands the minimum funding requirements of all defined benefit plans, as detailed under 26 U.S.C. §412, in that actuarial losses experienced when fund assets earn less than the guaranteed interest rate, or when other funding assumptions are not actually realized, will generate greater required contribution levels from the sponsoring employer to properly fund all of the liabilities as they come due.

48. *Id.* at 638.

The need for legal justification brings us full-circle back to the issue of the proper definition of “benefit accrual,” on which the court made its second most important, and most controversial, conclusion: the term “benefit accrual,” with respect to a defined benefit plan, is analogous to the term “allocation” as it applies to defined contribution plans, in that *they both refer to inputs*. More specifically, the court stated its belief that:

The phrase “benefit accrual” reads most naturally as a reference to what the employer puts in (either in absolute terms or as a rate of change), while the defined phrase “accrued benefit” refers to outputs after compounding. That’s where this litigation went off the rails: a phrase dealing with inputs was misunderstood to refer to outputs. As long as we think of “benefit accrual” as referring to what the employer imputes to the account — an understanding reinforced by the use of the word “allocation” in the subsection addressing defined-contribution plans — there is no statutory difference between the treatment of economically equivalent defined-benefit and defined-contribution plans.<sup>49</sup>

In further support of its viewpoint that the statutory provisions applicable to both plan types are one in the same, the court offered up two inferences, one in the negative and one in the positive. For the first, Judge Easterbrook pointed out that the language and legislative history of ERISA’s age discrimination prohibition(s) does not indicate that Congress intended interest accrual to be cast as a form of age discrimination, branding such an approach as “not sensible.”<sup>50</sup> This, of course, is a predictable result, as the drafters of ERISA (as later amended by OBRA) would likely not have contemplated this possibility, as hybrid arrangements did not exist, or were at least very uncommon at that time.<sup>51</sup>

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49. *Id.* at 639.

50. *Id.* In support of this conclusion, the court cites to the Supreme Court case of *Hazen Paper Co. v. Biggins*, 507 U.S. 604, 611 (1993) for the proposition that “variables correlated with age must be kept ‘analytically distinct’ from age when searching for discrimination.” *Id.*

51. ERISA was enacted in 1974, and the first cash balance plans appeared in 1985. *Lyons v. Georgia-Pacific Corp. Salaried Employees Ret. Plan*, 221 F.3d 1235, 1238 n.2 (11th Cir. 2000). Bank of America is usually credited with establishing the first cash balance plan, in 1985. *See Kozak, supra* note 5, at 760 n.35. Although ERISA did actually sanction a hybrid plan at 26 U.S.C. § 414(k) and at 29 U.S.C. § 1002(35), its statutory definition is confusing since such a plan is treated as a defined benefit plan for some purposes, as a defined contribution for others, and as a bifurcated plan for yet other purposes; however, there are some statutory provisions, such as age-discrimination, where the definition itself provides no guidance. Because of the ambiguity in the only sanctioned hybrid plan under ERISA, it is arguably impossible for a court to determine how the drafters of ERISA anticipated compliance with age discrimination prohibitions by the cash balance plans that were developed after enactment.

Second, the court cited *proposed* Treasury regulations that would have permitted cash balance plans to calculate benefit accrual rates as expressing the annual increase in the hypothetical account balances,<sup>52</sup> and, for the purposes of discrimination testing, then dividing by the applicable participant's compensation.<sup>53</sup> With respect to these, the court stated that "(a)ppropriations riders have prevented the Treasury from taking final action on the draft regulations, but they still help to inform our understanding of the statute."<sup>54</sup>

Armed with this construction of the term "benefit accrual," the Seventh Circuit proceeded to hold that the IBM plan was not unlawfully discriminatory. Because natural interest accumulation in a defined contribution plan can hardly be construed as discriminatory against the aged, the court was persuaded that an interest credit provision in a cash balance plan was sufficiently analogous to justify the same treatment, regardless of the fact that it was characterized as a "credit" and allocated to a hypothetical account, rather than a cash accrual in an actual account. In sum, the court held that because any disparity in benefits under such a plan would be attributable to interest accumulation rather than an "actual" reduction of accrual rate for older workers (i.e., an accrual rate reduction once a certain age was attained as provided for by the plan document), this provision was "age neutral" and thus not inherently age-discriminatory under ERISA. Of course, this finding rested upon the court's resolution of the key issue with respect to this litigation: that *the term "benefit accrual" refers to plan inputs*, and as such, cash balance plans *may* calculate benefit accrual rates based upon additions to the hypothetical participant account balances, as opposed to the value of an expected annuity commencing at normal retirement age.

This decision by the Seventh Circuit, while likely to draw applause from those who favor this type of plan arrangement as a

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52. *Id.* (citing 67 Fed. Reg. 76123 & 76125 (Dec. 11, 2002)).

53. *Id.* (citing 67 Fed. Reg. 76126 (Dec. 11, 2002)).

54. *Id.* For purposes of objectivity, the authors note that the regulations were withdrawn in a highly political environment. First, some Senators indicated that they would only confirm John W. Snow as President Bush's replacement for Secretary of Treasury if he promised not to finalize these regulations if they contradicted the Cooper *holding* (ironically, prior to his nomination, Mr. Snow was CEO of CSX Corp. at the time they converted their traditional defined benefit plan into a cash balance plan design). Then, Congress passed amendments to the Treasury appropriations legislation and directed Treasury and IRS to stop work on the proposed regulations and instead to put forward a legislative proposal providing transition relief for older and longer-service participants affected by cash balance conversions. In response, Treasury withdrew the proposed regulations and made a legislative proposal (included in the Administration's FY 2005 and FY 2006 budgets). See [http://www.aarp.org/research/press-center/testimony/cash\\_balance.html](http://www.aarp.org/research/press-center/testimony/cash_balance.html) (last visited 6/30/07).



mutually advantageous retirement savings vehicle for both employers and employees alike, is likely to provoke controversy and discussion for its seemingly activist approach to statutory interpretation. Such criticisms, which will be discussed later on, may certainly have merit. However, it should be noted that the Seventh Circuit was charged with attempting to construct Congressional intent with respect to a statute whose key term was undefined, an unenviable position in that it unavoidably forced the line between a court's policy considerations and legal considerations to become grayed. Thus, while *Cooper* may appear at first blush to have overstepped traditional judicial bounds, Judge Easterbrook's common-sense, economic approach was not a betrayal but a good-faith attempt to give effect to *general* Congressional intent with respect to a *specific* situation it could not have foreseen. After all, both the district court and the court of appeals in the case had opined based upon their own respective reading of the phrase "benefit accrual," and while the Seventh Circuit's resolution may fly in the face of traditional notions of the nature of defined benefit plans, it is more than a defensible position considering the decidedly untraditional circumstances presented by cash balance arrangements.

Of course, much of the potential dialogue surrounding *Cooper* has likely been stifled by the passage of the PPA,<sup>55</sup> relevant provisions of which provide clear legislative endorsement of cash balance arrangements going forward from June 29, 2005 in regards to avoiding age discrimination (but not with respect to litigation commencing prior to this date). All discussion and discourse aside, *Cooper* has validated cash balance arrangements as non-age discriminatory, with respect to both future and retroactive litigation within the gambit of the Seventh Circuit. It is noteworthy that two subordinate district courts within the Seventh Circuit, previous to the appellate court's holding in *Cooper* and the almost simultaneous passage of the PPA, had reached opposite conclusions on the issue of whether such a plan arrangement indeed violated ERISA anti-discrimination provisions.<sup>56</sup>

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55. P.L. 109-280, 120 Stat. 780.

