FINDING THE BALANCE IN CASH BALANCE PENSION PLANS

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As companies abandon traditional pension plans in favor of the newer cash balance plans, disputes over benefit calculations under the new plans have arisen between employers and employees. Courts have had the formidable task of resolving disputes over the present value of benefits when participants in cash balance plans terminate their participation in the plans early and elect a lump-sum distribution. This note reviews two recent cases that demonstrate how applying traditional calculation formulas to cash balance plan lump-sum distributions perpetuates the "whipsaw" effect—a phenomenon that results when the lump-sum calculation is greater than the current cash balance account value.

This note asserts that the cases of Esden *and* Lyons *may encourage employers to reduce the benefits of all employees with cash balance plans in order to avoid liability with respect to the employees who cash out of their plans early. Even if the cases do not expressly require employers to reduce benefits across the board in order to ensure compliance with ERISA, employers may see this as the simplest, most economically sound and safest response to the decisions. The author offers two suggestions on how Congress can address the "whipsaw" effect—one is that Congress draft legislation specifically governing cash balance plans and the other is that Congress discourage lump-sum payment options.*

I. INTRODUCTION

Congress headed home to campaign for the 2000 election after the longest session in recent history. But before they could go, they were forced to do battle on Capitol Hill with a more formidable opponent—pension fund regulation. One of the last votes of the session, the Retirement Security and Savings Act of 2000,[1] overwhelmingly passed the House, but loomed in the Senate until recess delayed the vote. This legislation, if passed, would have impacted a decidedly large constituency as

1. H.R. 1102, 106th Cong. (2000).

it dealt with a range of issues from health care to the minimum wage.[2] Among the most significant provisions in the proposed legislation, however, was a plan to protect employees during conversion from traditional defined benefit plans to defined contribution plans. This proposed legislation came to the forefront just weeks after a Second Circuit decision struck down the terms of a cash balance plan established by the venerable Bank of Boston.[3] This recent activity seems to be in response to the widespread fears over cash balance plans and how they will change the face of retirement plans.

This note proposes that the cash balance pension plan may in fact be a good option for both employees and employers. However, the application of existing defined benefit and defined contribution regulations under the Employee Retirement Income Support Act of 1974 (ERISA)[4] to hybrid pension plans has created several problems. One of the most contentious debates centers around which calculation formula should be used for lump-sum distributions. This note will highlight the background of benefit plans in order to provide a context for an analysis of why this new type of plan has gained popularity in many of the largest companies in the world. In part III, this note will analyze the current legislation dealing with cash balance plans and how two cases, *Esden v. Bank of Boston*[5] and *Lyons v. Georgia-Pacific Corp. Salaried Employees Retirement Plan*,[6] have interpreted the existing legislation and applied it to cash balance plans and lump-sum distributions. This note will refrain from revisiting the extensive statutory interpretation involved in these decisions, and instead focus on why the application of traditional defined benefit plan methodology to a hybrid plan may be inappropriate. Part IV recommends changes to the current legislation that will expand the benefits of cash balance plans for both the employer and the employee and clarify the calculation of lump-sum distributions.

II. BACKGROUND ON THE DEVELOPMENT OF CASH BALANCE PLANS

A. *What Got Left Behind: The "Traditional" Defined Benefit Plan*

Congress has developed two different categories for pension plans: defined benefit plans and defined contribution plans.[7] Until recently, most Americans participated in the traditional defined benefit plan, and

2. The proposed statute is a compilation of popular insurance, retirement and education assistance reform that was designed to appeal to the middle class. The minimum wage increase was a last minute addition to avoid a veto by President Clinton. *Id*.

3. *See* Esden v. Bank of Boston, 229 F.3d 154 (2d Cir. 2000).

4. 29 U.S.C. § 1001 (1994).

5. 229 F.3d 154 (2d Cir. 2000).

6. 221 F.3d 1235 (11th Cir. 2000).

