CASH BALANCE PENSION PLAN CONVERSIONS

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One of the hottest issues in the pension world today involves companies replacing their traditional pension plans with cash balance plans. A cash balance plan is a pension plan that looks like a bank account or a 401(k) plan. The problem is that replacing a traditional pension plan with a cash balance plan will reduce the expected pension benefits of older workers. As a result, older workers can see their future pensions cut—in some cases deeply. Not surprisingly, many of these older workers have felt cheated, and they have filed a number of lawsuits to stop these so-called cash balance conversions.

This Article considers the various legal issues that are raised by cash balance conversions. In particular, this Article considers whether these conversions violate the Employee Retirement Income Security Act (ERISA) or the Age Discrimination in Employment Act (ADEA). The Article concludes that the typical cash balance conversion will not violate these laws. As long as the conversion protects the already-accrued benefits of older workers, ERISA will be satisfied. And, as long as post-conversion benefit allocations are nondiscriminatory, ADEA should be satisfied.

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I. INTRODUCTION

One of the hottest issues in the pension world today involves companies replacing their traditional pension plans with so-called cash balance plans. A cash balance plan is a defined benefit plan that looks like a bank account or a 401(k) plan. A cash balance plan accumulates, with interest, a hypothetical account balance for each worker. The individual account


balances are determined by the plan’s benefit formula and consist of two components: an annual cash balance credit and an interest credit.

For example, a simple cash balance plan might allocate 5% of salary to each worker’s account each year and credit the account with 7% interest on the balance in the account. Under such a plan, a worker who earned $30,000 in a given year would get an annual cash balance credit of $1500 (5% x $30,000), plus an interest credit equal to 7% of the balance in her hypothetical account as of the beginning of the year. Like bank accounts and 401(k) plans, workers find that cash balance plans are easy to understand.5

So what’s the problem? Simply put, replacing a traditional pension plan with a cash balance plan will reduce the expected pension benefits of older workers.6 Many older workers will see their future pensions cut—in some cases deeply.7 No doubt, these older workers will feel cheated,8 and some


5. See, e.g., Mitchell, supra note 4, at 28.


7. See, e.g., Congel, supra note 1; Sheppard, supra note 1.

8. Treasury Benefits Tax Counsel J. Mark Iwry recently summarized the problem as follows:

Most of the recent controversy relating to the use of cash balance pension plans has focused on conversions of traditional defined benefit plan structures into cash balance plans. When an employer amends a defined benefit plan that has a traditional final average pay defined benefit formula to provide for a cash balance plan formula, there is a very real change in accrual patterns that can adversely affect certain workers. Older workers who were nearing the peak years of their economic accrual under the traditional plan formula will be deprived of the opportunity to realize those large accruals. These workers might quite understandably view the plan change as tantamount to a pay cut.

attorneys for older workers argue that cash balance plan conversions violate the Employee Retirement Income Security Act (ERISA) and the Age Discrimination in Employment Act (ADEA).

Not surprisingly, a number of older workers have filed lawsuits to stop these conversions, and they have complained to Congress, the Executive Branch, and the media. So far, however, Congress and the Executive Branch have been decidedly laissez faire about these cash balance plan conversions. With the economy booming, government officials don’t seem to want to impose costly limits on the ability of corporations to restructure their


13. See discussion of the legislative response, infra Part V.A.


15. See, e.g., Schultz, supra note 1; Congel, supra note 1.
pension plans.\textsuperscript{16} And, so far, the courts have been less than receptive to the pension law and age discrimination complaints of older workers.\textsuperscript{17}

All in all, the objections of older workers have done little to slow the steady stream of cash balance plan conversions. More than 400 mid-sized and large companies have already shifted to cash balance plans, including at least twenty-two of the \textit{Fortune} 100 companies.\textsuperscript{18} So far, more than seven million workers are already covered by cash balance plans.\textsuperscript{19}

But is it legal? Should companies be allowed to replace their traditional pension plans with cash balance plans? In general, the United States has what is called a “voluntary” pension system.\textsuperscript{20} That is, the federal government does not require employers to provide pension benefits to their workers. If an employer chooses to provide pension benefits, however, the Employee Retirement Income Security Act (ERISA) governs how those benefits are to be provided. ERISA generally ensures that workers will actually receive the pension benefits that their employers have promised them.

Does that mean that a company has to stick with a traditional pension plan that it designed fifty years ago? Under current law, the answer is generally no.\textsuperscript{21} Employers are free to terminate their pension plans or amend

\begin{itemize}
  \item[17.] \textit{See, e.g.,} Goldman v. First Nat’l Bank, 985 F.2d 1113 (1st Cir. 1993) (affirming the dismissal of an age discrimination suit that implicated a cash balance plan conversion); \textit{but see} Lyons v. Georgia Pac. Corp. Salaried Employees Retirement Plan, No. 99-10640, 2000 U.S. App. LEXIS 19180 (11th Cir. Aug. 11, 2000) (holding that, after a cash balance conversion, the Georgia Pacific plan violated ERISA when it failed to properly compute Lyons’ lump-sum distribution).
  \item[18.] \textit{See Congel, supra} note 1, at 656.
  \item[19.] \textit{See id.}
  \item[20.] \textit{See, e.g.,} Daniel Eisenberg, \textit{The Big Pension Swap Accounts That Yield Benefits Sooner are Replacing Traditional Plans, but Older Workers are Crying Foul}, \textit{Time}, Apr. 19, 1999, at 36.
  \item[21.] \textit{See infra} Part IV.
\end{itemize}
them—with only one major caveat: employers can never reduce the benefits that a worker has already earned. Employers can cut future benefit accruals, but they cannot cut the amount of pension benefits that workers have already accrued. In short, ERISA does seem to permit employers to amend their traditional pension plans and thereby convert them into cash balance plans for future years.

Another possible limit on cash balance plan conversions can be found in the Age Discrimination in Employment Act (ADEA). That Act generally makes it unlawful to pay older workers less than younger workers for the same work. But it is difficult to see how older workers can use ADEA to overturn the typical cash balance plan conversion. No court has suggested that ADEA protects an older worker’s right to backloaded benefit accruals in the future.

All in all, older workers may feel cheated when their employers replace traditional pension plans with cash balance plans, but current law seems to permit these cash balance conversions. As long as an older worker’s accrued benefit is protected, ERISA should be satisfied. As long as future benefit allocations are nondiscriminatory, ADEA should be satisfied. And, as long as Fortune 500 companies want to make these changes, Congress and the Executive Branch are unlikely to interfere in any substantive way.

The purpose of this Article is to consider the various legal issues that are raised by these cash balance conversions. At the outset, Part II of this Article provides an overview of cash balance plans, and Part III explains how cash balance conversions work. Next, Part IV of this Article discusses the legality of cash balance conversions. In particular, Part IV considers whether these conversions violate ERISA or ADEA. Finally, Part V discusses proposed legislative and regulatory responses.


There are other deterrents to terminating a defined benefit plan, however. For example, an employer that terminates an overfunded defined benefit plan and recovers the excess assets can be liable for a nondeductible 50% excise tax on the amount of the reversion. See I.R.C. § 4980 (1994 & Supp. 1998). Also, if a plan is terminated, then all participants will vest in their accrued benefits, even if they have not yet met the plan’s normal vesting requirements (e.g., five years of service). See id. § 411(d)(3) (1994).

II. BACKGROUND ON CASH BALANCE PLANS

This Part provides an overview of pension plans, in general, and cash balance plans, in particular.

A. An Overview of Private Retirement Plans

Most private retirement plans are governed by the Employee Retirement Income Security Act (ERISA).\(^{24}\) These private retirement plans typically qualify for favorable tax treatment under the Internal Revenue Code. Basically, an employer’s contributions to a tax-qualified pension plan on behalf of an employee are not taxable to the employee.\(^ {25}\) Nevertheless, the employer is allowed a current deduction for these contributions (within limits).\(^ {26}\) Moreover, the pension fund’s earnings on these contributions are tax-exempt.\(^ {27}\) Workers pay tax only when they receive distributions of their pension benefits,\(^ {28}\) and, at that point, the usual rules for taxing annuities apply.\(^ {29}\)

Employer-sponsored retirement plans generally fall into two broad categories based on the nature of the benefits provided: defined benefit plans and defined contribution plans. These are discussed in turn.

1. Defined Benefit Plans

In a defined benefit plan, an employer promises employees a specific benefit at retirement. To provide this benefit, the employer makes payments into a trust fund and makes withdrawals from the trust fund.\(^ {30}\) Employer


\(^ {26}\) See id. §§ 404, 4972.

\(^ {27}\) See id. § 501(a) (1994).

\(^ {28}\) See id. § 402(a).


contributions are based on actuarial valuations, and the employer bears all of the investment risks and responsibilities. Because the employer bears the risk, the employer also keeps any investment gains and may use the gains to reduce contributions. On the other hand, a defined benefit plan can easily become underfunded because of a decline in value of the pension fund’s investment portfolio or even because of changes in the employer’s workforce (such as increasing life expectancies).

Defined benefit plans typically provide each worker with a specific annual retirement benefit that is tied to the worker’s average compensation and number of years of service. For example, a [typical “final average pay”] plan might provide that a worker’s annual retirement benefit (B) is equal to 2% times years of service (yos) times final average compensation (fac) (B = 2% x yos x fac). Under this formula, a typical worker with 30 years of service would receive an annual retirement benefit equal to 60% of her preretirement earnings (B = 60% x fac = 2% x 30 yos x fac). Final average compensation is typically computed by averaging the worker’s salary over the three [or five] years immediately prior to retirement.

“Career average pay” plans pay benefits based on compensation averaged over a much greater number of years of service, say, thirty rather than five.

2. Defined Contribution Plans

Under a typical defined contribution plan, the employer simply contributes a specified percentage of the worker’s compensation to an individual investment account for the worker. For example, contributions might be set at 5% of annual compensation. Under such a plan, a worker who earned $30,000 in a given year would have $1500 (5% x $30,000) contributed to an individual investment account for her. Her benefit at retirement would be based on all such contributions plus investment earnings thereon. There are a variety of different types of defined contribution plans.

31. Because the employer bears the risk, the employer also keeps any investment gains and may use the gains to reduce contributions. On the other hand, a defined benefit plan can easily become underfunded because of a decline in value of the pension fund’s investment portfolio or even because of changes in the employer’s workforce (such as increasing life expectancies).
34. See EMPLOYEE BENEFIT RESEARCH INSTITUTE (EBRI), supra note 4, at ch. 5.
including money purchase pension plans, target benefit plans, profit-sharing plans, stock bonus plans, and employee stock ownership plans (ESOPs).