56. Compare *Cooper*, 274 F. Supp. 2d at 1022 (holding IBM's cash balance plan to be age discriminatory, concluding that "like in any defined plan, the interest credits must be valued as an age 65 annuity. At this point in the analysis, the result is inevitable. In terms of an age 65 annuity, the interest credits will always be more valuable for a younger employee as opposed to an older employee.") with *Eaton v. Onan Corp.*, 117 F. Supp. 2d 812, 826 (S.D. Ind. 2000) (holding the opposite). In *Eaton* the court also noted:

[T]he court does not believe those statutes *require* that the rate of benefit accrual be measured *solely* in terms of change in the value of an annuity payable at normal retirement age. Plaintiffs' proposed interpretation would produce strange results totally at odds with the

## 2. Analysis of the Strengths and Weaknesses of the Cooper Holding

In a nutshell, the Seventh Circuit in *Cooper* attempted to establish that no policy justification exists for requiring that hybrid plan types be subject to the same age discrimination requirements as traditional defined benefit plans, which measure benefit levels in terms of expected annuities, justify their legal conclusion that the term "benefit accrual" is a reference to contributions or inputs rather than outputs in annuity form.<sup>57</sup> As stated earlier, the court endeavored to demonstrate the absence of any such policy justification by establishing that there is no *relevant* difference between a cash balance plan and a defined contribution plan,<sup>58</sup> thus relegating such differences as underfunding and investment performance risk irrelevant. The authors agree with this conclusion, and like the court, while acknowledging differences, can identify no persuasive rationale for why an employer who wishes to provide benefits to employees in this manner should be prohibited from doing so. However, with respect to the above-stated legal conclusion upon which *Cooper* is underpinned, the Seventh Circuit could have developed its argument more completely to better advance its position through precedential guidance.

Recall that the court stated the following with respect to its belief of the proper construction of the term in question:

The phrase "benefit accrual" reads most naturally as a reference to what the employer puts in (either in absolute terms or as a rate of change), while the defined phrase "accrued benefit" refers to outputs after compounding. That's where this litigation went off the rails: a phrase dealing with inputs was misunderstood to refer to outputs.<sup>59</sup>

This statement, taken at face value, may lead to two conclusions of gargantuan distinction. The first is that *Cooper* stands for the general proposition that *all* defined benefit plans are subject only to input-based age discrimination requirements. If true, this would turn thirty-plus years of ERISA practice on its head. After all, and returning once more to our discussion of annuities,<sup>60</sup> if a traditional defined benefit plan can pass age discrimination muster by demonstrating only that the

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intended goal of the OBRA 1986 pension age discrimination provisions.

57. See *Cooper*, 457 F.3d at 639. In *Cooper* the court stated:

Nothing in the language or background of § 204(b)(1)(H)(i) suggests that Congress set out to legislate against the fact that younger workers have (statistically) more time left before retirement, and thus a greater opportunity to earn interest on each year's retirement savings. Treating the time value of money as a form of discrimination is not sensible.

58. See *supra* note 47 and accompanying text.

59. *Cooper*, 457 F.3d at 639.

60. See *supra* note 47 and accompanying text.

contributions or inputs to the plan are not decreased because of age, then the size of annuities payable to retirees may permissibly decrease as the employee gets older and older because the same amount of money will purchase a less valuable annuity as the annuity's commencement date draws closer.<sup>61</sup> The court presumably would not have intended this result, and why this is clearly an incorrect reading of *Cooper* will be discussed momentarily.

Alternatively, the above statement could be taken to mean that "benefit accrual" does not *necessarily* denote outputs in annuity form, and may refer to inputs *only* with respect to plans where benefit amounts are defined as dollar amounts rather than as annuities payable. This second interpretation is certainly the superior (and we believe, the correct) one, in that it avoids subjecting hybrid plans to nonsensical age discrimination rules that were unintended for them without creating a massive disruption to the *status quo* of benefits law, and without betraying the retirement planning expectations of workers. After all, most employees who are unfamiliar with the legal nuts and bolts of ERISA would not expect that the rate at which their promised annuity payments increase may be slowed as they reach their critical retirement years because the annuity payment size(s) are the stick by which their expected benefit is measured. Likewise, the same lay employees probably gauge the increase in their benefit under a hybrid plan by its respective measuring stick — the hypothetical account balance — as they would if it was an actual defined contribution plan.

Unfortunately, the *Cooper* holding does not clearly state which interpretation the court intended. On one hand, the above-cited quotation lends credence to the notion that any defined benefit plan may satisfy ERISA's age discrimination requirements through input-based testing. The authors, of course, do not believe that the Seventh Circuit intended this result. We bring it up here only to illustrate our belief that the holding, save the court's reference to the proposed Treasury regulations which were retracted before consideration of public comments, is simply too vague on its face leaving many loose ends and thus leaving the holding vulnerable to attack. We further hypothesize that the court's failure to state its intention more clearly was its (over?) reliance on the proposed Treasury regulations.<sup>62</sup> The regulations treat hybrid arrangements and other defined benefit plans differently by proscribing that "the rate of benefit accrual under . . . eligible cash balance plan(s), as defined in these proposed regulations, is permitted to be determined as the

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61. See Zelinsky, *Controversy*, *supra* note 38, at 721-22

62. *Cooper*, 457 F.3d at 639 (citing 67 Fed. Reg. 76123).

additions to the participant's hypothetical account for the plan year, except that previously accrued interest credits are not included in the rate of benefit accrual.<sup>63</sup> The general rule for defined benefit plans, however, remains that these measurements be performed in terms of the normal benefit payment (annuity) form.<sup>64</sup>

As such, the threshold for determining whether input- or output-based age discrimination testing is required is not always the plan's categorization (defined benefit v. defined contribution), but rather, in this limited circumstance, the natural form of the benefit as it would be understood by a plan participant. Thus, the authors suggest that it would have been preferable for the Seventh Circuit to state something similar to the following in place of its "natural reading" passage:

In accordance with legislative intent with respect to ERISA's age discrimination prohibitions, we believe that the phrase "benefit accrual" should be considered a reference to the annual addition to a participant's benefit as it is communicated to, and understood by, the participant. Thus, the phrase denotes a reference to inputs in the case of this type of hybrid arrangement where benefits are expressed as an account value, and as an increase in the size of annuity payments in the case of a plan whose benefits are defined in annuity terms.

Of course, had the above-cited regulations actually been finalized, this case likely would have been a straight-forward decision on the merits. Because they were not, however, the court should have developed and expressed its brief opinion more thoroughly by establishing from a historical perspective that this type of plan arrangement was not contemplated when the relevant ERISA provisions were drafted (the holding, surprisingly, does not state this anywhere), by crafting its argument more in terms of a good-faith attempt to discern congressional intent, consistent with like prior holdings (citations to which were also noticeably absent),<sup>65</sup> and with less emphasis on the court's own economic viewpoints. On this note, while endorsing the Seventh Circuit's strong treatment of the policy considerations surrounding cash balance age discrimination claims, we favor<sup>66</sup> the later opinion of

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63. Proposed Rules, 67 Fed. Reg. 76123, 76126 (Dec. 11, 2002).

64. *Id.*

65. For instance, the United States District Court for the Southern District of New York produced a well reasoned holding consistent with the Seventh Circuit's approach only a couple of weeks before, in *Hirt v. Equitable Ret. Plan for Employees, Managers, and Agents*, 441 F. Supp. 2d 516 (S.D.N.Y. 2006).

66. In all fairness to the Seventh Circuit, it should be noted that the Third Circuit had the benefit of utilizing the *Cooper* holding as a strong precedential foundation for its own findings.

the Third Circuit in *Register v. PNC Financial Services Group, Inc.* for its legal treatment, and will discuss this case below.

Finally, the authors question the Seventh Circuit's opinion in that it did not balance and reconcile the differing interpretations of the term "benefit accrual" between its two subordinate district courts' opinions, *Anan v. Eaton* in the Southern District of Indiana and *Cooper v. IBM* in the Southern District of Illinois. In *Anan*, District Judge Hamilton determined that for two separate reasons, as a matter of law, nothing in ERISA, its legislative history, or its associated public policy concerns *requires* a cash balance plan to convert accounts into annuities to test compliance.<sup>67</sup> As discussed, the opposite interpretation was made in *Cooper* by Chief Judge Murphy. The authors question the Seventh Circuit's total disregard of *Anan's* analysis of statutory interpretation for support, even though that case settled after trial and was not actually on appeal.

### 3. *The Third Circuit Chimes In: Register v. PNC Financial Services Group, Inc.*

On January 30, 2007, the Third Circuit became the second appellate court to confront this issue head-on.<sup>68</sup> In affirming the order of the United States District Court for the Eastern District of Pennsylvania<sup>69</sup> that PNC's conversion from a traditional defined benefit plan to a cash balance plan did not result in violations of ERISA's defined benefit anti-age discrimination provision,<sup>70</sup> the court adopted essentially the same approach as the Seventh Circuit, but was arguably more successful in justifying its conclusion by developing its holding in a more legally credible manner.