7. For a more thorough discussion of the different types of benefit plans, see generally Jonathan Barry Forman, *Public Pensions: Choosing Between Defined Benefit and Defined Contribution Plans*, 1999 L. REV. M.S.U.–D.C.L. 187.

more specifically, the "final average" plan.[8] Under such a plan, the employee receives a set amount of money every month after retirement. This set amount is based on "a percentage of her highest paid years multiplied by a factor reflecting the retiree's length of service."[9] Given that most senior employees receive higher salaries than their junior counterparts, this plan is most favorable to workers who have been employed with the company for several years.[10]

In the event that the employee wishes to leave her current employer, the defined benefit plan does not follow her. Assuming that she is vested, the employee receives nothing until she attains retirement age. However, many plans provide for a lump-sum option at the end of employment, which is calculated by determining the cost of an annuity to provide for the fixed amount payable in accordance with the pension plan.[11] Then, this amount is reduced to present-day worth and distributed in one payment.[12] Although the employee cannot be forced to take the lump-sum payment unless the total is less than $5,000,[13] many feel that the complexity of having several separate retirement benefits is not worth the return on their investment and would rather sever all ties with the old employer.[14]

While some argue that the defined benefit plan provides the best retirement benefits for all employees and that conversion to another type of plan is damaging to both young and old alike, this is not necessarily true.[15] Fixed benefit plans, by design, are backloaded, meaning the majority of benefits are accrued during the last years of participation. Because the final calculation of benefits is based on the last three years of employment, senior employees who elect a lump-sum distribution just short of retirement (as a result of a plan conversion) are deprived of the benefit of those last years of accrual. However, younger employees who still have time to build up equity in their retirement plans will not be af-

8. From 1975 to 1993, the number of participants in defined benefit plans remained relatively level after experiencing a slight boost from 1975 to 1981, while the number of participants in large defined contribution plans has more than tripled. *See* Olivia S. Mitchell & Sylvester J. Schieber, *Defined Contribution Pensions: New Opportunities, New Risks*, *in* LIVING WITH DEFINED CONTRIBUTION PENSIONS: REMAKING RESPONSIBILITY FOR RETIREMENT 3 fig.2 (Olivia S. Mitchell & Sylvester J. Schieber eds., 1998).

9. Edward A. Zelinsky, *The Cash Balance Controversy*, 19 VA. TAX REV. 683, 687 (2000). Although not always the case, these three highest paid years usually come at the end of the employee's career. *See id*. at 687 n.8.

10. *See id*. at 687.

11. Zelinsky, *supra* note 9, at 753; *see also* Ellen E. Schultz, *Young and Vestless: Many Mobile Workers Fail to Reap Promise of New-Style Pensions*, WALL ST. J., Dec. 16, 1999, at A1 (describing the minimal amounts that most workers receive from the cash-out of their pension plan).

12. *See* Zelinsky, *supra* note 9, at 753.

13. ERISA § 203(e), 29 U.S.C. § 1001 (1994 & Supp. 1998); *see also* I.R.C. § 417(e)(1) (1994) ("A plan may provide that the present value of a qualified joint and survivor annuity or a qualified preretirement survivor annuity will be immediately distributed if such value does not exceed the dollar limit under section 411(a)(11)(A).").

14. *See* Zelinsky, *supra* note 9, at 753–54.

15. *See id.* at 754.

fected. In fact, two employees who start their employment with a defined benefit and a defined contribution plan, respectively, will retire with approximately the same amount of benefits.[16]

Although the defined benefit plan was the standard for many years, it is flawed. As previously mentioned, the plan lacks meaningful mobility, requiring the employee to either cash out of the plan and take whatever she can get, or keep ties with her former employer.[17] In addition, because the plan is backloaded, employees are required to work until the plan's normal retirement age[18] in order to ensure maximum benefits. This feature was designed to give an incentive to older workers to stay on the job until retirement in order to provide the company the benefit of the senior employee's experience.[19] However, many employers now place a premium on young talent, rendering this feature obsolete.[20]

B. The Defined Contribution Craze

Defined contribution plans also enjoy a long history in the American workplace.[21] Defined contribution plans focus on the amount of money that the company will contribute to the employee's account, rather than the amount of money to which the employee will be entitled upon retirement.[22] One of the most popular defined contribution plans is the 401(k), in which the employee determines the amount of money she will contribute, and this amount is then typically matched by her employer.[23] Employees often enjoy the ability to make decisions about how

16. *See id.*; *see also* U.S. GEN. ACCOUNTING OFFICE, CASH BALANCE PLANS: IMPLICATIONS FOR RETIREMENT INCOME 24 fig.7 (2000) [hereinafter GAO REPORT].