Profit-sharing and stock bonus plans may include a 401(k) feature which allows workers to choose between receiving cash currently or deferring taxation by placing the money in a retirement account. Consequently, they are sometimes called cash or deferred arrangements (CODAs). The maximum annual amount of elective deferrals that can be made by an individual in 2000 is $10,500.

3. Hybrid Plans

Alternatively, many companies rely on so-called “hybrid” retirement plans that mix the features of both defined benefit and defined contribution plans. Pertinent here, a cash balance plan is a defined benefit plan that looks like a defined contribution plan. Like other defined benefit plans, employer contributions are based on actuarial valuations, and the employer bears all of the investment risks and responsibilities. Like defined contribution plans, however, cash balance plans provide workers with individual accounts (albeit hypothetical).

Similarly, a so-called “target benefit plan” is a defined contribution plan that looks like a defined benefit plan. A target benefit plan uses a defined benefit formula to establish a “target” benefit for each participant. The employer contributions for each participant are actuarially determined to achieve this goal, but this “target” benefit is not guaranteed. Instead, a worker’s ultimate retirement benefit is based on the actual balance in the worker’s individual account.

38. See infra Part II.B.
Still another approach is for an employer to offer a combination of defined benefit and defined contribution plans. For example, many companies with traditional defined benefit plans have added 401(k) plans. 39

4. Traditional Defined Benefit Plans Are Backloaded

Pension benefits typically accrue differently under defined benefit and defined contribution plans. In particular, under a traditional (i.e., final average pay) defined benefit plan, benefit accruals increase significantly the closer a worker gets to retirement. On the other hand, under a defined contribution plan, benefits accrue at a constant rate (e.g., 10% of annual compensation).

Indeed, one of the most obvious features of traditional final average pay pensions is that they are “backloaded.” That is, they tend to disproportionately favor older workers who have stayed with the company for twenty-five or thirty years. The primary reason for this backloading is that the value of benefit accruals typically increases as a percentage of pay as workers approach retirement age. 39 In fact, well over half of the value of a worker’s pension can accrue in the last five or ten years of service. 40

5. The Implication of Backloading

The differing rates of benefit accrual under traditional defined benefit plans and defined contribution plans result in different incentives that can affect employee decisions about work and retirement. 42 In particular,
traditional defined benefit plans (i.e., final average pay plans) typically penalize workers who change jobs frequently, create large financial incentives for workers to stay on the job at least until they are eligible for early retirement, and push workers out of the work force once they have reached the plan’s normal retirement age.

For example, Table 1 shows the magnitude of this financial penalty on the mobile worker. Table 1 compares the retirement benefits of four workers. These workers all have identical thirty-year pay histories (6% annual pay increases starting at $20,000 and ending at $108,370) and all their employers have identical final average pay plans (1.5% times years of service times final pay). The only difference among these workers is that the first worker spent his entire career with one employer, while the other workers divided their careers over two or more employers. Nevertheless, the long-tenure worker would receive an annual benefit of $49,000 at retirement, while the worker who holds five jobs would receive just $27,000 per year.

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43. See Michael Falivena, Pension Portability: No Easy Solution, PENS. & INVESTMENTS, Feb. 5, 1990, at 15, as reprinted in LANGBEIN & WOLK, supra note 3, at 172 [hereinafter Falivena, in LANGBEIN & WOLK]. See also Olsen & VanDerhei, supra note 37, at 11-12.
In short, the mobile worker covered by a final average pay plan will suffer large benefit losses each time she changes jobs. Moreover, even greater financial penalties can result if a worker changes jobs without vesting. All in all, final average pay plans penalize workers who change jobs frequently.

At the same time, however, final average pay plans create large financial incentives for workers to stay with a firm at least until they are eligible for early retirement. This is the so-called “golden handcuffs” phenomenon.

Also, final average pay plans typically push older workers out of the workforce at normal retirement age. That’s because once a worker is eligible to receive full retirement benefits, delaying retirement can actually be quite costly. Those who delay retirement lose current benefits, but the increase in benefits that can result from an additional year of work rarely

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44. Falivena, in LANGBEIN & WOLK, supra note 43, at 172.

compensates for the benefits lost. And those who work until they drop may leave nothing behind for their survivors.\footnote{46}

On the other hand, because defined contribution plans are not typically backloaded, vested workers do not suffer benefit losses from changing jobs or retiring too early, nor do they face financial penalties for working past the plan’s normal retirement age.\footnote{47} Instead, mobile employees can typically roll over their individual account accruals and accumulate large account balances to be used for retirement.\footnote{48} Indeed, this portability is one of the most important advantages of defined contribution plans,\footnote{49} especially for women who typically have shorter job tenures because of greater child and dependent care responsibilities.\footnote{50}

In that regard, consider two workers, Alex and Bob, working side-by-side and each earning $50,000 a year. Assume further that Alex is thirty-five years old, Bob is fifty-five, and both are covered by a final average pay...
defined benefit plan that provides a retirement benefit equal to 2% times final average pay for up to thirty years of service. Because Bob is closer to retirement age than Alex, their employer would have to contribute more to the pension plan this year on behalf of Bob than Alex. It’s as if the employer contributed $8000 this year for Bob’s pension (which must be fully funded in ten years) but only $2000 for Alex’s pension (which can grow that contribution for thirty years). That’s backloading, and the net effect is that thirty-five-year-old Alex costs the employer just $52,000 to employ, but Bob costs $58,000.

On the other hand, under a defined contribution plan, the employer would contribute the same specified percentage of pay to both workers’ accounts. For example, if contributions were set at 10% of annual pay, both Alex and Bob would see $5000 credited to their individual accounts. Needless to say, younger workers (like Alex) see little reason to go to work for a rust-belt company with a backloaded final average pay pension when they can go to work for a high-tech company—like Microsoft—that will immediately stuff money into their 401(k) accounts.

6. Cash Balance Plans Are Not Backloaded

That’s where cash balance plans come in. Like traditional pension plans, cash balance plans are defined benefit plans, but they look like defined contribution plans. Consequently, corporations stuck with traditional pension plans can mimic defined contribution plans—and get rid of backloading—by amending their traditional pension plans and thereby converting them into cash balance plans.

For example, recall that under the final average pay plan described above, fifty-five-year-old Bob would see an $8000 pension benefit accrual this year, and thirty-five-year-old Alex would see a $2000 accrual. If their employer converts this final average pay plan into a cash balance plan, both Bob and Alex would see $5000 annual credits added to their hypothetical accounts.

Having worked for the company for many years, Bob may feel cheated out of $3000. On the other hand, Alex is thrilled to see a $3000 increase in his benefit accrual, and the employer is happy because it now finds it easier to recruit talented, young workers.

51. See Congel, supra note 1, at 658.
In short, replacing a traditional final average pay pension plan with a cash balance plan will reduce expected benefits for older workers and increase benefits for younger workers, at least for those younger workers who stay with the employer long enough to vest. Indeed, that seems to be why so many companies have made the change. But how else should they compete for workers with Microsoft and the other high-tech companies that are not burdened with traditional pension plans?

7. The Shift Away From Traditional Defined Benefit Plans

Not surprisingly, in recent years, there has been a marked shift away from traditional defined benefit plans and towards defined contribution plans and cash balance plans.\textsuperscript{53} As of 1993, about 43% of private-sector workers were covered by at least one pension plan.\textsuperscript{54} Defined contribution plans comprised 88% of these plans, up from 67% in 1975.\textsuperscript{55} Moreover, 42% of the active participants in those private-sector plans had a defined contribution plan as their primary plan, up from just 13% in 1975.\textsuperscript{56} Similarly, in 1993, 88% of private employers with only one retirement plan sponsored only a defined contribution plan, up from 68% in 1984.\textsuperscript{57} The number of defined benefit plans reporting to the Pension Benefit Guaranty Corporation has also declined—from 111,000 in 1987 to just 43,000 in 1998.\textsuperscript{58} Also of note, 401(k) plans are the fastest growing part of the defined


\textsuperscript{54} See EMPLOYEE BENEFIT RESEARCH INSTITUTE, EBRI DATABOOK ON EMPLOYEE BENEFITS 81 (Employee Benefit Research Institute ed., 4th ed. 1997).

\textsuperscript{55} See id.

\textsuperscript{56} See id.

\textsuperscript{57} See U.S. GENERAL ACCOUNTING OFFICE, supra note 39, at 4.

contribution world. In 1995, for example, there were 201,000 401(k) plans, up from 17,000 in 1984, and the total number of active participants increased from eight million to twenty-eight million over that time period. At the same time, the nature of defined benefit plans has been moving away from the traditional final average pay and career average pay models. According to a recent survey of large U.S. employers that offer defined benefit plans, the percentage utilizing a final average pay formula has decreased from 85% to 72% over the past five years. Similarly, the percentage of large employers using a career average pay formula has declined from 15% in 1995 to 9% today. At the same time, utilization of cash balance plans has increased from 6% to 16% of the large defined benefit plans surveyed. All in all, the era of the traditional defined benefit plan is largely behind us.

B. Cash Balance Plan Basics

For all their novelty, cash balance plans are technically defined benefit plans. However, cash balance plans differ in some key ways from more traditional defined benefit plans (like final average pay plans).

1. An Overview of Cash Balance Plans

A cash balance plan is a defined benefit plan that looks like a defined contribution plan. The plan accumulates, with interest, a hypothetical account balance for each participant. The individual account balances are determined by the plan’s benefit formula and consist of two components: an

59. See Yakoboski, supra note 39, at 29.
61. See id.
62. See id.
63. See Edward A. Zelinsky, ERISA and the Emergence of the Defined Contribution Society, in NYU 57TH INST. ON FED. TAX’N — EMPLOYEE BENEFITS & EXECUTIVE COMPENSATION, §§ 6.01-05 (Alvin D. Lurie ed., 1999) [hereinafter Zelinsky, Defined Contribution Society]. Yakoboski, supra note 39, at 32, views the shift to individual account-type plans as “a plus for workers.” He believes that the enhanced portability inherent in defined contribution plans and cash balance plans provides a better match for today’s mobile work force. See id.
64. See generally references cited supra note 4; Zelinsky, supra note 23, at 687-715.
annual cash balance credit and an interest credit.\textsuperscript{65} For example, a simple cash balance plan might allocate 5% of salary to each participant’s cash balance account each year, and credit the account with 7% interest on the balance in the account.\textsuperscript{66}

Cash balance account statements are issued to participants each year and may provide benefit projections at retirement age. Cash balance statements look like defined contribution plan statements and are generally easier for participants to understand than a traditional defined benefit plan formula. Cash balance plans may pay out account balances in the form of a lump-sum distribution or as an annuity, but some sponsors encourage the selection of an annuity by specifying a favorable actuarial basis to convert accounts to annuities. Table 2 provides an example of a simple cash benefit plan.