To begin, the Third Circuit framed the debate in a subtly persuasive manner by pointing out, early on:

[T]he classification of cash balance plans as defined benefit plans triggers a host of regulatory provisions applicable to defined benefit plans but not to defined contribution plans. Application of the provisions, however, may be difficult because Congress enacted ERISA and the administrative agencies adopted the defined benefit plan regulations before the creation of cash balance plans and thus before employers such as PNC began converting their extant plans to cash balance plans. Thus, *the original rules for defined benefit plans simply did not address the unique features and hybrid nature of cash balance plans.*<sup>71</sup>

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67. *Eaton*, 117 F.Supp.2d at 836 (emphasis added).

68. *Register v. PNC Fin. Services Group, Inc.*, 477 F.3d 56 (3d Cir. 2007).

69. *Register v. PNC Financial Services Group, Inc.*, No. 04-6097, 2005 WL 3120268 (E.D. Pa., Nov. 21, 2005).

70. 29 U.S.C. § 1054(b)(1)(H).

71. *Register*, 477 F.3d at 63 (emphasis added).

By setting the stage for discussion within this historical context, the Third Circuit lent great credibility to its forthcoming holding as a genuine attempt to give effect to the true legislative intent behind ERISA's proscriptions, rather than as a treatise on economic theory.

Along the same lines, a second provision of *Register* (beginning at the onset of the holding's analysis section), which is noticeably absent in *Cooper*, is the court's reference to and application of Third Circuit and Supreme Court case law governing the proper bounds of the courts in interpreting federal statutory law.<sup>72</sup> While a full examination of this topic is beyond the scope and purpose of this Article, one example that particularly bears noting is its citation to the recent Third Circuit case of *Alaka v. Attorney General*,<sup>73</sup> in which the court noted its

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72. The court in *Register* noted:

It is well-settled that "[t]he role of the courts in interpreting a statute is to give effect to Congress's intent." *Rosenberg v. XM Ventures*, 274 F.3d 137, 141 (3d Cir.2001). "When interpreting statutes or regulations, the first step is to determine whether the language at issue has a plain and unambiguous meaning." *Dobrek v. Phelan*, 419 F.3d 259, 263 (3d Cir. 2005). "Because it is presumed the Congress expresses its intent through the ordinary meaning of its language, every exercise of statutory interpretation begins with an examination of the plain language of the statute." *Rosenberg*, 274 F.3d at 141. "[T]he plain meaning of statutory language is often illuminated by considering not only the particular statutory language at issue, but also the structure of the section in which the key language is found, the design of the statute as a whole and its object . . ." *Alaka v. Attorney General*, 456 F.3d 88, 104 (3d Cir. 2006) (internal quotation marks omitted); see also *King v. St. Vincent's Hosp.*, 502 U.S. 215, 221, 112 S.Ct. 570, 574 (1991) ("a statute is to be read as a whole . . . since the meaning of statutory language, plain or not, depends on context"); *M.A. ex rel. E.S. v. State-Operated Sch. Dist. of Newark*, 344 F.3d 335, 348 (3d Cir. 2003) (holding that it would be a mistake to "squint[ ] myopically" at the phrase in question and interpret it in isolation rather than in the context of the "text and structure" of the statute as a whole). Where the statutory language, on examination of "the language itself, the specific context in which that language is used, and the broader context of the statute as a whole" is plain and unambiguous, further inquiry is not required. *Rosenberg*, 274 F.3d at 141.

The requirement that "[s]tatutes must be interpreted to receive a sensible construction, limiting application so as not to lead to injustice and oppression . . ." also guides us." *Evcco Leasing Corp. v. Ace Trucking Co.*, 828 F.2d 188, 195 (3d Cir. 1987). In this light, "[s]tatutes should be interpreted to avoid untenable distinctions and unreasonable results whenever possible." *American Tobacco Co. v. Patterson*, 456 U.S. 63, 71, 102 S.Ct. 1534, 1538 (1982).

With these principles in mind, we again set forth the defined benefit plan anti-discrimination provision at issue . . . ."

477 F.3d at 67 (emphasis added).

73. 456 F.3d 88, 104 (3d Cir. 2006).

belief that “the plain meaning of statutory language is often illuminated by considering not only the particular statutory language at issue, but also the structure of the section in which the key language is found, the design of the statute as a whole and its object.”<sup>74</sup> Later on in the opinion, the court revisited this quotation again in support of its statement that, in looking to the parallel anti-discrimination provision applicable to defined contribution plans for guidance on the meaning of “benefit accrual” in the cash balance context, it was not ignoring the statutory language, but rather gave effect to the spirit and purpose behind Congress’s actions.<sup>75</sup>

Because the Third Circuit, in most respects, adopted essentially the same framework for analyzing this issue as did the Seventh Circuit, a full examination of *Register* would be needlessly duplicative. In short, *Register* relied heavily on the headship provided by the courageous *Cooper* holding, and the above provisions that we have cited as “improvements” on *Cooper* are certainly present in the former case, but there they are more vaporous and require a more intimate understanding of the nuances of ERISA practice — the better to “read between the lines” a bit. Thus, *Register* is a more complete holding — taking the best of the form provided by the Seventh Circuit and enhancing it through delivery in a more palatable form.

#### 4. District Court Decisions

At present, the Seventh and Third Circuits are the only appellate courts to have ruled decisively on the issue at hand. It is noteworthy that in *Campbell v. BankBoston, N.A.*<sup>76</sup> the First Circuit offered indications *in dicta* that cash balance plans may pass ERISA anti-discrimination muster (the plaintiff in *BankBoston* raised antidiscrimination arguments based on the Age Discrimination in Employment Act, but because he failed to raise an ERISA claim at the district court level, the issue was waived<sup>77</sup>). The First Circuit relied on the same proposed Treasury Regulations on which the Seventh Circuit relied in *Cooper* (although still published in the Federal Register at the time of its decision) that permitted calculation of benefit accrual rates in the cash balance context by dividing the annual increase in the hypothetical account balances by participant compensation.<sup>78</sup>

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74. *Id.* (internal quotation marks omitted).

75. *Register*, 477 F.3d at 69.

76. 327 F.3d 1 (1st Cir. 2003).

77. *Id.* at 9.

78. *Id.* at 10. In *Campbell* the court noted:

The IRS has also reviewed the challenge to cash balance plans under the age discrimination provision of ERISA. On December 11, 2002, the IRS issued proposed regulations which attempt to address, among other

Likewise, in the 2000 case of *Eaton v. Onan Corp.*,<sup>79</sup> the United States District Court for the Southern District of Indiana opined that, given an examination of legislative history and social policy considerations, there was no mandate that cash balance plans calculate accrual rates based "solely in terms of change in the value of an annuity payable at normal retirement age."<sup>80</sup> Much like its superiors in the Seventh Circuit, the *Eaton* court went on to provide a glowing review of the policy merits of measuring benefit accrual rate according to changes in hypothetical cash balance accounts, noting:

There is no statutory or public policy reason that the rate of benefit accrual could not be measured, at least for these purposes, in terms of the rate of change in the balance of an employee's hypothetical account. In fact, that measure provides a precise, quantifiable, and clear measure that does not require any estimates or actuarial assumptions.<sup>81</sup>

Citing significantly to *BankBoston* and *Eaton*, the United States District Court for the District of Maryland similarly endorsed this method of accrual rate calculation and in turn rejected the plaintiff's claims of age discrimination under ERISA in *Tootle v. ARINC, Inc.*<sup>82</sup> Similarly, in the days preceding the Seventh Circuit's pronouncement in *Cooper*, the United States District Court for the Southern District of New York joined the growing majority of "pro-cash balance plan" courts with its decision in *Hirt*,<sup>83</sup> a decision that employed an admirable and thorough examination of legislative history, analysis of the above sister court decisions, and (yes, once again) the notorious proposed Treasury regulations, on which it offered the following: "Proposed regulations do not have the force of law. They are entitled to respect to the extent that they have the power to persuade."<sup>84</sup> Like *Register*, *Hirt* is a credible opinion both from a policy and legal point of view.

The growth of the majority, however, has stagnated post-*Cooper*. Less than two months after *Cooper* and *Hirt*, the southern district of New York reaffirmed its position in *Laurent v. PriceWaterhouseCoopers LLP*, which disposed of the age discrimination issue in essentially the same manner, but the

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issues, the proper definition of the rate of benefit accrual for cash balance plans for purposes of IRS approval of a plan.

*Id.*

79. 117 F. Supp. 2d 812 (S.D. Ind. 2000).

80. *Id.* at 826.