17. Although many argue that the defined benefit plan is just as easy to cash out as the defined contribution plan, the employee may hesitate to elect a lump sum because of the mysterious math involved. *See* Schultz, *supra* note 11, at A1. Whereas defined contribution and hybrid plan participants know the approximate value of their account at any given time, the defined benefit participant's lump-sum value is not calculated until their final days of employment, no doubt leading many to be suspicious of the accuracy of the pay out amount. *See generally* Alvin D. Lurie, *Cash Balance Plans: Enigma Variations*, TAX NOTES, Oct. 25, 1999, at 507 [hereinafter Lurie, *Enigma*].

18. Typically, the normal retirement age is sixty-five years old. However, many traditional retirement plans offer an early retirement option. *See* Mark J. Ugoretz, *Sheppard's Attack on Cash Balance Plans: A Response*, TAX NOTES, July 19, 1999, at 465, 467 (describing the benefits of the cash balance plan in response to widespread criticism); *see also* BUREAU OF LABOR STATISTICS, DEP'T OF LABOR, DEFINED BENEFIT PLANS: SUMMARY OF PLAN PROVISIONS, FULL-TIME EMPLOYEES, MEDIUM AND LARGE PRIVATE ESTABLISHMENTS, 1995, tbl.125 (1998), *available at* http://stats.bls.gov/ebs2/ebbl0010.txt.

19. *See* Ugoretz, *supra* note 18, at 467.

20. *See* Ellen E. Schultz & Elizabeth MacDonald, *Retirement Wrinkle: Employers Win Big with a Pension Shift; Employees Often Lose*, WALL ST. J., Dec. 4, 1998, at A1.

21. According to the Bureau of Labor Statistics, participation in defined contribution plans has steadily increased over the last several years: in 1991, 48% of participants contributed to defined contribution plans. BUREAU OF LABOR STATISTICS, U.S. DEP'T OF LABOR, EMPLOYEE BENEFITS IN MEDIUM AND LARGE PRIVATE ESTABLISHMENTS, tbl.11, *available at* http://stats.bls.gov/news.release/ebs3.t11.htm (last modified Jan. 7, 1999). That percentage increased to 57% in 1997. *Id.*

22. *See* Zelinsky, *supra* note 9, at 692.

23. *See* Mitchell & Schieber, *supra* note 8, at 4.

their money will be invested and reap the gains of their investment choices.[24]

Employers also find the defined contribution plan appealing.[25] Employers benefit from the ability to allocate their financial resources to reward workers who save their money through matching contributions. If the employee chooses not to contribute to the plan, then the employer does not have to contribute either.[26] In addition, many argue that the administrative costs associated with defined contribution plans are less than the cost of traditional defined benefit plans, although the amount of savings varies among programs.[27] Many of these popular features of the defined contribution plan can also be found in the new cash balance plans.[28]

C. Cash Balance Plans: The New Breed of Defined Benefit Plans

Over the past decade, many companies have abandoned their traditional plans in favor of cash balance plans, a derivative of both the defined benefit and defined contribution plan.[29] Under this plan, the company contributes a set percentage of the employee's income into a notional individual cash account.[30] This account is notional, or hypothetical, because the company does not actually set aside any money for an individual employee, but rather the money is pooled with other participants' money.[31] The employee does, however, receive periodic statements listing the account balance, much like a 401(k).[32] Congress and the courts consider cash balance plans to be defined benefit plans because the employer guarantees not only the principal contribution, but a set rate of return that is not subject to market variations.[33] For instance, un-