\textsuperscript{65} See, e.g., Mitchell, \textit{supra} note 4, at 28.

\textsuperscript{66} In addition to contributions based on salary, cash balance plans may use a flat dollar amount for the credit and may integrate the plans with Social Security. The interest credit may be at a specified rate or it may be indexed to an economic monitor such as the CPI. See Employee Benefit Research Institute (EBRI), \textit{supra} note 4.
This example illustrates how an employee's cash balance account grows over five years. A new employee in this example earns $30,000 per year. Each year the employee will earn cash balance pay credits equal to 5% of $30,000, or $1500, and an interest credit of 7%.

For purposes of this example, assume that each year's pay credit earns one-half of the annual interest credit rate in that year (i.e., 3.5%), since pay credits normally will be credited throughout the year.

The balance after the first year would be $1,552.50 ($1,500 + 3.5% of $1,500). To determine the interest credit for the second year, add 7% of the balance at the beginning of the year ($108.67) to 3.5% of the pay credit for the year ($52.50) to arrive at $161.17. Continuing in this manner, at the end of five years, the account value will be $8,928.01, or almost 30% of annual pay (see table below).

<table>
<thead>
<tr>
<th>Year</th>
<th>Account Value (Beginning of Year)</th>
<th>Annual Pay</th>
<th>Pay Credit (5 percent)</th>
<th>Interest Credit/a/ (7 percent)</th>
<th>Account Value (End of Year)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$0.00</td>
<td>$30,000</td>
<td>$1,500</td>
<td>$52.50</td>
<td>$1,552.50</td>
</tr>
<tr>
<td>2</td>
<td>1,552.50</td>
<td>30,000</td>
<td>1,500</td>
<td>161.17</td>
<td>3,213.67</td>
</tr>
<tr>
<td>3</td>
<td>3,213.67</td>
<td>30,000</td>
<td>1,500</td>
<td>277.46</td>
<td>4,991.13</td>
</tr>
<tr>
<td>4</td>
<td>4,991.13</td>
<td>30,000</td>
<td>1,500</td>
<td>401.87</td>
<td>6,893.00</td>
</tr>
<tr>
<td>5</td>
<td>6,893.00</td>
<td>30,000</td>
<td>1,500</td>
<td>535.01</td>
<td>8,928.01</td>
</tr>
</tbody>
</table>

/a/ Pay credits assumed to receive one-half of the annual interest credit.

2. Cash Balance Plans Look Like Defined Contribution Plans

The key to cash balance plans is the hypothetical account balances they provide for employees.68 However, the accounts are merely bookkeeping devices for cash balance plans.69 The payment and interest credits of a cash balance plan are designed to be similar to those used in defined contribution plans.70 Employers choose these characteristics because they appeal to younger, more mobile employees. However, cash balance plans differ in some key ways from defined contribution plans.

Cash balance plans differ from defined contribution plans because the plan formula defines the future benefit an employee will receive rather than the amount of the employer’s contribution.71 Among other things, that means that a cash balance plan may be underfunded and employees can lose benefits when a plan terminates.72 In contrast, defined contribution plans, once funded, are always fully funded. Because defined contribution plans, once funded, continue to be fully funded, an employee’s account balance is more secure.

Also, under a cash balance plan, the employer assumes the investment risk. The employer must make up the difference if plan assets underperform. On the other hand, if investment returns are high, the employer is allowed to keep any investment returns that the plan earns over and above the amounts promised to employees.73

68. See Quick, supra note 4.
71. See EMPLOYEE BENEFIT RESEARCH INSTITUTE (EBRI), supra note 4.
72. See id. Because cash balance plans are defined benefit plans, however, benefits are guaranteed by the Pension Benefit Guaranty Corporation. See ERISA §§ 4001-4009, 29 U.S.C. §§ 1301-1309 (1994 & Supp. 1998); EMPLOYEE BENEFIT RESEARCH INSTITUTE (EBRI), supra note 4, ch. 3; CONISON, supra note 32, 424-54.
73. See Hearing on Pension Reform, supra note 9 (prepared testimony of Patrick J. Purcell, Specialist in Social Litigation, Congressional Research Service, Washington, D.C.). Also, Financial Accounting Standard No. 87 allows companies to report their excess pension assets as income on their financial statements. See EMPLOYERS’ ACCOUNTING FOR PENSIONS, Statement of Financial Accounting Standards No. 87 (Fin. Accounting Standards
On the other hand, defined contribution plans allocate the financial risks to employees. The employer’s only funding obligation is to make the initial contribution. As a result, the employer makes no guarantees concerning the level of benefits an employee will receive.

Defined contribution plans can also be cumbersome in some respects. Because contributions are kept in separate accounts and not pooled, capital is often locked into low-risk investments. This result occurs because employees often invest too conservatively. In contrast, cash balance plans offer pooling of assets and management by professionals rather than individual employees. This feature, plus the individual account statements that employees receive, are two reasons for the growth of cash balance plans. However, the rise of cash balance plans can also be attributed to other factors.


As already explained, traditional defined benefit plans are backloaded. Like defined contribution plans, however, cash balance plans provide for more uniform accruals over an employee’s working career. They provide

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74. See Purcell, supra note 4, at 1-2.
75. See id. at 2.
76. See id.
79. See id.
81. See supra Part II.A.4.
for larger benefit accruals than final-average-pay plans for younger workers and smaller benefit accruals for older workers. Table 3 provides a comparison between a cash balance plan and a traditional plan. Even though the two plans in Table 3 produce almost identical values at age sixty-five, the cash balance plan offers a more level pattern of accrual throughout the employee’s career.

Table 3. Cash Balance Plan v. Final-average-pay Plan: Comparison of Accumulated Single Sum Values

<table>
<thead>
<tr>
<th>Age</th>
<th>Final-Average-Pay-Plan</th>
<th>Cash Balance Plan</th>
</tr>
</thead>
<tbody>
<tr>
<td>30</td>
<td>$200</td>
<td>$900</td>
</tr>
<tr>
<td>40</td>
<td>$7,200</td>
<td>$19,000</td>
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<td>50</td>
<td>$42,300</td>
<td>$74,700</td>
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<tr>
<td>60</td>
<td>$184,800</td>
<td>$212,000</td>
</tr>
<tr>
<td>65</td>
<td>$323,200</td>
<td>$329,000</td>
</tr>
</tbody>
</table>

Chart I provides a graphic comparison between a cash balance plan and a traditional defined benefit plan. Chart I compares the contributions made on behalf of an individual for the following two hypothetical pension plans: (1) a simple cash balance plan with a flat 6% pay credit and an annual interest credit of 5%, and (2) a traditional defined benefit plan with a benefit at age sixty-five of 1% multiplied by the years worked and multiplied by the final pay. Chart I shows that the cash balance plan has fairly level contribution accruals at all ages. On the other hand, the traditional defined benefit plan is backloaded, and there are financial penalties for staying past retirement age. All in all, Chart I illustrates that cash balance plan contributions are much larger than the accruals of the traditional defined


84. Making the Transition, supra note 82.

benefit plan for young employees, but are much smaller for older employees.\textsuperscript{86}

\textbf{III. Cash Balance Plan Conversions}

On their face, cash balance plans seem particularly benign. The plans favor uniform accruals for employees. However, cash balance plans have generated a fair amount of controversy and are currently the subject of a number of legislative proposals aimed at curtailing the perceived inequities under the plans.\textsuperscript{88} The controversial aspects of cash balance plans are not a result of the plan formulas. The plans receive attention because of negative consequences often resulting to older employees when a traditional defined benefit plan is converted into a cash balance plan.

\begin{itemize}
  \item \textsuperscript{86} See id.; see also Steve J. Kopp & Lawrence Sher, \textit{A Benefit Value Comparison of a Cash-Balance Plan with a Traditional Final Average Pay Defined Benefit Plan}, \textit{The Pension Forum}, Oct. 1998, at 1.
  \item \textsuperscript{87} \textit{Hearing on Hybrid Pensions, supra} note 8 (testimony of Ron Gebhardtsbauer) and \textit{supra} note 85.
  \item \textsuperscript{88} See infra Part V.A.
\end{itemize}
A. Plan Conversion Basics

Many companies favor cash balance plans because these plans are easy to administer, an employer’s required contribution is more readily ascertainable, and the plans benefit mobile workers.\textsuperscript{89} Other more cynical reasons may also explain why companies convert to cash balance plans. A conversion to a cash balance plan may be a way for an employer to reduce future benefit accruals without employees noticing.\textsuperscript{90}

As discussed earlier, traditional defined benefit plans are “backloaded.”\textsuperscript{91} As a result, older employees can be very expensive to employ.\textsuperscript{92} When an employer decides to convert a traditional defined benefit plan to a cash balance plan, the accrued benefits under the old plan cannot be reduced.\textsuperscript{93} However, the interaction of several factors results in older employers receiving less benefits.

1. How a Conversion Works

In a conversion, the employer determines an employee’s accrued benefit.\textsuperscript{94} However, this accrued benefit is usually not the opening balance of the nominal cash balance account.\textsuperscript{95} This results from regulations allowing employers to use two different interest rates in calculating the accrued benefits under the old plan and the opening balance of the new plan.\textsuperscript{96} The employer often chooses the combination of interest rate assumptions most favorable to it. Additionally, an employer can set the opening account

\textsuperscript{89} See Veenhuis, supra note 80, at 13.
\textsuperscript{90} See id.
\textsuperscript{91} See supra Part II.A.4-5.
\textsuperscript{92} For example, it typically costs employers more to provide pension and health benefits for older workers than for younger workers, and salary costs and other benefits can also be higher. See, e.g., Gary Minda, Opportunistic Downsizing of Aging Workers: The 1990s Version of Age and Pension Discrimination in Employment, 48 HASTINGS L.J. 511, 523-25 (1997).
\textsuperscript{93} See Mitchell, supra note 4, at 29.
\textsuperscript{94} See id.
\textsuperscript{95} See Congel, supra note 1, at 658.
balance at almost any level as long as an employee who leaves can receive a lump sum equal to the present value of her accrued benefit under the old plan.97

2. Benefit Accrual in Cash Balance Conversions

Replacing a traditional pension with a cash balance plan can have an adverse impact on middle-aged workers. The mid-career worker “gets the worst of both plans—the lower early accruals provided by the final pay plan, along with the lower late accruals provided by the cash balance plan.”98 For most defined benefit plans, an employee accrues most of her benefits in the last few years of employment.99 As a result, employees accrue very little in the first years of employment.