81. *Id.*

82. 222 F.R.D. 88 (D. Md. 2004).

83. 441 F. Supp. 2d 516.

84. *Id.* at 547 (citing *Christensen v. Harris County*, 529 U.S. 576, 587 (2000)).



court's last two holdings on the subject took the opposite view.<sup>85</sup> Since then, at least two other district courts have dismissed cash balance age discrimination claims on their legal merits.<sup>86</sup>

Unfortunately, in quite a few jurisdictions, the possibility of liability arising out of events prior to the effective date of June 29, 2005, for the new cash balance benefit accrual provisions in the PPA<sup>87</sup> continues to linger. Of course, save an unlikely review by the Supreme Court,<sup>88</sup> the issue has been put to rest in the Seventh Circuit (Illinois, Indiana, and Wisconsin) and the Third Circuit (Pennsylvania, New Jersey, and Delaware). Likewise, it seems probable that, based on the First Circuit's remarks in *BankBoston*,<sup>89</sup> this court would reach a similar resolution. (The First Circuit encompasses Maine, New Hampshire, Massachusetts, and Rhode Island).

Apart from these, however, the question remains unanswered. Naturally, even with respect to other district courts that have come out on the side of cash balance plans, their pronouncements are only as good as the next review by their respective appellate circuit. Furthermore, The United States District Court for the District of Connecticut denied a motion to dismiss a claim of cash balance age discrimination in the matter of *Parsons v. AT&T Pension Benefit Plan*,<sup>90</sup> refusing to reconsider its prior decision in *Richards v. FleetBoston Financial Corp.*<sup>91</sup> that cash balance plans do indeed discriminate on the basis of age. Coupled with its sister court in the southern district of New York, the Second Circuit now seems to be a bastion of anti-cash balance sentiment, subject to an inevitable decision from the Court of

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85. See *In re J.P. Morgan Cash Balance Litigation*, 460 F. Supp. 2d 479, 489 (S.D.N.Y. 2006) (pronouncing on Oct. 30, 2006, that the "statutory text" of ERISA mandates that all defined benefit plans, including cash balance arrangements, must provide non-discriminatory benefit accruals as measured by increases in the size of annuity payments); *In re Citigroup Pension Plan ERISA Litigation*, 470 F. Supp. 2d 323 (S.D.N.Y. 2006) (answering the same proposition).

86. See *Drutis v. Quebecor World (USA), Inc.*, 459 F. Supp. 2d 580 (2006) (granting a defendant employer's motion to dismiss); *Finley v. Dun & Bradstreet Corp.*, 471 F. Supp. 2d 485 (D.N.J. 2007) (granting a defendant employer's motion to dismiss, in part, with respect to age discrimination claims, including a "wearaway" claim, resulting from the conversion of a traditional defined benefit plan to a cash balance arrangement).

87. See *infra* Part III.

88. The Supreme Court has already denied certiorari in *Cooper v. IBM Personal Pension Plan*, 127 S. Ct. 1143 (2007).

89. See *BankBoston*, 327 F.3d at 9-10 ("[C]ritics of the age discrimination argument have contended that there are various methods for determining benefit accrual rates under ERISA, and it is by no means clear that the annuity method is the only permitted method in this context.").

90. No. 3:06CV552 (JCH), 2006 WL 3826694 (D. Conn. Dec. 26, 2006).

91. 427 F. Supp. 2d 150 (D. Conn. 2006).

Appeals there.<sup>92</sup> In sum, while it is safe to say that the future of cash balance plans seems bright, the issue of retroactive liability is still very much alive,<sup>93</sup> as several district courts (with more possible to come) have refused to deviate from the black letter law of ERISA and subject these hybrid arrangements to different requirements than traditional defined benefit plans in the absence of a Congressional mandate.

### III. OTHER LEGAL ISSUES WITH HYBRID PLANS

In addition to participants suing plans for age discrimination under ERISA, plaintiffs have tried to make other claims against their employer plans, such as age discrimination under the ADEA, wearaway, whipsaw, and excessive backloading, among various other claims. The PPA settled the first three issues on a prospective basis only.

Before summarizing the legal issues for each of these claims, however, it will be beneficial to take a step back and see the forest through the trees. The existing cases generally represent the situation where an employer maintained a traditional defined benefit plan, and where the benefits at retirement were expressed as an annual benefit. At some point in time (probably in the 1990s), the employer made a business decision to amend the traditional defined benefit formula into a cash balance-type

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92. *Hirt* is now pending before the Second Circuit (notice of appeal filed Oct. 13, 2006).

93. All of the above-cited decisions disfavoring cash balance plans state as the courts' principal reason for so holding their disbelief that Congress intended the term "benefit accrual" to be a reference to plan inputs. See *J.P. Morgan*, 460 F.Supp.2d at 488-89. The court in *J.P. Morgan* noted:

The fact is that 'accrual,' using its dictionary meaning and in line with the structure of defined benefit plans, refers to what the employee accumulates . . . , whereas "allocation," using its dictionary definition and in line with the structure of defined contribution plans, refers to what an employer puts into the account. . . . As this Circuit has observed, "[w]hen Congress uses particular language in one section of a statute and different language in another, we presume its word choice was intentional."

*Id.* (citing *United States v. Peterson*, 394 F.3d 98, 107 (2d Cir. 2005)). In *Parsons* the court stated:

In light of the great similarity that "rate of benefit accrual" bears to the statutorily defined term "accrued benefit," and the fact that ERISA requires accrued benefit to be measured as an annual benefit commencing at normal retirement age for defined benefit plans, but requires accrued benefit to be measured as the balance of an individual's account for defined contribution plans, in this court's opinion the term "rate of benefit accrual," as used in § 204(b)(1)(H)(i), refers to rate measured as a change in the annual benefit commencing at normal retirement age. The statute is unambiguous in this respect, and the court need not inquire further into its meaning.

2006 WL 3826694, at \*1 (citing *FleetBoston*, 427 F. Supp. 2d at 164-65).

formula, whether to have a better ability to budget and control funding requirements,<sup>94</sup> to express the retirement benefit in a manner that seems to be better appreciated by the average plan participant, or for any other reason. Immediately after the conversion, most employers attempted some sort of mitigation, but, as should be obvious because the plan designs are not identical, there is always a chance that some plan participants will have been better off in the old design before any amendment, regardless of the employer's attempt at mitigation. These affected plan participants generally form a litigation class and argue that the new cash balance design somehow is in violation of the Code, ERISA, or other federal laws. The authors note that, regardless of the merits of any individual litigation claim, the employer provides a qualified retirement plan to its employees on a purely voluntary basis, and could have terminated the traditional defined benefit plan<sup>95</sup>, which would have caused all plan participants who have not reached normal retirement age to lose out on some of the future benefit accruals promised through the plan. In a conversion to a cash balance plan, especially with some attempt at mitigation, most participants will fair as well or better in the new plan design and leave only a minority plaintiff class as the losers. Again, while the plaintiff class might have our heart-felt sympathies, it is probably still better to negatively impact a minority of plan participants in a cash balance plan conversion rather than all of the plan participants in a plan termination.

There are rules that apply to all qualified defined benefit plans, and just because a traditional defined benefit is converted into something that resembles a defined contribution plan, the rules are still applicable. Many benefits professionals have been arguing for Congress to look at the full spectrum of defined benefit plan rules and modify them for hybrid plan designs. Fortunately, Congress did so in regard to age discrimination, wear-away, and whipsaw claims when they passed the PPA; unfortunately, they neglected to amend any other provision. Since the age discrimination fix is prospective only for hybrid designs implemented after June 29, 2005, age discrimination claims for plans in existence before that threshold date are still relevant. Statutory provisions that were not amended by the PPA will be

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94. The minimum funding rules are detailed in 26 U.S.C. § 412, and require an enrolled actuary to compare expected plan liabilities to plan assets on an annual basis and determine the contribution amount required to keep the plan properly funded, which could result in volatile and unpredictable contribution targets, especially when interest rates drop.

95. Most defined benefit plans are covered by the Pension Benefit Guaranty Corporation, the quasi-federal agency that insures retirement promises delivered through a qualified defined benefit plan, and the termination rules are described at 29 U.S.C. § 1341.

fair game for litigation, regardless of whether the cash balance design was adopted after June 29, 2005.