24. On the contrary, many studies show that the average investor is overly conservative in investments and not diversified. One reason for poor investment decisions is a lack of training and guidance. In fact, the Department of Labor attempted to remedy this deficiency in 1995 by promoting "a 'national pension education program aimed at drawing the attention of American workers to the importance of taking personal responsibility for their retirement education in the workplace.'" B. Douglas Bernheim, *Financial Illiteracy, Education, and Retirement Saving*, *in* LIVING WITH DEFINED CONTRIBUTION PENSIONS: REMAKING RESPONSIBILITY FOR RETIREMENT 38, 39 (Olivia S. Mitchell & Sylvester J. Schieber eds., 1998) (citations omitted).

25. In the period from 1975 to 1993, the number of companies with 100 or more employees who established defined contribution plans rose from approximately 200,000 to almost 600,000. Mitchell & Schieber, *supra* note 8, at 3 fig.2.

26. *See id*. at 7. The authors argue that there is a correlation between contributions to retirement vehicles and productivity, giving the employer the ability to reward the type of behavior most beneficial to their organization. *See id*.

27. *See id*. at 9.

28. Zelinsky, *supra* note 9, at 692.

29. GAO REPORT, *supra* note 16, at 15 fig.5.

30. *See* Zelinsky, *supra* note 9, at 693.

31. *See* THE SOCIETY OF ACTUARIES, ACTUARIAL ASPECTS OF CASH BALANCE PLANS 1 (2000) [hereinafter SOCIETY OF ACTUARIES].

32. *See generally* Jonathan Barry Forman & Amy Nixon, *Cash Balance Pension Plan Conversions*, OKLA. CITY U. L. REV. 379, 380 (2000).

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

der the Bank of Boston cash balance plan, as detailed in *Esden v. Bank of Boston*, the rate of return was tied to the current three-month Treasury bill rate.[34] While the cash benefit interest credit is guaranteed, the employer and not the employee gets any excess interest if the plan outperforms the guaranteed interest rate.[35]

D. How Do You Get There from Here: The Conversion

Although the cash balance plan is heralded as a simplified version of the traditional pension, the conversion from traditional to cash balance plans is anything but straightforward.[36] Companies that wish to convert their current defined benefit plan to a cash balance plan have several options to integrate this new employee benefit. First, they may offer the cash balance plan to only new employees, eliminating the need for rollover of all current plans. Second, the company can preserve the current assets of the traditional plan and simply start a new cash balance account for every employee. And finally, the company can rollover all of its current traditional plans into cash balance plans.[37]

The conversion option requires some calculation. First, the company must determine the amount of money to which the employee would be entitled each month upon retirement based on the employee's salary and years of service.[38] Then, the company determines how much an annuity would cost at the time of retirement in order to supply the monthly payment. Additionally, this amount is reduced to current dollar value. Finally, the company puts this dollar amount into a notional, or hypothetical, individual cash account for the employee.[39] Despite the seem-

34. Esden v. Bank of Boston, 229 F.3d 154, 170 (2d Cir. 2000).

35. *See* Zelinsky, *supra* note 9, at 692. By the same token, if the plan loses money, the company must make up the difference. *See id.*; *see also* James D. Douglas, *Memorandum: Cash Balance Plans*, TAX MGMT. (BNA) 55 (2000) ("Interest credits are similar to earnings in a defined contribution plan. However, in a cash balance plan, unlike a defined contribution plan, interest credits are usually guaranteed.").

36. *See Esden*, 229 F.3d at 176; *see also* Schultz & MacDonald, *supra* note 20, at A1 (profiling one worker, an engineer by trade who practices actuarial science as a hobby, who spent one year attempting to determine the impact his company's conversion would have on his pension benefits).

37. Such was the case in *Esden*. This course of action, which on its face seems equitable, actually serves to disadvantage those workers who have the most seniority and are close to retirement by reducing their vested amount through the conversion formula. *See Esden*, 229 F.3d at 157.

38. For most plans, this would be the average of the three highest paid years, multiplied by 0.5, then multiplied by a ratio with the number of years of the employee's service as the numerator and the number of years to full benefit (usually thirty years) as the denominator. *See* Zelinsky, *supra* note 9, at 687–88.