Cash balance plans have more uniform accruals.100 When an employer converts from a traditional defined benefit plan to a cash balance plan, the employee never receives the benefit of those disproportionately large late career accruals. While the loss of expected accruals is troublesome for employees, they may also be hurt by not accruing more benefits for several years. This phenomenon is known as the “wearaway.”101

3. The Wearaway

When an employer amends a pension plan, it cannot reduce already accrued benefits.102 As a result, an employee who had accrued a benefit of $1000 a month at age sixty-five before the amendment is entitled to at least $1000 a month at age sixty-five after the amendment.103 To ensure that employees’ accrued benefits are not reduced, employers use two methods. Under one method, the “sum of” formula, the benefits accrued after the

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97. See Hearing on Pension Reform, supra note 9 (testimony of Patrick J. Purcell) and supra note 73.
98. Making the Transition, supra note 82. See also Hearing on Pension Reform, supra note 9 (testimony of Patrick J. Purcell) and supra note 73, at 7.
100. See id.
103. See Hearing on Hybrid Pensions, supra note 8 (testimony of J. Mark Iwry).
amendment are added to the benefits accrued before the amendment. The other option is the “greater of” formula. Under this option, the employer determines the benefits that would be due under the new plan and compares that number to the accrued benefits under the old plan. The employer meets these requirements as long as the employee receives the greater benefit.

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104. See id.
105. See id.
106. I.R.S. Notice 96-8, supra note 70, provides the following example:

As explained below, in order to comply with sections 411(a) and 417(e) in calculating the amount of a single sum distribution under a cash balance plan, the balance of the employee’s hypothetical account must be projected to normal retirement age and then the employee must be paid at least the present value, determined in accordance with section 417(e), of that projected hypothetical account balance. If a cash balance plan provides interest credits using an interest rate that is higher than the section 417(e) applicable interest rate, payment of a single sum distribution equal to the hypothetical account balance as a complete distribution of the employee’s accrued benefit may result either in a violation of section 417(e) or a forfeiture in violation of section 411(a). This is because, in such a case, the present value of the employee’s accrued benefit, determined using the section 417(e) applicable interest rate, will generally exceed the hypothetical account balance. The following example illustrates this potential problem.

Example. A cash balance plan provides for interest credits at a fixed rate of 8% per annum that are not conditioned on continued employment, and for annuity conversions using the section 417(e) applicable interest rate and mortality table. A fully vested employee with a hypothetical account balance of $45,000 terminates employment at age 45 and elects an immediate single sum distribution. At the time of the employee’s termination, the section 417(e) applicable interest rate is 6.5%.

The projected balance of the employee’s hypothetical account as of normal retirement age is $209,743. If $209,743 is discounted to age 45 at 6.5% (the section 417(e) applicable interest rate), the present value equals $59,524.

Accordingly, if the plan paid the hypothetical account balance of $45,000, instead of $59,524, the employee would receive $14,524 less than the amount to which the employee is entitled.

Even if a cash balance plan provides interest credits using an interest rate that exceeds the section 417(e) applicable interest rate, the plan can satisfy sections 417(e) and 411(a). Such a plan would provide that the amount of any single sum distribution is equal to the present value of the employee’s accrued benefit determined in a manner that satisfies sections 411(a) and 417(e) even if the amount of the single sum exceeds the employee’s hypothetical account balance. Thus, in the example above, the plan would satisfy sections 411(a)
If the employer sets the opening account balance at less than the present value of the old pension plan, the employee will not receive any new pension benefits until the benefit under the new plan equals the benefit the employee has earned under the old plan.\(^{107}\) The employer is also allowed to freeze its contributions until the employee has earned under the cash balance plan the amount she was entitled to under the old defined benefit plan.\(^{108}\) As a result, employers may not have to pay for benefit accruals for as long as five years after a conversion.\(^{109}\) This result has been dubbed the “wearaway” (or “benefit plateau”), and it is one of the most contentious features of cash balance plans. Some critics contend that the wearaway results in an end-run around the rule that accrued benefits cannot be reduced.\(^{110}\)

One of the principal causes of wearaways in most cash balance conversions is the elimination of early retirement subsidies from the pension plan.\(^{111}\) After a conversion, the opening balance in a worker’s cash balance account is typically based upon the worker’s normal retirement age benefit under the old plan and does not include the value of any early retirement subsidy that the worker may have already earned under the old plan. Consequently, a wearaway will occur because a worker who has already earned an early retirement subsidy prior to the conversion will have an accrued benefit under the old plan that is higher than the opening balance of her cash balance account. If she were to leave the company at the time of the conversion, she would be entitled to the full value of her accrued benefits, including the value of any early retirement subsidy that she had accrued. If she were to stay with the company, however, it could take years before the

and 417(e) if the employee received a single sum distribution of $59,524 (the present value of the employee’s accrued benefit) rather than $45,000 (the employee’s hypothetical account balance).


107. See id.
108. See id.
109. See Harkin, supra note 41.
110. See id.
111. See, e.g., Senate Hearing on Cash Balance, supra note 9 (prepared testimony of Laurel Sweatt, Manager of Benefits, Central and South West Corporation, representing the Association of Private Pension and Welfare Plans, Dallas, Texas), at 8.
balance of her cash balance account exceeded the value of her accrued benefit at the time of conversion.\textsuperscript{112}

The extent of the wearaway can also depend on interest rates.\textsuperscript{113} If interest rates are increasing, the present value of the old benefits is less than under the cash balance plan.\textsuperscript{114} As a result, an employee would suffer more from the wearaway. With planning, a savvy employer can generate a large wearaway. Such an employer would use a high interest rate to determine the opening balance. As a result, an employee who had accrued $1000 under the old defined benefit plan may only be entitled to $800 as his opening cash balance account balance.\textsuperscript{115} In that case, that employee will not earn any more benefits until the $200 wears away.\textsuperscript{116}

\begin{itemize}
  \item \textsuperscript{112} See, e.g., \textit{Members of ABA Tax Section Say Cash Balance Plans Are Not Discriminatory}, \textit{TAX NOTES TODAY}, ¶¶ 69-72 (July 6, 2000) (LEXIS, FEDTAX Library, TNT File, 2000 TNT 130-53) (providing a numerical example of the basic wearaway problem) [hereinafter \textit{Members of ABA Tax Section}].
  \item \textsuperscript{113} See, e.g., \textit{Hearing on Cash Balance}, supra note 9 (testimony of Laurel Sweatt) and supra note 111, at 7; \textit{Time Out for Facts}, supra note 6; The ERISA Industry Committee, \textit{Understanding Cash Balance Plans} (visited Apr. 8, 2000) <http://eric.org/cashbalancebrief.htm>.
  \item \textsuperscript{114} This is a particularly difficult issue to understand. Basically, the problem is one of different interest rates. Section 417(e) of the Tax Code requires that a defined benefit plan that offers a lump-sum option convert the annuity into a lump sum using an interest rate that produces a lump sum that has a \textit{minimum} value. When you apply this law in reverse, as must be done in a cash balance plan — where the benefit is defined as a lump sum — this rule forbids the plan from converting that lump sum into an annuity that is too high. In other words, what sets a \textit{minimum} lump-sum value sets a \textit{maximum} annuity amount.
  \item Chart C [omitted] illustrates this effect. It assumes that a plan converts the participant’s accrued benefit under the traditional plan into an initial cash balance using an 8% interest rate based on current market conditions. The law, however, requires the use of a 6% interest rate for converting an annuity to a lump sum. As a result, the plan promises that the employee will get the greater of the cash balance account or the value of the accrued benefit at the time of transition. Chart C shows how the two values grow as a 40-year-old employee approaches retirement. The value of the frozen lump sum starts out higher. It grows rather slowly — at the 6% rate — until it is overtaken by the cash balance account, which grows with both interest and new contribution credits.

\textit{Time Out for Facts}, supra note 6, at 7.
  \item \textsuperscript{115} See id.
  \item \textsuperscript{116} See id.
\end{itemize}
4. Transitional Benefits

Because cash balance conversions can have an adverse impact on mid-career employees, many companies offer them transitional benefits to temper those adverse effects.\textsuperscript{117} Indeed, one survey of about seventy-five cash balance plans found that, in two out of three cases, employers provided transition benefits of one type or another.\textsuperscript{118} For example, some companies allow some or all of their employees the right to choose between the new and old plans.\textsuperscript{119} Still other employers offer stock options or an increased employer matching contributions in a 401(k) plan.\textsuperscript{120} Of course, such generous transitional provisions can alleviate much of the concerns about ERISA or age discrimination violations that might otherwise arise in connection with the conversion.\textsuperscript{121}

\begin{footnotesize}
\begin{enumerate}
\item[119.] See Time Out for Facts, supra note 6.
\item[120.] See Making the Transition, supra note 82.
\item[121.] See Time Out for Facts, supra note 6.
\end{enumerate}
\end{footnotesize}
B. How Cash Balance Conversions Can Affect Employers

1. Cash Balance Conversions Can Save Employers Money

A switch to a cash balance plan can result in significant savings for employers. Indeed, some believe that a conversion can even make a pension plan a profit center for a company.\textsuperscript{122} An employer can save money on a conversion in two possible ways.\textsuperscript{123} First, because future benefit accruals for older employees will fall, the employer should be able to reduce its future contributions to the plan. Second, an employer can promise a low rate of return to employees and keep any actual returns above that rate.

On the other hand, the empirical evidence shows that the typical company realizes little, if any savings, when it shifts to a cash balance plan.\textsuperscript{124} For example, in its study of seventy-eight large companies that had converted their traditional pensions to cash balance or other hybrid plans, Watson Wyatt Worldwide found average employer cost savings from such conversions of just 1.4%.\textsuperscript{125} At the same time, however, that study found that cash balance conversions did result in a significant redistribution of benefits among workers, and while most workers were better off with the new hybrid plan, the average sixty-year-old worker with thirty years of service would get only 78% of the benefit she would have received under the original plan.\textsuperscript{126}

a. Employers Save as Benefit Accruals for Older Workers Fall

Cash balance plan conversions reduce future benefit accruals for older workers, even if the plan does not create a wearaway. Because of these reduced future accruals for older workers, cash balance plans can save

\begin{footnotesize}
\textsuperscript{122} See Harkin, \textit{supra} note 41; \textit{Arousing Suspicions}, PENS. \& INVESTMENTS, June 12, 2000, at 12.
\textsuperscript{123} See Purcell, \textit{supra} note 4, at 6.
\textsuperscript{125} See Brown et al., \textit{supra} note 118, at ii.
\end{footnotesize}
employers significant amounts on required contributions. Indeed, an over-funded pension plan can pay for its own “contributions.”  