*A. Age Discrimination under the ADEA*<sup>96</sup>

The ADEA was enacted to prevent employment discrimination based upon age, and the protected class of employees is those who have attained age forty. The ADEA in many ways mirrors Title VII of the Civil Rights Act ("Title VII"), as each shares the common notion of eliminating discrimination in the workplace. Title VII recognizes a couple of theories of liability for employment discrimination cases, one being disparate impact. Disparate impact prohibits certain employment practices that have only a discriminatory effect upon employees. For a plaintiff to succeed under a disparate impact theory under Title VII, he must demonstrate that his employer uses neutral factors in its decision making process that disproportionately impacts a protected group. Stated another way, employment practices that seem fair in form, but are actually discriminatory in operation, violate Title VII. Due to the similarities between the ADEA and Title VII, however, it was unclear whether the ADEA also recognizes the disparate impact theories.

Before the Supreme Court determined that disparate impact theories are indeed allowed under the ADEA<sup>97</sup>, several age discrimination claims under ADEA were argued in cash balance plan conversions. The district court of southern Indiana granted the plan's motion for summary judgment on the issue because it determined that the Seventh Circuit does not accept the disparate impact theory,<sup>98</sup> and the First Circuit did not actually decide the plaintiffs' claims because of procedural reasons, but opined in dicta that the First Circuit probably would not accept disparate impact theories.<sup>99</sup> However, in light of the Supreme Court's holding, disparate impact claims for age-discrimination under ADEA are absolutely acceptable. Congress made similar amendments regarding age discrimination under a statutory hybrid plan design to the ADEA as they did to ERISA and the Code, but they similarly made those changes prospective only, and the amended statute does not apply for cash balance plans in operation before June 29, 2005. Therefore, the field of ADEA age discrimination claims should be watched closely.

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96. Kozak, *supra* note 5, at 774.

97. Smith v. City of Jackson, Miss., 544 U.S. 228 (2005).

98. Eaton, 117 F. Supp. 2d 812.

99. Campbell v. BankBoston, NA, 327 F.3d 1 (1st Cir. 2003), *aff'g* 206 F. Supp. 2d 70 (D. Mass. 2002).

### B. *Wearaway*<sup>100</sup>

No participant's accrued benefit under a qualified defined benefit plan can ever be reduced due to a plan amendment.<sup>101</sup> This restriction applies to the conversion of a traditional defined benefit plan into a cash balance plan. If the employer does not mitigate the effect of lost future promised benefits, then the simple rule is that the participant's hypothetical cash balance account can never be less than the present value of previously accrued benefits on the day before the conversion. The wear-away problem occurs when the method for determining the opening account balances for all participants produces opening accounts for some of the older workers that are less than their present values of previously accrued benefits. Such accounts grow with annual cash balance and interest credits, but can never be less than the respective present value of previously accrued benefits. Therefore, it may take several years under the new cash balance formula for a participant's cash balance account to exceed the preserved present value. It is only at that point in time that such a participant will reap any benefits from the cash balance conversion. In other words, it may take several years for the preserved present value to "wear away" And be subsumed by additional accruals in the new cash balance plan design.

To illustrate this point, assume an employer maintains a traditional defined benefit plan that promises one percent of compensation for each year of service. Assume that Employee B, age sixty, has twenty years of service on December 31, 2006, when the plan is converted into a cash balance design, and assume further that the present value of her accrued benefit, based on the actuarial assumptions stated in the plan document, including a five percent interest rate, is \$150,000. Assume further that the cash balance plan will provide an allocation of ten percent of salary plus five percent interest credits, and the method of determining opening cash balance accounts, whatever it is, produces an opening balance of \$130,000 for Employee B. Employee B's benefits from the plan, when communicated as a lump sum, must always be at least \$150,000, improved with interest. Therefore, on January 1, 2007, she is entitled to the greater of (1) \$150,000 or (2) \$130,000. Assume that Employee B's salary is \$100,000 for 2007. On December 31, 2007, she is entitled to the greater of (1) \$150,000 times 1.05 (which is \$157,500) or (2) \$130,000 times 1.05 plus \$10,000 (which is \$146,500). Assume that Employee B's salary is \$110,000 for 2008. On December 31, 2008, she is entitled to the greater of (1) \$157,500 times 1.05 (which is \$165,375) or (2) \$146,500 times 1.05 plus \$11,000 (which

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100. See Kozak, *supra* note 5, at 771.

101. 26 U.S.C. § 411(d)(6); 29 U.S.C. § 1054(g).

is \$164,825). Assume that Employee B's salary is \$115,000 for 2009. On December 31, 2009, she is entitled to the greater of (1) \$165,375 times 1.05 (which is \$173,644) or (2) \$164,825 times 1.05 plus \$11,500 (which is \$184,566). Therefore, in this example, it would take Employee B three years until she actually accrues a benefit in the cash balance plan design after the conversion that would increase her preserved accrued benefits from the traditional defined benefit plan on the day before the conversion. However, note that in this example Employee B would be sixty-three years old, and would have earned no benefit accruals between ages sixty and sixty-three, and even though her account from the cash balance plan design at age sixty-five will be more than her lump sum would have been at age sixty-five if the plan had merely been terminated on December 31, 2006, it will still be less than her lump sum would have been at age sixty-five if the plan had not been converted from the traditional defined benefit design.

The problem of wear-away has been eliminated, prospectively, by the PPA. If a traditional defined benefit plan is converted into a statutory hybrid plan after June 29, 2005, then the preserved benefit from the old formula must be *added* to all new accruals after the conversion (many refer to this as the traditional A plus B approach), and *cannot* be preserved until the new accrued benefit subsumes the preserved accrued benefit (the traditional wear-away approach).<sup>102</sup> Again, since the requirement is for conversions after the pivotal date of June 29, 2005, with all prior conversions where wear-away actually occurs plaintiffs can still make an argument that such wear away is impermissible under the law as it existed prior to June 29, 2005.

### C. Whipsaw<sup>103</sup>

While a participant in a statutory hybrid plan with a cash balance design is still employed, she is credited with cash balance credits and interest credits. However, there is a question as to whether the future interest credits constitute part of the accrued benefit. In other words, if a participant in a cash balance plan terminates employment at age fifty, then are the interest credits that would be added to her account over the next fifteen years (until normal retirement at age sixty-five) part of her accrued benefit, even if the participant takes a complete lump sum distribution at age fifty? One of the requirements of a distribution that is paid in a form other than a life annuity, is that no portion of the accrued benefit may be forfeited. Although many employers concede that future interest credits do constitute part of the accrued benefit that can never be reduced or taken away, there is

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102. 26 U.S.C. § 411(b)(5)(B)(iii), as amended by the PPA.

103. See Kozak, *supra* note 5, at 772.

still no affirmative statutory provision that requires it, and it is only discussed in non-regulations guidance.<sup>104</sup>

Also at issue is the calculation of the lump sum payable to a participant that so elects to receive a lump sum. In a traditional defined benefit plan, the document expresses the promised retirement benefits in the form of an annuity starting at normal retirement age, and it might provide a lump sum as an optional form of distribution. If a defined benefit plan offers a lump sum option, then minimum interest rates (commonly referred to as the "GATT § 417(e) rates") must be used to calculate the minimum lump sum that must be distributed at any point in time, regardless of the plan's actuarial assumptions.<sup>105</sup> Congress added the qualified joint and survivor annuity provisions, including this minimum lump sum distribution amount, in order to make it easier for working women to participate in pension plans, and to permit surviving spouses to share in participating workers' retirement benefits.<sup>106</sup>

In a cash balance plan, however, interest credits are part of the benefit itself, not just a way to express mathematically equivalent benefit values at different points of time. The IRS issued guidance that indicated cash balance plans, as defined benefit plans, must also comply with the discounting rules of I.R.C. § 417(e). The problem is that if the sponsoring employer wants to provide interest credits until normal retirement with a guaranteed rate that is greater than the GATT § 417(e) applicable interest rate, and then discount to current age using the currently low GATT rates, then the minimum lump sum distribution that actually must be paid will be greater than the account balance. For example, if the employer wants to be benevolent and guarantee an eight percent interest credit rate on the cash balance account, and if, according to the IRS, the plan is required to discount the distributions using a lower GATT interest rate, such as 4.68% for December 2006,<sup>107</sup> then the distribution will be greater than the

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104. I.R.S. Notice 96-8, 1996-1 C.B. 359.