39. "[T]he present value shall not be less than the present value calculated by using the applicable mortality table and the applicable interest rate." I.R.C. § 417(e)(3) (1994). This applicable interest rate is based on the "rate of interest on thirty-year Treasury securities." *Id.* These calculations, however, only get you to the current value of the traditional plan. This amount is usually then considered the balance of the new cash balance plan account. However, many companies offer an added "incentive" by taking the higher of either the traditional account balance or the amount that would be in the account had the employee started with a cash balance account at the beginning of his employment. Zelinsky, *supra* note 9, at 702. For the determination of the cash balance plan value, the cash balance plan equation is applied retroactively to determine what the employee would have received

ingly complex conversion procedures, many companies are making the switch from traditional defined benefit plans to cash balance plans.

E. The Trouble with Cash Balance Plans

1. The Backloaded Benefit

The controversy with respect to these conversions centers around the financial ramifications faced by employees who began their employment under the old plan.[40] Depending on the program, the conversion could cost an employee a large amount of her accrued benefits, not to mention the effect on her expectations of future benefits.[41] The first controversy involves an employee who is nearing retirement age. Because the traditional defined benefit plan backloads benefits, older employees lose out on the opportunity to drastically increase their annuity amount by completing their last (and highest paid) years of service under the old plan.[42] Although they receive contributions to their cash balance plan for the remaining years, the amount pales in comparison to what could have been collected without the conversion.[43] As one scholar explains, older employees are getting "the worst of both plans—the lower early accruals provided by the traditional pension plan and the lower late accruals provided by the cash balance plan."[44]

2. "Wear-away"

Another controversy centers on what are known as "wear-away" provisions. Under this scenario, the employer calculates the present value of the benefits accrued under the traditional plan and compares it to what the employee would have made had the cash balance plan been in effect during the entire time of employment.[45] The employer then deposits the larger of the two amounts into the employee's notional account. However, if the benefit accrued under the cash balance plan would have been lower, the employee suspends contributions to the em-

under the cash balance plan. Although the employee receives the higher of the two amounts, many companies then freeze contributions to the account until the cash balance plan and traditional plan amounts are equal. *Id*. This is called "wear-away." *Id.*

40. *See* Mary Beth Franklin, *Balancing Act: As More Companies Replace Traditional Pensions with Cash-balancing Plans, Longtime Workers Can End Up Teetering on the Edge*, KIPLINGER'S PERS. FIN. MAG., Dec. 1999, at 123, 123–25 (discussing a twenty-one-year veteran of IBM who was forced to convert to the cash balance plan, which greatly reduced her expected benefits).

41. *See id*. In the case of the IBM worker, early retirement plans were derailed when the conversion significantly reduced the expected benefits.

42. *See* Zelinsky, *supra* note 9, at 695.

43. Some companies have remedied this disparity by increasing the annual contribution percentages based on seniority. *See id*. at 697–98. However, this measure is purely voluntary and not required under ERISA.

44. Jonathan Barry Forman, *Senate Finance Committee Gives Green Light to Cash Balance Conversions*, TAX NOTES, Oct. 2, 2000, at 141.

45. *See* Zelinsky, *supra* note 9, at 702–03.

ployee's cash balance account. These contributions are suspended until the accrued benefits due under the cash balance plan "catch up" with the account balance.[46] While the employee does not lose any previously accrued benefits, which would be a violation of ERISA,[47] she essentially stands still until the account balance matches the benefits accrued under the cash balance method.[48]

A second kind of "wear-away" arises when the company, as part of the conversion, eliminates early retirement benefits.[49] For example, under a typical early retirement program, the employee would be able to leave the company at age fifty-five and immediately receive retirement benefits at a reduced rate. Although the employee receives a reduced pension amount, she gets that amount for ten years longer than a sixty-five-year-old retiree.[50] In addition, many companies offer a subsidized early retirement plan that increases the amount of the payments in order to mitigate the reduction resulting from early retirement.[51] This subsidy makes the early retirement benefit, if expressed in terms of an annuity, more valuable than a normal retirement benefit annuity, encouraging many workers to take advantage of this feature.[52]