The wearaway can compound employer savings. As discussed earlier, employers determine the opening balance of the cash balance plan under the new formula, and some employees might start with cash balance account balances that are much less than the amount of their already accrued benefits under the old plan. As a result, the employer will not have to contribute any more for those employees until the benefit entitlement under the new plan exceeds the benefits accrued under the old plan.

These wearaways follow from the IRS guidance allowing employers to determine use by the “greater of” formula discussed earlier. Under the “greater of” method of plan amendment, the employer can freeze contributions to the new plan until the accrued benefit due exceeds the employee’s already accrued benefit in the old plan. The employer is still making hypothetical contributions to the plan, but the employee will not be earning any additional benefits until the extra wears away. These factors can make an underfunded pension plan into a fully funded plan after a conversion.

b. Employers Can Save If the Actual Rate of Return on Plan Assets Exceeds the Rate of Return Promised to Employees

Employers may also have another opportunity to profit from cash balance plans. An employer is allowed to promise a low rate of interest to employees on the hypothetical account balances and keep any actual returns on pension fund assets above that interest rate. The employer can use the extra returns as pay and interest credits and not have to make contributions each year. However, an employer would have to make up the difference in

127. See Purcell, supra note 4, at 6.
128. See Mendelson, supra note 77, at 8.
129. See id.
130. See id.
131. See Hearing on Hybrid Pensions, supra note 8.
132. See id.
133. See id.
134. See Harkin, supra note 41.
135. See Purcell, supra note 4, at 6.
136. See id.
137. See id.
the event that the actual rate of return on pension fund assets was less than
the promised interest rate.\footnote{138}

2. Cash Balance Plan Conversions Can Affect the Composition of the
Work Force

A switch to a cash balance plan can also make companies more
attractive to certain workers. Younger employees favor the monthly
statement of benefits included in a cash balance plan.\footnote{139} The conversion from
a traditional defined benefit plan to a cash balance plan also functions to
redistribute benefit accruals in favor of younger workers.\footnote{140} These factors
combine to make cash balance plans very desirable for younger workers, at
least those who vest.

In addition to being more popular with younger workers, conversion to
a cash balance plan may also provide an incentive for costly older workers
to retire. Older workers may be continuing to work primarily because they
want to maximize their benefits under their original backloaded pension plan.
After a conversion to a cash balance plan, however, these older workers
would accrue benefits at a much lower rate than under the original plan.
Moreover, when the conversion creates a wearaway, some older workers
might not accrue any new benefits for several years.\footnote{141} As a result, older
workers would have less incentive to continue working and might choose to
quit earlier than if the company had retained its original pension plan.\footnote{142}

In fact, sometimes the only way for older workers to avoid the adverse
impact of a wearaway is to quit and receive a payment equal to the present
value of their accrued benefits under the original plan.\footnote{143} The loss of older
workers means less health insurance, life insurance, salary, and other costs
for employers. This factor combined with younger workers’ interest in
monthly statements makes cash balance plan conversion an effective tool for
planning workforce composition.

\footnote{138}{In addition, see the discussion of Financial Accounting Standards No. 87, \textit{supra} note 73.}
\footnote{139}{See Sheppard, \textit{supra} note 1, at 171.}
\footnote{140}{See, e.g., Brian Tumulty, \textit{Cash Balance Plans Slight Older Workers}, \textit{Salt Lake Tribune}, May 2, 1999, at D1.}
\footnote{141}{See Mendelson, \textit{supra} note 77, at 8.}
\footnote{142}{See Sheppard, \textit{supra} note 1, at 171.}
\footnote{143}{See \textit{Morning Edition, supra} note 96.}
On the other hand, because a cash balance conversion reduces the retirement benefits available to older workers, it may induce them to work longer than they otherwise would have. Indeed, according to Dr. Sylvester J. Schieber, Director of the Research and Information Center of Watson Wyatt Worldwide, one key feature of most cash balance conversions is the elimination of early retirement subsidies. Schieber believes that employers are eliminating these early retirement subsidies in response to tightening labor markets and changing demographics.

3. Why Many Employers Find that a Cash Balance Plan Conversion Is the Best Alternative

Converting a traditional defined benefit plan into a cash balance plan can also avoid the kind of negative publicity and tremendous costs that could result from terminating a traditional plan. Some critics believe that companies use cash balance plans as a cheaper alternative than simply terminating plans all together. This claim is bolstered by the fact that most cash balance plans are instituted as conversion plans. Employers do not usually create a pension program with a cash balance plan. However, supporters of cash balance plan conversions strongly disagree with the notion that employers convert to a cash balance plan to avoid the costs of a plan termination.

Employers may also favor cash balance plans because the funding requirements are more level than for traditional defined benefit plans. This result occurs because benefits are not defined in terms of final average

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144. See Hearing on Cash Balance, supra note 9 (prepared testimony of Sylvester L. Schieber) and supra note 118, at 1.
146. In particular, an employer that terminates an overfunded defined benefit plan and recovers the excess assets can be liable for a nondeductible 50% excise tax on the amount of the reversion. See I.R.C. § 4980 (1994 & Supp. 1998).
147. See Stein, supra note 78, at 29.
148. See id.
150. See Purcell, supra note 4, at 5.
Instead, under a cash balance plan, funding is directly proportional to current payroll (e.g., 5% of current pay). Consequently, cash balance plans can avoid the increasing costs associated with backloading that occur under final average pay plans, especially as an employer’s workforce ages.  

4. When an Employer Loses With a Cash Balance Plan Conversion

Cash balance plans do not always result in savings for employers. Because the benefits are no longer backloaded and are designed to benefit mobile employees, plan costs will increase if many younger employees leave early. Moreover, the complexities of cash balance plans may make them more expensive for employers to administer. In general, the factors determining whether an employer will save money on a conversion from a traditional defined benefit plan to a cash balance plan are the overall design of the plan, whether the employer provides transition benefits, how the workforce is composed, and the impact on other employee benefit programs.

Employers who convert to a cash balance plan often increase contributions to other employee benefit plans. Also, employers who initially save on decreased contributions to older employees will pay over the long term with higher contributions on behalf of their younger employees. Indeed, that is one reason why cash balance plan supporters dispute claims that employers switch to cash balance plans to save money. As some supporters point out, an employer who wanted to save money could reduce the generosity of the defined benefit plan formula, terminate the plan altogether, or replace it with a less expensive defined contribution plan.

All in all, the overall characteristics of cash balance plans make these plans very attractive for employers. Employers have funding flexibility and

151. See id.
152. See id. at 7.
153. See Perdue, supra note 69, at 197.
154. See id.
156. See Ugoretz, supra note 149, at 465.
157. See id.
158. See The ERISA Industry Committee, supra note 113.
159. See id.
can hire workers who favor the monthly statements of benefits and benefit accruals that are proportional to salary.\textsuperscript{160} As a result, with cash balance plans, employers can enjoy the most favorable characteristics of both defined benefit plans and defined contribution plans.

\textit{C. Employee Perspectives on Cash Balance Plans}

All in all, cash balance plan conversions can be very beneficial for employers, but the effect of a conversion on employees is less clear cut. Some mid-career employees are greatly hurt by the wearaway and loss of expected increased accruals.

1. How Employers Obtain Employee Approval for Conversions

Because the wearaway problem can have such a negative effect on workers, it is worth considering why most employees do not protest the change from a traditional defined benefit plan to a cash balance plan. For the most part, the failure to protest results from the fact that conversions are too complicated for most employees to understand and from the fact that employees usually receive very little notice of proposed conversions. Also, in many instances, an employer will offer “sweeteners” to assure employee acceptance of the new plan.\textsuperscript{161} These sweeteners can include higher contributions or giving some employees the power to elect to stay under the old plan.\textsuperscript{162} These sweeteners can ease the transition for employees, but not all employers offer them.

There have been some protests. The recent cash balance conversion by IBM, for example, was the subject of extensive protests by employees (and politicians). In particular, many older employees complained about having to suffer from wearaways at a time when the pension had an eight million dollar surplus and the company had record profits.\textsuperscript{163} At least one employee suit was brought because of the conversion.\textsuperscript{164} As a result of these widespread protests, IBM recently agreed to give a larger number of

\textsuperscript{160} See Congel, \textit{supra} note 1, at 658.
\textsuperscript{162} See \textit{id}.
\textsuperscript{163} See, \textit{e.g.}, sources cited \textit{supra} note 145.
employees the option of staying with the original plan or moving to the company’s new cash balance plan.165

2. Why Some Employees Benefit from Cash Balance Plans

On the other hand, many workers may applaud a cash balance plan conversion. In particular, younger workers typically favor cash balance plans because of the more favorable benefit formula and because the benefits are more portable than under traditional defined benefit plans.166 Women, too, may prefer cash balance plans. According to one actuarial study, most women would receive more benefits under a cash balance plan than under a traditional plan.167 Cash balance plans are very favorable for employees who leave and reenter the work force.168 Additionally, workers no longer have to work until some magic date to receive increased benefits.169 As a result, employees may be more able to leave unsatisfying jobs.170

Additionally, many workers prefer to have their benefits defined in terms of accounts, albeit hypothetical accounts.171 Workers may also appreciate their employer’s contributions more under a cash balance plan because they receive annual notification of employer credits to their accounts.172 Besides these benefits, many employees will actually profit from the conversion to a cash balance plan.

IV. THE LEGALITY OF CASH BALANCE CONVERSIONS

Replacing a traditional pension with a cash balance plan raises a number of complicated and unsettled legal issues under the Internal Revenue Code, the Employee Retirement Income Security Act (ERISA) and the Age

167. See Quick, supra note 4, at 7. See also Rappaport, supra note 50.
168. See The ERISA Industry Committee, supra note 113.
169. See id.
170. See id.
171. See id.
Discrimination in Employment Act (ADEA). These legal issues fall into four principal categories: (1) the protection of accrued benefits; (2) the rate of benefit accrual; (3) age discrimination; and (4) notice requirements.

A. The Protection of Accrued Benefits

The Internal Revenue Code and ERISA give employers very broad latitude in amending plans. The Internal Revenue Code states that a plan may not reduce "the accrued benefit of a participant." The same anti-reduction rule also appears in ERISA. Under these provisions, a plan amendment is permissible as long as a participant’s already accrued benefit is not decreased.