105. 26 U.S.C. § 401(a)(25) requires that in order for a defined benefit plan to provide definitely determinable benefits, the plan's actuarial assumptions must be stated in the plan document in a manner that precludes employer discretion. These are the plan's actuarial assumptions, and are used to determine the value of a lump sum distribution, in lieu of an annual benefit, if the plan allows that form of distribution. However, when Congress enacted the qualified plan provisions of the Uruguay Round Agreements Act, P.L. 103-465 (Dec. 8, 1994), it required that regardless of the plan's actuarial assumptions, if a lump sum distribution is paid, it must be at least as valuable as a lump sum calculated with the statutory rates (i.e., GATT rates).

106. David J. Guin, *The Retirement Equity Act of 1984: One Step Forward, Two Steps Back*, 37 ALA. L. REV. 163, 172 (1985).

107. The applicable federal rates under 26 U.S.C. § 417(e) are updated and published monthly in the Internal Revenue Bulletin. Many defined benefit plans, however, include procedures that set the GATT § 417(e) rate in effect in

hypothetical cash balance account since, mathematically, a lower discount rate will yield a higher present value. Assume Employee C is sixty-four years old, and has a cash balance account of \$100,000. If Employee C terminates employment and elects to receive a lump sum, then, under the IRS rules, the account balance must be projected to her age sixty-five at the plan's interest crediting rate of eight percent (i.e., \$100,000 times 1.08 (which is \$108,000)), but then discounted at the current GATT § 417(e) rate of 4.68% (i.e., \$108,000 divided by 1.0468 (which is \$103,172)). Therefore, in this case, if Employee C elected a lump sum distribution at age sixty-four, the plan would be required to pay her \$103,172, even though the account based on the cash balance formula is only \$100,000.

This means that terminated participants taking lump sums each receive more than their hypothetical cash balance accounts. Thus, an actuarial loss will occur in the plan that will require greater contributions from the employer to keep the plan properly funded for the remaining participants, who will likely cause further actuarial losses when they terminate employment and receive their respective lump sum distributions. This phenomenon is referred to as whipsaw. To avoid this whipsaw problem, employers are forced to credit interest using the lower guaranteed GATT rate rather than a higher rate. This practice avoids actuarial losses in the plan, but hurts participants who would have received greater interest credits if the cash balance plan did not need to comply with the minimum survivor annuity rules. In the above example, if the cash balance plan document indicated that interest would be credited at the current prevailing GATT § 417(e) rate rather than a locked-in rate of eight percent, then Employee C's account would be improved and discounted at the same interest rate and result in a distribution equal to her hypothetical account balance of \$100,000.

The PPA offers relief by providing that as long as the statutory hybrid plan credits interest at a rate that is no greater than a floating market rate of return, a reasonable guaranteed rate of return, or a set formula that determines the greater of a fixed or variable rate of return, then the plan does not need to project forward at the plan's interest crediting rate, but discount at the statutory § 417(e) GATT interest rate.<sup>108</sup> This provision is effective for plan years beginning after December 31, 2006, so again, cash balance plans in existence prior to 2007 are subject to litigation that whatever crediting rate that was defined in the plan

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the month preceding the current plan year as the single rate that will be used to determine the minimum present values of accrued benefits for all lump sums that are distributed during the current plan year.

108. 26 U.S.C. § 411(b)(5)(B)(i). The IRS has provided some safe harbor rates in Notice 2007-6, and will likely provide further guidance.



document violated the mandates of Notice 98-6 that were controlling until Congress passed the PPA.

#### D. Excessive Back-Loading<sup>109</sup>

One of the characteristics of a traditional defined benefit plan is the fact that the most valuable benefit accruals occur when a participant is close to retirement age. This is commonly referred to as back-loading. Although Congress acknowledged and accepted this mathematically absolute back-loading phenomenon, it included provisions in the statute that limit the amount of back-loading allowed in a defined benefit plan design. Congress provides three methods through which a defined benefit plan can prove that the accruals are not excessively back-loaded. Either the plan document provides that accruals will meet the three percent method,<sup>110</sup> the 133 1/3 percent rule<sup>111</sup> or the fractional rule.<sup>112</sup> Since the accrual patterns in a defined contribution plan are front-loaded (or at least ratably-loaded throughout an employee's career), defined contribution plans do not need to prove that they are not excessively back-loaded. Cash balance plans, by design, follow the accrual patterns of a defined contribution plan. However, cash balance plans, as a form of defined benefit plan, must satisfy one of the three statutory accrual methods permitted for all defined benefit plan designs, none of which were drafted to ensure that a front-loaded plan can provide non-excessive back-loading.<sup>113</sup> The PPA does not contain any provisions that excuse a statutory hybrid plan from these three ways of providing accrued benefits in a manner that does not violate the back loading rules. Therefore, this issue is ripe for litigation, even in new or newly converted hybrid plans.

#### IV. THE FUTURE OF THE STATUTORY HYBRID PLAN WITH A CASH BALANCE DESIGN

To summarize, the Seventh Circuit has concluded that the existing federal law did not render cash balance type plans to be age-discriminatory, and regardless of the interpretation of that existing law, Congress has recently blessed these hybrid designs going forward. So now what? Should every employer adopt a hybrid cash balance plan? Should every traditional defined benefit plan be converted into a hybrid type plan? Should all remaining unions negotiate for hybrid plan designs through the collectively bargained process?

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109. See *Kozak*, *supra* note 5, at 777.

110. 26 U.S.C. § 411(b)(1)(A).

111. 26 U.S.C. § 411(b)(1)(B).

112. 26 U.S.C. § 411(b)(1)(C).

113. See *supra* note 51.

Of course not! The world of private sector retirement programs is still going to be slanted more towards the defined contribution end of the spectrum than the defined benefit end. However, hybrid plans still have all of the inherent advantages of a defined benefit plan, and when promising pension benefits to employees and delivering them through a defined benefit plan meets the current and projected business goals of an employer, then hybrid plan designs should be part of the discussion. Here is a summary of some of the advantages and some of the disadvantages of a hybrid design, assuming a defined benefit plan is the proper plan design.

### *A. Advantages of Cash Balance Plans*

#### *1. Output Versus Input:*

A statutory hybrid plan, like all defined benefit plans, is designed around output rather than input (even if, for purposes of age discrimination, the inputs can be tested for compliance). Therefore, even though a statutory hybrid plan might look like a defined contribution plan, the limitation is only on annual benefits paid (\$180,000 per year, payable at age sixty-two if the participant is credited with ten years of participation, actuarially adjusted for payments at other ages and in other forms, but limited to 100% of the participant's highest average compensation based on the highest three consecutive years of pay over all of his years of service with the employer).<sup>114</sup> The annual contribution, as discussed below, requires the amount determined by the enrolled actuary to be deposited and deducted, regardless of its ratio to total payroll. This differs greatly from a defined contribution plan where any participant's annual addition is limited (\$45,000 per year, but limited to one hundred percent of his compensation for the year),<sup>115</sup> and where the maximum contribution and deduction for any year is limited to twenty-five percent of eligible payroll.<sup>116</sup> For this reason, statutory hybrid plans are still a good way to provide older participants with an adequate retirement benefit because a large account (or high accumulated percentage of final average compensation) can be funded in a few years to provide the maximum annual benefit, or at least a substantial benefit; whereas, a defined contribution plan is always limited to an

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114. 26 U.S.C. § 415(b). The statutory dollar limit of \$160,000 is adjusted annually for cost of living adjustments, and is \$180,000 for 2007. The PPA clarifies that average compensation for purposes of 26 U.S.C. § 415(b) is for all years of service with the employer, and is not limited to years of participation in the plan after it is adopted.

115. 26 U.S.C. § 415(c). The statutory dollar limit of \$40,000 is adjusted annually for cost of living adjustments, and is \$45,000 for 2007.

116. 26 U.S.C. § 411(a)(3).

allocation of \$45,000 per year, whatever that accumulates to in a few years when the employee retires.

## 2. *Sweeteners*

A statutory hybrid plan, like all defined benefit plans, is simply a mix of promises that need to be funded. In certain situations, the sponsoring employer might want to increase the level of benefits to take advantage of unexpected business profits, to encourage older employees to retire early with permanent or temporary subsidized early retirement benefits, to provide benefits for service earned by a predecessor employer or for periods before the plan was effective, or to enhance the benefits for selected employees who lose out on pension benefits from their former employer when they come work for this employer. All of these sweeteners are permitted in defined benefit plans, but are prohibited in defined contribution plans. Since many of these situations come up from time to time without much warning, an employer can take advantage of its options if it maintains a statutory hybrid plan. It seems that the advantages of a statutory hybrid plan over traditional defined benefit plans is that the hypothetical account (or accumulated percentage of final average salary) can be readily evident and appreciated by the employees who are provided the sweeteners.