Under many new cash balance plans, however, there is no early retirement feature because the benefits are equally accrued over the years of employment, requiring the employee to work longer in order to achieve the same amount of benefit.[53] Companies view conversion as a good time to eliminate early retirement features, which can be rather costly. As a result of the conversion, the company will start the employee's notional account at the normal retirement amount, not taking into account the higher value of an early retirement annuity.[54] This means that the employee will work for several years before his cash balance plan account value matches the value of the early retirement annuity he would have otherwise been entitled to.[55] Although recently proposed legislation sought to eliminate the first type of wear away, it specifically allowed employers to disregard early retirement benefits when calculating notional account balances.[56]

46. *Id*.
47. 29 U.S.C. § 1001(c) (1994 & Supp. 1998).
48. Zelinsky, *supra* note 9, at 702–03.
49. Forman, *supra* note 44, at 141. In 1995, 96% of all defined benefit plans in large- and medium-sized private companies offered some type of early retirement feature and 67% of those companies set the early retirement age at fifty-five. BUREAU OF LABOR STATISTICS, U.S. DEP'T OF LABOR, EMPLOYEE BENEFITS IN MEDIUM AND LARGE PRIVATE ESTABLISHMENTS, 1995, at 182 tbl.125 (1998), *available at* http://stats.bls.gov/special.requests/ocwc/oclt/ebs/ebbl0015.pdf.
50. Forman, *supra* note 44, at 141.
51. *Id*.
52. *Id*. at 142.
53. *See id*.
54. *See id*.
55. *Id*.
56. *Id*. at 143 (construing H.R. 1102, 106th Cong. (2000)).

3. *Calculation Factors*

A final concern, and the primary focus of this note, deals with the conversion rates that are used when determining the lump-sum payments for those who elect to terminate their participation in the plan. Although discussed in more detail later, section 203(e) of ERISA[57] provides guidance to companies as to what the conversion rate should be. But, within a certain tolerance, the company can make assumptions regarding the rate of return.[58] A rate of return equation can drastically change the amount of the lump-sum payment when compared to the hypothetical account balance. This formula projects into the future to determine the employee's entitlement based on an annual rate of return. The formula then determines what the cost of an annuity will be at the age of retirement and converts that amount into a current value using a prescribed discount rate.[59] If the employee is, for example, a thirty-year-old, newly vested employee at the time of the cash-out, he will no doubt suffer significantly from a lower rate of return when projected over thirty-five years.

F. *Who Benefits from the Benefit Plan? The Pros and Cons for Both Sides*

1. *The Benefits of Conversion*

Why is the cash balance plan so attractive to companies? Advocates argue that the plan helps lure new talent to the company in a climate of high job turnover rates.[60] But critics counter that perhaps the real motivation for employers is the significant savings many of them enjoy through these conversions. Because the bullish market over the past ten years increased the amount of return on pension plans invested in the stock market, companies have been trying to capitalize on the profits.[61] Under many traditional plans, the return on pension plans is directly keyed to the performance of the investments in the plan. If the fund makes money, the employees receive more, but if the fund loses money, the employees could receive nothing. Under the cash balance plan, however, the employees are guaranteed a lower, set rate.[62] If the financial markets have a bad year, the company must make up the difference.[63] But, if the markets are successful, the company gets to keep any amount over that set rate. Because the financial markets have been particularly strong over the past several years, some cash balance plans are currently

57. Employee Retirement Income Security Act (ERISA) § 203(e), 29 U.S.C. § 1053(e) (1997).
58. *See* Esden v. Bank of Boston, 229 F.3d 154, 160 (2d Cir. 2000).
59. *Id*.
60. *See id.* at 158 n.5.
61. Zelinsky, *supra* note 9, at 708.
62. This rate was averaging 5% during the *Esden* litigation. *See Esden*, 229 F.3d at 160.
63. *See id*.