In the case of a traditional defined benefit plan converted to a cash balance plan, the employer is, in effect, freezing past benefit accruals and adopting a new formula for future benefit accruals. As long as past benefit accruals are not reduced, it would seem that an employer is always free to amend its plan to reduce future benefit accruals. According to no less an authority than the Chief Counsel of the IRS, an "employee’s expectation that a benefit formula will remain in effect until the employee retires is not protected." Nor do these provisions "protect an employee’s expectation that future compensation increases will be taken into account in computing


174. "A plan shall be treated as not satisfying the requirements of this section if the accrued benefit of a participant is decreased by an amendment of the plan, other than an amendment described in section 412(c)(8), or section 4281 of the Employee Retirement Income Security Act of 1974." I.R.C. § 411(d)(6)(A) (1994).

175. See ERISA § 204(g)(1), 29 U.S.C. § 1054(g)(1) (1994). "The accrued benefit of a participant under a plan may not be decreased by an amendment of the plan, other than an amendment described in section 1082(c)(8) or 1441 of this title." Id.

176. These provisions “also protect[] associated fundamental rights, for example, the right to receive an early retirement benefit.” Hearing on Hybrid Pensions, supra note 8 (testimony of Stuart Brown) and supra note 22.

177. See Mitchell, supra note 4, at 30.

178. Hearing on Hybrid Pensions, supra note 8 (testimony of Stuart Brown) and supra note 22.
an employee’s benefits.”

For that matter, an employer is generally free to terminate an existing plan and provide no future benefit accruals whatsoever.

In short, replacing a traditional pension plan with a cash balance plan will not violate this anti-reduction rule as long as the new plan “protects the benefits that participants had accrued under the original plan at the time of the conversion.” As mentioned, employers can satisfy the anti-reduction rule by guaranteeing that each employee is assured “the greater of” the accrued benefits under the original plan or the benefits calculated under the new cash balance formula.

Moreover, this analysis is equally applicable to cash balance conversions that involve a wearaway. Many employers set the starting account balance of the defined benefit plan at a value less than the accrued benefits. Under that scenario, an employer does not have to make additional contributions until the value promised under the new plan exceeds the amount already accrued under the old plan. Nevertheless, as long as an employer does not reduce past benefits, it can set the rate of future benefit accrual at any level that it wants without risk of violating the anti-reduction rule.

In practice, however, some cash balance conversions may run afoul of the anti-reduction rule. In particular, if a plan relies solely on the value of a worker’s hypothetical account to protect accrued benefits, changes in the market interest rates can create problems. For example, a cash balance plan might violate the anti-reduction rule if the interest rate used for interest credits is less than the plan’s interest rate used for calculating a lump sum

179. Hearing on Hybrid Pensions, supra note 8 (testimony of Stuart Brown) and supra note 22.
180. See id.
181. Id.
182. See id.; Hearing on Hybrid Pensions, supra note 8. The employer must ensure that all benefits accrued as of the date of conversion are protected, including such optional forms of benefits as an early retirement option. See id. (testimony of Stuart Brown) and supra note 22. See supra Part III.A.3.
183. See Hearing on Hybrid Pensions (testimony of Stuart Brown) and supra note 22. But see Senator Tom Harkin, Harkin Letter to IRS Commissioner Rossotti, available in WL, 1999 TNT 135-59. Senator Harkin argues that the plans are using a legal fiction to reduce accrued benefits. Senator Harkin believes that companies are getting around the prohibition against reducing accrued benefits by denying benefits under the new plan due to the already accrued benefits. See id.
184. See Purcell, supra note 4, at 8.
185. See id.
A similar problem could result if the original plan allowed for subsidized early retirement and the value of that potential subsidized early retirement was not taken into account in establishing the initial cash balance.\textsuperscript{187}

\section*{B. Rate of Accrual Issues}

The Internal Revenue Code and ERISA provide specific rules that govern the pattern under which pension benefits must be accrued.\textsuperscript{188} In general, these rules were enacted to prevent excessive backloading of benefit accruals.\textsuperscript{189} The rules ensure that the benefits under a pension plan accrue at certain minimum rates. For example, a plan that provided a pension that accrued $1 a year for twenty-nine years and $100,000 in year thirty would violate these anti-backloading rules.

That’s where cash balance plan conversions that involve a wearaway can have a problem. Cash balance plans generally seek to satisfy the so-called 133\(\frac{1}{3}\)% method of benefit accrual.\textsuperscript{190} Under that method, the benefit accrual in a later year of service cannot exceed 133\(\frac{1}{3}\)% of the benefit accrual in any prior year of service. The IRS acknowledges that some cash balance plan conversions can satisfy the 133\(\frac{1}{3}\)% test.\textsuperscript{191} However, the IRS is concerned that the interplay of multiple benefit formulas, pay patterns, length of service, age of participants, and interest rates can result in accrual patterns that do not satisfy the rule.\textsuperscript{192}

In particular, the IRS seems to be concerned that the period of zero benefit accruals following a cash balance plan conversion may violate the


\textsuperscript{187} See Time Out for Facts, supra note 6. To avoid this risk, however, the cash balance plan can use the “greater of” formula discussed earlier. See Hearing on Hybrid Pensions, supra note 8 and text accompanying notes 104-06; supra Part IIIA.3.


\textsuperscript{189} Recall that backloading occurs when a disproportionate percentage of benefits are earned at the end of a worker’s career. See supra Part IIA.

\textsuperscript{190} See Hearing on Hybrid Pension, supra note 8 (testimony of Stuart Brown) and supra note 22. See also I.R.C. § 411(b)(1)(B).

\textsuperscript{191} See Hearing on Hybrid Pensions, supra note 8 (testimony of Stuart Brown) and supra note 22.

\textsuperscript{192} See id.
133\(\frac{1}{3}\)% test. The test would be violated, for example, if an employee accrued no benefit one year and $1000 the following year, as $1000 is infinitely larger than $0 (and so greater than 133\(\frac{1}{3}\) times $0).

The problem is much more complicated, however, and the appropriate conclusion depends on what is meant by the term “benefit accrual.”\(^{193}\) During a wearaway period, a worker will see pay credits and interest credits added to her account, but if she actually left the company and took a lump sum distribution, she might not see any increase in the amount of money that she received. Sometimes, under these circumstances the 133\(\frac{1}{3}\)% rule might be violated.\(^ {194}\)

In that regard, the IRS is currently litigating a case in the Tax Court in which it has asserted that the 133\(\frac{1}{3}\)% rule was violated in a cash balance conversion.\(^ {195}\)

\(^{193}\) See Lurie, supra note 6.

\(^{194}\) According to the IRS Chief Counsel, Stuart L. Brown:

[O]ne method [for measuring benefit accrual] focuses on the participant’s hypothetical account balance for the current year and projects it forward to normal retirement age using the interest crediting rates specified by the plan. This hypothetical account balance at normal retirement age is then converted to an annuity benefit, again using actuarial factors specified in the plan. The annuity benefit as of the end of the prior year is also measured using the same method. The difference in the accrued benefits (shown as an annuity) for the two years is the accrued benefit for the year. The accrual rate is determined by dividing the accrued benefit for the year by the participant’s compensation for the current year. . . . The accrued benefit and accrual rate for each year are calculated using this method, then compared. If the accrual rate for any year exceeds 133 1/3% of that for any prior year, the plan will fail to satisfy this method.

by the Onan Corporation. Participants in the plan filed a petition in Tax Court seeking a declaratory judgment that Onan’s cash balance plan conversion violated the I.R.C. § 411(b)(1) benefit accrual rules and that the plan should be disqualified from tax-exempt status. The participants claim that under the plan, the 133 1/3% accrual rule is violated for years in which employees receive no accruals. In its answer, the IRS agreed with the participants that the Onan plan violated the 133 1/3% rule, and it further asserted that the Onan conversion also violated other pension qualification provisions.

Of note, an internal IRS memorandum that discusses when a cash balance plan violates the qualification provisions was recently leaked to the press. That memorandum from one of the IRS district directors to the main employee benefits division discusses when a cash balance conversion will violate the Internal Revenue Code, and commentators believe that the letter addresses the Onan conversion. News reports have been careful to note that the memorandum addressed only one taxpayer’s plan and may not reflect the IRS’s view on cash balance plans in general. In that regard, the Onan case concerns a rather atypical cash balance plan conversion. Features of the Onan conversion that earned IRS disapproval include a provision providing smaller interest credits for participants who are no longer employees and a provision allowing benefit reduction in coordination with a


196. See *Amended Petition*, supra note 195.

197. See id.

198. See id.

199. See Brown & Ackerman, supra note 195.


201. See *Hearing on Hybrid Pensions*, supra note 8 (testimony of Stuart Brown) and supra note 22.

profit sharing plan. Most cash balance plan conversions do not share these features.

In any event, the question as to whether wearaways following a cash balance conversion violate ERISA’s anti-backloading rule is one of the principal issues that the IRS is studying, along with the Department of Labor and the EEOC. Of note, however, wearaways occur in lots of situations, and the IRS has never really complained.

Moreover, it should be noted that many wearaways in cash balance conversions are the result of the elimination of early retirement subsidies. In that regard, however, I.R.C. § 411(b)(1)(B)(iii) says that early retirement benefits are to be disregarded in applying the 133/3% test. Once early retirement subsidies are taken out of the mix, it seems unlikely that many cash balance plan conversions will fail the 133/3% test.

C. Age Discrimination

Cash balance conversions might also run afoul of the age discrimination laws. The Age Discrimination in Employment Act (ADEA) generally prohibits employers from discriminating against workers over the age of

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203. See Ryan J. Donmoyer, IRS Seeks To Disqualify Cash Balance Pension Plan, 84 TAX NOTES 1234, 1235 (1999); but see Onan Defends Conversion to Cash Balance Plan, TAX NOTES TODAY (Mar. 23, 2000) (LEXIS, FEDTAX Library, TNT File, 2000 TNT 57-35).