## 3. *Funding*

A statutory hybrid plan, like all defined benefit plans, needs to comply with annual funding requirements.<sup>117</sup> The new funding rules require that if the present value of accrued benefits as of the beginning of the year is fully funded, then the only required contribution is the present value of benefits expected to accrue during the year. If the plan is not fully funded at the beginning of the year, then the required contribution also includes the payment of a seven-year amortization of the shortfall. This is further complicated if the plan is at risk,<sup>118</sup> which results in more conservative assumptions as to when employees will retire and what optional forms of benefit they will select, a four percent increase in the values of the Present Values, and an additional surcharge per participant, which is the payment of a seven-year amortization of a \$700 per participant load. Therefore, in a statutory hybrid plan that expresses the accumulated benefit as a

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117. After the PPA, the concept of a minimum funding standard account is eliminated, and is replaced with a required annual contribution calculated by the enrolled actuary under the provisions of new 26 U.S.C. § 430 or § 431.

118. After the PPA rules are effective, a plan will basically be at risk "this year" if the ratio of liabilities to assets "last year" was less than seventy percent and eighty percent (the liabilities need to be calculated in two different ways).

hypothetical account, the present value of accrued benefits at the beginning of the year is simply the total value of hypothetical accounts at the beginning of the year, and if the plan assets can cover all accounts, then the required contribution for the year is simply the present value of benefits accruing during the year (i.e., the value of all accrual and interest credits for the year as defined in the plan document). If the plan is slightly underfunded, but not at risk, then the required contribution will include a seven-year amortization of the shortfall. If the plan has more than five hundred participants, and if it is at risk, then the contribution will require a load. Unfortunately this can get complicated, but if the plan is adequately funded, then the contributions are predictable and controllable. In addition, if the plan is properly funded and the employer has discretionary income, it can contribute and deduct about fifty percent more of the required contribution as a cushion amount (to act as a credit to stave off unexpectedly large contributions that might be required in the future).

#### *4. Investment of Plan Assets*

A statutory hybrid plan, like all defined benefit plans, needs to utilize an investment strategy that makes sense. Under the new PPA rules, an applicable defined benefit plan can use a market rate of return. For other reasons, since Notice 96-8 was issued, most cash balance plans had been crediting interest at the applicable interest rate under I.R.C. § 417(e). Once the Department of Treasury tells us what Congress means by a market rate of return, many existing statutory hybrid plans will simply be amended to substitute that market rate for the applicable rate.<sup>119</sup> However, the new rules also allow a guaranteed fixed rate without the need to pay lump sums calculated under the I.R.C. § 417(e) rates, even if greater than the hypothetical account. This will allow some plan sponsors to offer what looks like a defined contribution plan, but which has a guaranteed rate of interest, thus preserving the investment risk with the employer and not passing it on to the participants. This floating market rate, or a fixed rate, will really allow employers to invest the assets in a manner that often times will match the promised rate, thus avoiding the funding issues stated above. The only concern, after regulations are issued, is whether investing assets to tie into what the Department of Treasury believes is a good market rate of return will comply with the fiduciary requirements of prudence and diversification of plan assets in order to minimize the risk of

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119. Some safe harbors have been described in Notice 2007-6, pending further guidance.

large losses.<sup>120</sup> Hopefully the Department of Labor will see eye-to-eye with the Department of Treasury.

### 5. *Top Heavy*

A statutory hybrid plan, like all defined benefit plans, needs to comply with the accelerated vesting and minimum accrual rules in any year that the plan is determined to be top heavy.<sup>121</sup> However, under the PPA, all statutory hybrid plans after 2008 must fully vest participants after three years of service.<sup>122</sup> This new mandatory vesting schedule satisfies the “top heavy” rules,<sup>123</sup> so it no longer matters whether a statutory hybrid plan is top heavy when it comes to vesting schedules. As to the minimum accrued benefit of two percent of average compensation for each year of participation that the plan is top heavy (up to 10 years),<sup>124</sup> if the statutory hybrid plan is part of a combined program, and employees participate in both the defined contribution plan and the statutory hybrid plan, then the top heavy minimum allocations should probably be provided in the defined contribution plan. If, however, the employee only participates in a statutory hybrid plan, then the plan must be designed to comply with the “top heavy” rules in any year it is top heavy. However, as described below, every participant will be credited with at least a half percent of compensation for each year of service to satisfy the minimum participation requirements, so any additional credits required to satisfy the requirements for non-key employees in top heavy years is probably not excessively costly.

### 6. *Combining a Statutory Hybrid Plan with a Cash or Deferred Arrangement*

Currently, a cash or deferred arrangement (“CODA”) (i.e., a 401(k) plan with elective salary deferrals) is only allowed to be part of a profit sharing plan.<sup>125</sup> Starting in 2010, however, a CODA can be paired with a defined benefit plan<sup>126</sup> to form what is commonly referred to as a “DB(k) Plan,” which will be treated as a single plan for reporting and disclosure purposes. What better way to marry the advantages of a defined benefit plan with the advantages of a defined contribution plan than with a defined benefit plan with accounts that can harmonize with the CODA accounts? This type of design, however, will be limited to

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120. The Department of Labor has jurisdiction over the fiduciary rules codified at 29 U.S.C. § 1104.

121. 26 U.S.C. § 416.

122. 26 U.S.C. § 411(a)(13)(B), as amended by the PPA.

123. 26 U.S.C. § 416(b).

124. 26 U.S.C. § 416(c)(1).

125. 26 U.S.C. § 401(k)(1).

126. 26 U.S.C. § 414(x)(2), as amended by the PPA.

employers with less than five hundred employees.<sup>127</sup> If a statutory hybrid plan is paired with a CODA, then the pay credit must be at least two percent if the participant's age at the beginning of the year is thirty, four percent from ages thirty-one to thirty-nine, six percent from ages forty to forty-nine, and eight percent if age fifty or older (thus, a DB(k) plan will always satisfy the top heavy minimum benefit accrual rules).<sup>128</sup> In the CODA portion, the new automatic contribution arrangement rules must be utilized, and the employer must match at least fifty percent of the elective deferrals up to four percent of compensation.<sup>129</sup> Employer contributions from both portions of the combined plan must be fully vested within three years of credited service, and all contributions and benefits,<sup>130</sup> and all other rights and features must be provided on a uniform basis to all participants.<sup>131</sup> For purposes of the Form 5500, the combined plan arrangement constitutes a single plan.

#### *7. In Service Distributions and Phased Retirement*

Currently, all defined benefit plans are prohibited from distributing plan benefits to participants that are still actively employed (other than through a qualified plan loan). The PPA will permit defined benefit plans to allow in-service distributions upon the attainment of age sixty-two,<sup>132</sup> once the Department of Treasury provides guidance through regulations. This provision ties in with the concept of phased retirement. In a statutory hybrid plan design, whether the accrued benefit is expressed as a hypothetical account or as an accumulated percentage of final average salary, the in-service distribution portion will be an obvious reduction in the value of the account or in the accumulated percentage; whereas, in a traditional defined benefit plan design, the balance between benefits being taken during phased retirement and the benefits remaining after total termination of employment are sometimes not as obvious.

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127. 26 U.S.C. § 414(x)(2)(A)(iv).

128. 26 U.S.C. § 414(x)(2)(B)(iii).

129. 26 U.S.C. § 414(x)(2)(C)(i)(II).

130. 26 U.S.C. § 414(x)(2)(D).

131. 26 U.S.C. § 414(x)(2)(E).

132. 26 U.S.C. § 401(a)(36), as amended by the PPA.

## *B. Disadvantages of Cash Balance Plans<sup>133</sup>*

### *1. Minimum Participation*

A statutory hybrid plan, like all defined benefit plans, needs to comply with the additional participation rules<sup>134</sup> and must benefit at least fifty employees, or if less, forty percent of the employees (however, if there is more than one employee, then the cash balance plan must always benefit at least two employees). In order to count as benefiting under a hybrid plan, each participant used in this number count must accrue at least a half percent of compensation for each year of participation, and additionally, cannot be a short-service or part time employee if other longer-service or full time employees are not participating in the defined benefit plan.<sup>135</sup>

### *2. PBGC Premiums*

A statutory hybrid plan, like most defined benefit plans, needs to pay annual premiums to the PBGC if it is a covered plan.<sup>136</sup> Under the new rules, even if the plan is fully funded, it will still need to pay thirty dollars per participant as a premium, and if not fully funded, then an additional variable premium. Generally, defined benefit plans that only cover owners and their spouses, or that are sponsored by a professional corporation with less than twenty-five employees, are not covered by the PBGC.