funding themselves, saving the companies millions of dollars while capitalizing on a bullish stock market.[64]

The plans are also attractive to many employees. In a market with median job tenure of 3.5 years,[65] the plans are more conducive to short-term employees because they may readily withdraw the cash balance and "then roll the money over into an individual retirement account [IRA]."[66] In addition, young, aggressive employees who are sought after for their innovative ideas are not penalized for lack of seniority.[67] Unlike the backloaded traditional defined benefit plans, cash balance plans go into effect early in the employee's tenure and base contributions on salary, rather than seniority. Finally, the cash balance plans are easier to comprehend—a benefit for both senior and junior employees.[68] The amount in the individual account is the actual amount the employee has accrued,[69] eliminating the need for actuarial estimates and mortality tables.[70]

2. *The Disadvantages*

The drawbacks to the cash balance plan are just as compelling as the benefits. Older employees point to the lump-sum and "wear-away" calculations as their primary concern. Just as senior employees are nearing retirement, their planned benefits are dramatically altered.[71] This alteration often means that the employee elects to take the lump-sum amount and, if eligible, retire early with reduced benefits. Because the traditional plan is no longer in place, the employee loses a large incentive to weather her final years with the company.[72] In addition, many employees must completely readjust their financial retirement plan. If the anticipated benefits are greatly reduced, the employee may have to rely on other assets to make up for the loss of income.[73]

In the alternative, companies argue that the benefits from a pension plan are mere expectations and employees should not be shocked when

64. *See generally* Schultz & MacDonald, *supra* note 20, at A1.

65. BUREAU OF LABOR STATISTICS, DEP'T OF LABOR, LABOR FORCE STATISTICS FROM THE CURRENT POPULATION SURVEY, tbl.1, *available at* http://stats.bls.gov/news.release/tenure.t01.htm (last modified Mar. 14, 2001) (based on the February 2000 statistics for workers twenty-five years and older).

66. Schultz, *supra* note 11, at A6.

67. *See id*.

68. *See id*.

69. Many argue, however, that this is not an accurate reflection of the current cash-out value of the account. Lyons v. Ga.-Pac. Corp. Salaried Employees Ret. Plan, 221 F.3d 1235 (11th Cir. 2000).

70. Critics argue that the same characteristic could be true of defined benefit plans, if the companies would publish the calculations data necessary to complete the analysis. *See* Schultz & MacDonald, *supra* note 20, at A1.

71. *See* Hope Viner Samborn, *Now You See It, Now You Don't: Older Workers Watch Pensions Erode as Employers Turn to Cash-balance Plans*, ABA JOURNAL, Nov. 1999, at 34.

72. Zelinsky, *supra* note 9, at 734.

73. *See* Franklin, *supra* note 40, at 123.

the plan is altered to reflect the changing economy.[74] Although the company is committed to providing a pension plan and cannot take away previously earned benefits, the benefits and calculations under the plan may be altered as long as it is done in accordance with ERISA limitations.[75] Employers point to the need to stay competitive in a tight job market and fluctuating company profits as two justifications for the changes.[76]

The alterations can also hurt younger workers. Although the new cash balance plan is mobile, in many cases the vesting requirements (often up to five years) carry over from the old plan. Regardless of the mobility of the plan, if the employee is not vested, she receives nothing when she leaves.[77] In addition, for those who do receive their benefits, the amounts are often paltry, prompting many to simply spend the money, rather than reinvesting in an IRA.[78]

G. ERISA and Enforcement

Under the applicable provisions of both ERISA and the Internal Revenue Code, private companies are severely restricted in their activities as pension managers.[79] One of the most significant penalties for noncompliance with these provisions is loss of tax deductions for company plan contributions—a consequence that could cost larger employers millions. In addition, companies are routinely sued in class-action proceedings for noncompliance, producing varied results.[80] Many argue that the courts' recent rulings suggest a dislike for cash balance plans. On the contrary, perhaps the real problem that the courts face is not the cash balance plan itself, but the vague treatment that the IRS and Congress have given to cash balance plan questions.