206. See Hearing on Cash Balance, supra note 9 (testimony of Laurel Sweatt) and supra note 111, at 8.

forty.\textsuperscript{208} Pertinent here, I.R.C. § 411(b)(1)(H) prohibits a defined benefit plan from ceasing accruals, or reducing the rate of benefit accruals, “because of the attainment of any age.”\textsuperscript{209} Parallel provisions are found in ERISA\textsuperscript{210} and in the Age Discrimination in Employment Act.\textsuperscript{211}

While these statutes clearly forbid a cessation of benefit accruals or a reduction in the rate of benefit accruals because of age, they do not automatically prohibit benefit reductions that merely correlate with age. Indeed, these statutes expressly state that a plan will not fail solely because it limits the total amount of benefits that the plan provides or the total number of years that can be used to compute benefits.\textsuperscript{212} Still other exceptions ensure “that subsidized early retirement benefits, social security supplements, and disability benefits do not violate the age discrimination prohibitions, even though the value of such plan provisions to participants may decline with age.”\textsuperscript{213}

1. Does the Typical Cash Balance Plan Violate the Age Discrimination Laws?

In a recent law review article, Professor Edward A. Zelinsky of the Benjamin N. Cardozo School of Law of Yeshiva University concluded that, “as a matter of law, the typical cash balance plan violates the statutory prohibition on age-based reductions in the rate at which participants accrue their benefits.”\textsuperscript{214} Needless to say, supporters of cash balance plans

\begin{itemize}
\item \textsuperscript{208} See 29 U.S.C. § 623(a) (1994).
\item \textsuperscript{209} Similarly, I.R.C. § 411(b)(2)(A) prohibits a defined contribution plan from ceasing allocations, or reducing the rate at which amounts are allocated, to a participant’s account, “because of the attainment of any age.” I.R.C. § 411(b)(2)(A) (1994).
\item \textsuperscript{211} See 29 U.S.C. § 623(i) (1994).
\item A plan shall not be treated as failing to meet the requirements of this subparagraph solely because the plan imposes (without regard to age) a limitation on the amount of benefits that the plan provides or a limitation on the number of years of service or years of participation which are taken into account for purposes of determining benefit accrual under the plan.
\item \textsuperscript{213} \textit{Id.} Hearing on Hybrid Pensions, supra note 8 (testimony of Stuart Brown) and supra note 22.
\item \textsuperscript{214} Zelinsky, supra note 23, at 686, 733-43.
\end{itemize}
The dispute focuses on competing interpretations of the applicable age discrimination provisions. The question is a highly technical one that merits, at least, a basic explication.

I.R.C. § 411(b)(1)(H)(i) prohibits a defined benefit plan from reducing the “rate of an employee’s benefit accrual” because of the “attainment of any age.” However, “the rate of an employee’s benefit accrual” is nowhere defined. In that regard, however, I.R.C. § 411(a)(7) defines an employee’s “accrued benefit” under a defined benefit plan as an annuity commencing at normal retirement age (e.g., an “age-65 annuity”), and Zelinsky believes that this definition is applicable under I.R.C. § 411(b)(1)(H). On the other hand, supporters of cash balance plans argue that an employee’s “benefit accrual” under I.R.C. § 411(b)(1)(H) cannot mean the same thing as an employee’s “accrued benefit” under I.R.C. § 411(a)(7).

Consider an employer with two employees each of whom make $40,000 in the current year and have $1000 credited to their cash balance accounts. The only difference is that one employee is age thirty-five and the other is age fifty-five. The mathematics are not in dispute. On the one hand, because the amounts credited to the two employees are equal, there does not appear to be any age discrimination. On the other hand, everyone agrees that the I.R.C. § 411(a)(7) age-65 annuities are different: as of age sixty-five, the $1000 credited to the account of the thirty-five-year-old will buy an annuity of $1094 per year, while, as of age sixty-five, the $1000 credited to the account of the fifty-five-year-old will buy an annuity of just $235 per year. Is that age discrimination, or have both employees been treated equally?

If all we had to go on was the statutes themselves, Zelinsky’s interpretation would seem to be the most plausible. However, because Congress, in fact, used different terms in § 411(b)(1)(H) and § 411(a)(7), it created an ambiguity. Consequently, there is significant reason to look beyond the statutes to see if Congress intended to use these different terms synonymously. In that regard, the two provisions are geared towards regulating completely different pension plan design problems. Consequently,

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217. Id.
219. See Zelinsky, supra note 23, at 733.
220. See Barker & O’Brien, supra note 23, at 79.
221. See Zelinsky, supra note 23, at 722.
it seems that the better view is to interpret the terms differently and in a way that can best effectuate the very different purposes for the two provisions.\footnote{222}

In short, although the matter is not free from doubt, it appears that the normal operations of a cash balance plan should not run afoul of the prohibition against age discrimination.\footnote{223}

2. Does the Typical Cash Balance Plan Conversion with a Wearaway Violate the Age Discrimination Laws?

By the same token, replacing a traditional pension plan with a cash balance plan should not automatically result in a violation of the age discrimination laws.\footnote{224} Here, one of the key issues becomes whether the cessation of benefits due to the wearaway happens because of age. The issue is complicated by the fact that so many benefit reductions which are tied to age-related factors, such as limits on years of service and limits on total accruals, do not violate age discrimination rules.\footnote{225}

Almost the only guidance issued by the government on this issue comes from the preamble to some IRS regulations issued in 1991 to address issues of discrimination in favor of highly compensated employees under I.R.C. § 401(a)(4).\footnote{226} Although the 1991 regulations are silent on the question of age discrimination, the preamble says that the age discrimination rules are not

\begin{footnotes}
\footnotetext{222}{See Members of ABA Tax Section, supra note 112, ¶ 37.}
\footnotetext{223}{In that regard, IRS Chief Counsel Stuart Brown noted that “[t]he Service has not to date asserted that cash balance plan benefit formulas result in per se violations of the age discrimination requirements of section 411(b)(1)(H).” Hearing on Hybrid Pensions, supra note 8 (testimony of Stuart Brown) and supra note 22.}\n\footnotetext{224}{See Hugh Forcier, Understanding the Assault on Cash Balance Plans (Dec. 1999) (visited Sept. 21, 2000) <http://www.faegre.com/article_print.asp?id=349>.}\n\footnotetext{225}{Almost the only guidance issued by the government on this issue comes from the preamble to some IRS regulations issued in 1991 to address issues of discrimination in favor of highly compensated employees under I.R.C. § 401(a)(4).} \footnotetext{226}{Although the 1991 regulations are silent on the question of age discrimination, the preamble says that the age discrimination rules are not}\n\end{footnotes}
227. Id. at 47,528.

The fact that interest adjustments through normal retirement age are accrued in the year of the related hypothetical allocation will not cause a cash balance plan to fail to satisfy the requirements of section 411(b)(1)(H), relating to age-based reductions in the rate at which benefits accrue under a plan.

Id. See also Ugoretz, supra note 149, at 467; Strella, supra note 4.

228. See Hearing on Hybrid Pensions, supra note 8 (testimony of Stuart Brown) and supra note 22.

229. Id.

230. Id.

231. See especially Shea et al., supra note 23; Barker & O’Brien, supra note 23.


233. Id.

234. See id. at 1119.
that the cash balance plan conversion was not evidence of age animus. The plaintiff cited the decreasing accruals with age and the employer’s desire to attract younger employees as strong motivation for the cash balance plan.\textsuperscript{235} The court stated that these factors were insufficient to show age discrimination unless the plaintiff could show that the benefits received under the old plan were lowered.\textsuperscript{236} However, the court did cite the employer’s protections for older employees in the form of a choice between the old and new plan. As a result, employees could argue that an employer who did not provide such protections might be liable for age discrimination.

Courts have, however, addressed issues relating to pensions plans and ADEA outside of cash balance plans. Several of these case illustrate how courts might view ADEA claims for cash balance plans. For example, in one case, the plan stated that the current value of an employee’s accrued benefit would be deducted in determining his or her separation pay.\textsuperscript{237} Because older employees were closer to retirement, they would receive less. Nevertheless, the court ruled that the plan did not violate ADEA.\textsuperscript{238} This case suggests that the leveling of future benefit accruals that is characteristic of cash balance plan conversions is not age discriminatory.

The Goldman case and other ADEA cases not dealing with cash balance plans are also instructive because they show what an employee would have to prove concerning a cash balance plan. An employee would have to establish that the cash balance plan reduced benefits on the basis of age.\textsuperscript{239} Because cash balance plans have uniform accrual rates (i.e., a pay credit equal to 5% of salary), it will be difficult for an employee to establish a prima facie case of age discrimination. Instead, an employee would have to argue that the uniform accrual rates violate ADEA because they have a disparate impact on older workers. Disparate impact is where a facially neutral policy “fall[s] more harshly on one group.”\textsuperscript{240}

All in all, it is extremely difficult to establish a prima facie case of age discrimination when the plaintiff claims disparate impact of facially neutral

\begin{itemize}
\item \textsuperscript{235} See id. at 1120.
\item \textsuperscript{236} See id.
\item \textsuperscript{238} See id. at 302. The court even went on to state that finding for the plaintiffs would hurt older workers by making them more expensive to employ. See id.
\item \textsuperscript{240} Hazen v. Higgins Paper Co., 507 U.S. 604, 609 (1993).
\end{itemize}
rules. The Supreme Court has shown resistance to the use of disparate impact analysis under ADEA, and at least two circuits have refused to apply disparate impact to ADEA claims. As a result, it seems likely that an employee’s claim that a cash balance conversion violates ADEA will face an uphill battle.

D. Notice Requirements

ERISA also requires that participants in a defined benefit plan receive notice of a plan amendment at least fifteen days before its effective date. The statute does not give any further guidance as to what information must be included in the notice, and the courts have been fairly lenient in determining whether an employer has given sufficient notice of a benefit reduction.

243. See Eglit, supra note 242, at 697.
244. Forcier puts it this way: “Since an older worker hired after the conversion is not impacted by the wear-away, the use of the technique is not inherently related to age. Therefore, the opponents of cash balance plans must rely on a ‘disparate impact’ claim.” Forcier, supra note 224, ¶ 15.
245. A plan described in paragraph (2) may not be amended so as to provide for a significant reduction in the rate of future benefit accrual, unless, after the adoption of the plan amendment and not less than 15 days before the effective date of the plan amendment, the plan administrator provides a written notice, setting for the plan amendment and its effective date, to—
(A) each participant in the plan, . . .
(C) each employee organization representing participants in the plan.

246. See, e.g., Scott v. Admin. Comm. of the Allstate Agents Pension Plan, 113 F.3d 1193, 1200 (11th Cir. 1997) (The court applied the test of whether an average participant would understand that the benefit accrual formula would change after a certain date. The court stated “[t]he summary need not explain how the individual benefit of each participant or alternate payee will be affected by the amendment.”)
Employers vary greatly in the level of information provided to employees concerning a conversion. In any event, it seems fairly certain that most employers converting to cash balance plans can easily meet the current notice requirements. In that regard, however, several of the legislative proposals relating to cash balance plans center on increasing notice requirements, and the Treasury Department has also indicated that it agrees that the current notice requirements are insufficient.