### *3. Enrolled Actuary*

A statutory hybrid plan, like all defined benefit plans, needs to have an enrolled actuary certify its funded status on an annual basis, and under the new PPA rules, will also need to certify whether it is at risk.<sup>137</sup> Although some employers that do not currently sponsor any type of defined benefit plan might view this as an additional administrative expense, at least a competent and qualified professional is required to review the funded status of the plan and consult with the sponsor on an annual basis.

### *4. Limitations on Lump Sum Distributions*

A statutory hybrid plan, like all defined benefit plans, might not be able to pay out lump sums (i.e., the participant's hypothetical account if the plan expresses the accrued benefit as

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133. Please note that the authors are big advocates of defined benefit plans, so although the disadvantages are important to consider, they are oftentimes obstacles that can be overcome in a good defined benefit plan design.

134. 26 U.S.C. § 401(a)(26).

135. 26 C.F.R. § 1.401(a)(26)-3(c)(2).

136. 29 U.S.C. § 1321.

137. 26 U.S.C. § 412, generally, before and after being amended by the PPA.

an account). Under the PPA rules, if the funded percentage is between sixty percent and eighty percent then the lump sum will be limited to the lesser of the PBGC guaranteed payment or fifty percent of the hypothetical account. The PPA does not seem to eliminate the existing provision in Treasury regulations that restrict lump sum distributions to the top twenty-five paid employees if the plan is funded at less than one hundred and ten percent of current liability (which has no meaning after 2008),<sup>138</sup> so we need to see what the Department of Treasury does with those regulations.

##### *5. No Wear-Away on Plan Conversions*

A statutory hybrid plan, like all defined benefit plans, can be terminated, or can be converted into a different type of defined benefit plan. Under the PPA, however, if a traditional defined benefit plan is converted into an applicable defined benefit plan, then the preserved benefit must be added to all new accruals after the conversion (the traditional A plus B approach), and cannot be preserved until the new accrued benefit subsumes the preserved accrued benefit (the traditional wear-away approach).<sup>139</sup>

##### *6. Qualified Joint and Survivor Annuity*

A statutory hybrid plan, like all defined benefit plans, must pay a "Qualified Pre-Retirement Survivor Annuity" to the surviving spouse of any married participant that dies before attaining "Normal Retirement Date," and must pay a "Qualified Joint and Survivor Annuity" to any married participant upon attaining his or her "Annuity Starting Date," unless the spouse agrees to an alternate form of benefit.<sup>140</sup> Under the new PPA rules, the QJSA options have become slightly more complicated, and every pension plan will need to add a seventy-five percent "Joint and Survivor Annuity" option ("J&S option") if it does not already include that option (or does not at least offer the choice between a fifty percent J&S option and a one hundred percent J&S option).<sup>141</sup> In order to mitigate problems in a hybrid plan design when an annuity will be paid instead of a lump sum, the plan documents can be written in a manner that mandates that the plan use the hypothetical account balance or the accumulated percentage of final average compensation to purchase the necessary annuity from an insurance company.

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138. 26 C.F.R. § 1.401(a)(4)-5(b)(3).

139. 26 U.S.C. § 411(b)(5)(B)(iii).

140. 26 U.S.C. § 401(a)(11).

141. 26 U.S.C. § 417(g), as amended by the PPA.



### 7. Normal Retirement Age

A statutory hybrid plan, like all defined benefit plans, must specify a "Normal Retirement Age," not only for "Annuity Starting Date" purposes, but for full vesting and accrual purposes as well.<sup>142</sup> Based on proposed Treasury regulations on phased retirement and some recent litigation in the Southern District of New York, the normal retirement age in a statutory hybrid plan might be more restrictive than a normal retirement age in a defined contribution plan.<sup>143</sup>

### 8. Back-Loading

A statutory hybrid plan, like all defined benefit plans, must meet one of three statutory accrued benefit provisions to avoid excessive back-loading.<sup>144</sup> Although the provisions of the PPA seem to indicate that cash balance plans do not violate age discrimination prohibitions if the accrued benefit for any participant is not less than the accrued benefit for a similarly situated participant that is younger,<sup>145</sup> there are no amendments to the statutory anti-back-loading rules. Unfortunately, some court opinions might become relevant.<sup>146</sup>

### 9. Protected Accrued Benefits in a Conversion

A statutory hybrid plan, like all defined benefit plans, cannot be amended in a way that has the effect of eliminating or reducing an early retirement benefit or a retirement-type subsidy, or eliminating an optional form of benefit.<sup>147</sup> Before the PPA, several courts determined that the conversion from a traditional defined benefit plan into a cash balance plan improperly excluded early retirement benefits or subsidies protected under the old plan.<sup>148</sup>

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142. 26 U.S.C. § 411(a)(8).

143. See *Laurent v. PricewaterhouseCoopers*, 448 F. Supp. 2d 537 (S.D.N.Y. 2006) (rejecting PWC's motion to dismiss, and allowing the Plaintiffs to argue that the normal retirement age in the PWC plan violates ERISA).

144. 26 U.S.C. § 411(b)(1).

145. 26 U.S.C. § 411(b)(5)(A).

146. In *Esdén v. Ret. Plan of First Nat'l Bank of Boston*, 229 F.3d 154 (2d Cir. 2000), cert. denied 531 U.S. 1061 (2001), the court opined in dicta, since the plaintiffs apparently did not argue it at the lower court and were refused to amend their complaint, that this particular plan's interest crediting rate might not comply with any of the three accrued benefit rules under 26 U.S.C. § 411(b)(1) (including the 133 1/3% rule). In the original case, *Cooper v. IBM Personal Pension Plan*, 274 F. Supp. 2d 1010 (S.D. Ill. 2003), the lower court determined that IBM's contention that its cash balance plan design complied with the fractional rule was a matter of fact to be proven, but after that decision denying the plan's motion for summary judgment, IBM and the plaintiffs settled on all issues except for the ERISA age discrimination claim, which was ultimately rejected by the Seventh Circuit.

147. 26 U.S.C. § 411(d)(6).

148. See *Esdén*, 229 F.3d 154; *Berger v. Xerox*, 338 F.3d 755 (7th Cir. 2003).

The PPA clears this up and requires that the preserved benefit before the conversion must include all early retirement benefits and retirement-type subsidies if at the time of conversion the participant has met the age, years of service, and other requirements.

#### CONCLUSION

Returning once again to the central issue around which this Article is oriented—age discrimination issues in cash balance arrangements—the authors conclude by stating their belief that good news for cash balance plans is good news for America's retirement system, and that while the PPA and some federal courts have put the issue mostly to bed, the authors regard the pockets of potential liability that still exist to be an unfortunate circumstance.

The authors have not adopted a pro-cash balance plan position arbitrarily. Rather, they regard Congress's endorsement of this plan type, like the aforementioned DB(k) Plan, as an overdue step to help reinvigorate the defined benefit plan market that has been languishing (and slowly dying) in the shackles of overly-rigid regulation. Lawmakers have certainly become cognizant of the fact that voluntary 401(k)s, for all of their advantages, are not an adequate stand-alone solution for providing retirement income for America's aging workforce, especially in light of the uncertain future of the Social Security system and the existence of historically low personal savings rates.

Defined benefit plans are a good and powerful weapon in the fight against the poverty of the aged, and while hybrid arrangements may not be as ideal of a solution as traditional plans could be, it is clear at this point that regulatory endorsement of *only* a narrow class of traditional plan types has been a factor in the slow death of defined benefit plans in general. And to the extent that lawmakers fail to protect plan sponsors from creatively-drafted lawsuits that attempt to capitalize on nuances of language and unintended "black-letter-only" prohibitions, it is a weapon we should expect to do without. The authors very much hope that Congress and the various regulatory bodies continue to try and find middle ground with employers by permitting (albeit cautiously) new and more flexible defined benefit plan breeds to better improve the outlook for generations of future retirees.