V. RECENT LEGISLATIVE AND REGULATORY ACTION RELATING TO CASH BALANCE PLANS

Due to the current attention on cash balance plan conversions, Congress and the Executive Branch have been put under considerable pressure to take action. Moreover, there is reason to believe that cash balance plan conversions may be an issue in the year 2000 elections. This Part outlines some of the recent legislative proposals and Executive Branch efforts.

A. Recent Legislative Efforts

Recently, a number of bills have been introduced in Congress that would have an impact on cash balance plan conversions. Some of these proposals would affirmatively discourage conversions, while others merely seek to ensure adequate disclosure of the consequences of conversions. The Executive Branch also supports legislation that would expand the disclosure required when an employer replaces a traditional pension with a cash balance plan.

247. See Purcell, supra note 4, at 7.
In addition, there have been a number of Congressional hearings and reports issued on the subject of cash balance conversions.

1. Legislation that Would Discourage Conversions

a. Older Workers Pension Protection Act

One of the most ardent critics of cash balance plan conversions has been Senator Tom Harkin. Senator Harkin maintains that the wearaway inherent in a conversion from a traditional defined benefit plan to a cash balance plan violates the spirit of laws protecting against age discrimination. As a result, Senator Harkin has proposed the Older Workers Pension Protection Act of 1999. His bill would outlaw wearaways.

Senator Harkin recognizes the primary objection to his plan. An employer might be motivated to terminate pension benefits altogether. No law requires an employer to provide a pension plan. Additionally, many employers choose to convert to cash balance plans because a conversion is cheaper than fully funding a terminated pension plan. However, Harkin maintains that employers provide pension benefits to attract employees and his law would not affect this consideration. Critics of Harkin’s bill are

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253. See, e.g., Purcell, supra note 4.
254. See Harkin, supra note 41.
256. See id.
257. See id.
258. See id.
unconvinced and claim that older workers would be hurt more by termination of pension plans than by conversions to cash balance plans.\footnote{259}

Harkin’s bill would amend the anti-reduction rule in I.R.C. § 411(d)(6) and ERISA § 204(g). The bill would make it impermissible for a plan amendment to reduce accrued benefits if the accrued benefit after the plan amendment is less than the sum of the old benefits and new benefits added every year under the new plan.\footnote{260} This rule would, in effect, mean that the old traditional defined benefit is frozen and future accruals would be added at the cash balance plan accrual rate. As a result, the wearaway would be eliminated. Harkin’s original proposal contained a tax penalty. However, he removed that portion of the proposed bill when he reintroduced the bill.\footnote{261} Senator Harkin also managed to get the Senate to pass a non-binding resolution expressing the “sense of the Senate” that something needs to be done to protect long service workers from the adverse consequences of cash balance conversions.\footnote{262}

\textbf{b. Representative Sanders’ Plan}

\begin{itemize}
\item For purposes of subparagraph (A), a plan amendment adopted by a large defined benefit plan shall be treated as reducing accrued benefits of a participant if, under the terms of the plan after the adoption of the amendment, the accrued benefit of the participant may at any time be less than the sum of -
\begin{itemize}
\item ‘(I) the participant’s accrued benefit for years of service before the effective date of the amendment, determined under the terms of the plan as in effect immediately before the effective date, plus
\item ‘(II) the participant’s accrued benefit determined under the formula applicable to benefit accruals under the current plan as applied to years of service after such effective date.
\end{itemize}
\end{itemize}

\textit{Id.} § 2(a)(6).


Representative Bernard Sanders and Senator Paul Wellstone also introduced legislation that would prohibit wearaways. Their legislation would go further and impose a 50% excise tax on any surplus in the pension fund at the time of the conversion. This tax would only apply if the employer did not offer all vested employees the choice between the old pension plan and the new cash balance plan. If this bill were enacted, employers would have a very strong incentive to provide generous transitional benefits for their older employees.

2. Legislation that Would Require More Disclosure

Tax legislation passed by Congress in 1999, but vetoed by President Clinton, would have required additional disclosure by defined benefit plans that were amended to reduce future benefit accruals. This legislation was based upon a number of bills introduced earlier in 1999.

a. Pension Right to Know Act

For example, Senator Daniel Patrick Moynihan introduced the Pension Right to Know Act. That legislation would require employers to generate individual statements comparing benefits under the old plan and the new cash balance plan. Critics of the bill complain that it would require employers to predict how much employees would make in the future and would consequently be expensive and burdensome to administer. However, the plan would not affect the overall legality of the conversions. As a result, the age discrimination debate would continue. Senator Moynihan later backed The Pension Reduction Disclosure Act of 1999.

265. See id.
266. See APPWP, supra note 204, at 33.
268. See Quick, supra note 4, at 6.
270. See Congel, Disclosure Bill, supra note 251, at 2395.
b. The Pension Reduction Disclosure Act of 1999

The Pension Reduction Disclosure Act of 1999\(^{271}\) was introduced in response to the main objections to the Pension Right to Know Act. This bill would require employers to provide notice only to adversely affected employees.\(^{272}\) This bill was introduced by Senators Moynihan and Jeffords in the Senate, and Representatives Matsui and Weller introduced the bill in the House.\(^{273}\)

Labor Department officials examining cash balance plans have also focused on disclosure requirements.\(^{274}\) As a result, the Secretary of Labor endorsed the Pension Reduction Disclosure Act.\(^{275}\) The Pension Reduction Disclosure Act was also endorsed by President Clinton,\(^{276}\) and it was incorporated into proposed legislation giving small business owners a tax break.\(^{277}\) That legislation was passed by Congress, but vetoed by the President (for other reasons).\(^ {278}\)

c. The Comprehensive Retirement Security and Pension Reform Act

Representatives Ben Cardin and Rob Portman’s Comprehensive Retirement Security and Pension Reform Act\(^{279}\) also required comparison of benefits under the old and new cash balance plan. However, their bill would not require individualized statements.\(^{280}\) As a result, their bill would not be as burdensome on employers, but it would be less informative for employees.

B. Executive Branch Efforts

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\(^{273}\) See Congel, Disclosure Bill, supra note 251, at 2395.
\(^{274}\) See id.
\(^{275}\) See Congel, Disclosure Bill, supra note 251, at 2395.
\(^{276}\) See id.
\(^{278}\) See APPWP, supra note 204, at 33.
\(^{279}\) H.R. 1102, 106th Cong., 1st Sess. (1999). The bill would require plan sponsors to provide participants with a summary or copy of the plan amendment itself thirty days before the amendment is to be made.
\(^{280}\) See Congel & White, supra note 274.
As discussed earlier, the Clinton Administration endorsed the Pension Reduction Disclosure Act.\textsuperscript{281} According to President Clinton, “[t]his legislation would ensure that all Americans have the necessary information to plan for retirement. It would provide workers with meaningful and timely notice of plan changes and clearly demonstrate the impact of those changes now and in the future.”\textsuperscript{282} Executive Branch agencies are also in the process of developing a comprehensive set of legislative principles on cash balance pension plans.\textsuperscript{283}

1. Internal Revenue Service (IRS)

The IRS is responsible for administering the tax qualification rules that govern pension plans.\textsuperscript{284} In particular, the IRS promulgates regulations and issues determination letters that relate to pension plans, in general, and cash balance plans, in particular. Recently, the IRS directed its employees to refer all open determination or examination cases involving cash balance plan conversions to the national office for technical advice.\textsuperscript{285} The IRS recently requested comments on cash balance plans, in general, and conversions, in particular.\textsuperscript{286}

\begin{itemize}
\item 281. See Congel, Disclosure Bill, supra note 251, at 2395.
\item 282. Id.
\item 283. See, e.g., Vineeta Anand, Consensus Needed: Long Wait for Clinton Administration Letter; First, Everyone Must Agree on Cash Balance Position, PENSION & INVESTMENTS, June 12, 2000, at 2.
\end{itemize}
2. Department of Labor

a. The Pension and Welfare Benefits Administration (PWBA)

The PWBA administers and enforces the fiduciary, reporting and disclosure provisions of Title I of the Employee Retirement Income Security Act of 1974 (ERISA).\(^{287}\) Along with the IRS and the EEOC, the Department of Labor was asked to examine cash balance plans by Representative Sanders.\(^{288}\) The PWBA has endorsed the disclosure requirements in the Pension Reduction Disclosure Act,\(^{289}\) and the PWBA has indicated an interest in reviewing whether actuaries have been involved in cash balance plan conversion “schemes designed to mislead or confuse workers.”\(^{290}\) The PWBA has also recently published guidance about cash balance conversions.\(^{291}\)

b. The ERISA Advisory Council

The ERISA Advisory Council provides advice and recommendations to the Secretary of Labor regarding the Secretary’s functions under ERISA.\(^{292}\) Among its recent projects, the ERISA Advisory Council studied hybrid pension plans, in general, and cash balance plans, in particular.\(^{293}\) The

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\(^{289}\) See Congel, Disclosure Bill, supra note 251, at 2395.


\(^{291}\) See PENSION AND WELFARE BENEFITS, supra note 117.


Council had a number of hearings on cash balance plans, and it recently completed its report for the Secretary of Labor. The report endorses defined benefit plans, supports increased disclosure, and recognizes that cash balance conversions sometimes harm workers. The group was unable to reach agreement on the legal issues surrounding cash balance plan conversions.

3. Pension Benefit Guaranty Corporation (PBGC)

The PBGC is responsible for administering the insurance program that guarantees benefits provided under defined benefit plans covered by ERISA. Consequently, the PBGC is interested in the shift from traditional defined benefit plans to defined contribution plans and cash balance plans. Among other things, the PBGC is looking at the question of how to value cash balance plans upon plan termination.

4. Equal Employment Opportunity Commission (EEOC)

The EEOC is principally responsible for the Administration’s policy with respect to age discrimination. Along with the IRS, and the Department

294. See, e.g., Congel & White, supra note 274; Stein, supra note 78.
296. See supra note 295.
297. See id.
of Labor, it is studying the age discrimination questions raised by cash balance plan conversions.  

VI. CONCLUSION

In most cases, it appears that replacing a traditional pension plan with a cash balance plan is perfectly legal. No doubt, there are abuse situations, but it seems unlikely that a routine cash balance conversion will run afoul of current laws. Indeed, even most conversions that result in a wearaway should pass muster.

Nevertheless, retirement income security is an important goal, and Congress might want to take action to ensure that all Americans have adequate retirement incomes. But not much would be accomplished by an outright ban on cash balance conversions, in general, or wearaways, in particular. The era of traditional defined benefit plans is largely behind us now. The time has come for us to accept and embrace defined contribution plans and their cash balance plan cousins.


302. See generally Forman, Universal Pensions, supra note 2.

303. See Zelinsky, Defined Contribution Society, supra note 63.