H. The Cases

1. The Lyons *Case*

The most frequent bases for pension plan disputes are violations of notice requirements and violations of calculation factors.[81] *Lyons v.*

74. *See* Samborn, *supra* note 71, at 35.
75. 29 U.S.C. § 1001 (1994 & Supp. 1998).
76. Schultz & MacDonald, *supra* note 20, at A1.
77. *See* Schultz, *supra* note 11, at A1.
78. *Id*.
79. ERISA § 203, 26 U.S.C. § 411 (1994).
80. *Compare* Lyons v. Ga.-Pac. Corp. Salaried Employees Ret. Plan, 221 F.3d 1235, 1252–54 (11th Cir. 2000) (reversing summary judgment for the defendant where plaintiff alleged violations of the lump-sum calculations), *with* Thomson v. Saatchi & Saatchi Holdings (USA), Inc., 159 F.3d 1348 (2d Cir. 1998) (affirming summary judgment for defendant where plaintiff alleged improper salary caps on cash balance plan).
81. *See generally* Esden v. Bank of Boston, 229 F.3d 154, 160 (2d Cir. 2000) (holding the cash balance plan in issue in violation of ERISA and the Code).

Georgia-Pacific Corp. Salaried Employees Retirement Plan[82] and *Esden v. Bank of Boston*[83] are two of the most recent cases that deal with these issues.

Lyons involved a dispute over calculation factors and amply demonstrated the confusion over cash balance plan legislation. In that case, Jerry Lyons, the representative of the class, participated in the Great Northern Corporation's defined benefit plan from 1965 to 1990, until the plan merged with the Georgia-Pacific defined benefit plan in 1991 in conjunction with the merger of the two companies.[84] Because Lyons was a participant in a cash balance plan during the entire relevant time, the issue is not one of conversion, but rather of calculation of benefits when he left the company in 1991.

In accordance with the benefit plan, Lyons elected a lump-sum payment and the company distributed $36,109.15, representing the balance in his personal account. However, Lyons challenged this amount as inaccurate.[85] Lyons argued that the Treasury Department's interpretations of section 203(e) of ERISA[86] suggested that he was entitled to the present value of his retirement benefit.[87] Lyons argued that the present value of his retirement benefit was not the balance in his cash balance account, but rather the value of the account when he turned sixty-five, reduced to present value. Although this may seem like a distinction without a difference, the result was a $13,232 discrepancy.[88]

Under Lyons' interpretation of Treasury Regulation 1.417(e)-1,[89] the company must determine the value of the retirement account at age sixty-five.[90] Then, the Pension Benefit Guaranty Corporation[91] rate (PBGC or discount rate) reduces this amount, in order to arrive at the present value of the retirement benefit.[92] If the interest credits and the

82. 221 F.3d 1235 (11th Cir. 2000).
83. 229 F.3d 154 (2d Cir. 2000).
84. *Lyons*, 221 F.3d at 1239.
85. *Id.*
86. ERISA § 203(e), 29 U.S.C. § 1053(e) (1994).
87. 26 C.F.R. § 1.417(e)-1 (1994).
88. *Lyons*, 221 F.3d at 1239.
89. 26 C.F.R. § 1.417(e)-1 (1994).
90. This is achieved by multiplying the account balance by the yearly interest credits that Lyon would accrue had he not cashed out until the age of sixty-five to arrive at the value of the account at normal retirement age. *Id.*
91. "The Pension Benefit Guaranty Corporation is 'a wholly owned United States Government corporation . . . modeled after the Federal Deposit Insurance Corporation,' whose Board of Directors 'consists of the Secretaries of the Treasury, Labor, and Commerce.'" *Lyons*, 221 F.3d at 1238 n.3 (quoting Pension Benefit Guar. Corp. v. LTV Corp., 496 U.S. 633, 636–37 (1990)).
92. Both I.R.C. § 417(e) and ERISA § 203(e) were added as part of the Retirement Equity Act, enacted in 1984 to ensure that the discount rate was limited to the PBGC rate. *Lyons*, 221 F.3d at 1242. In 1986, the Tax Reform Act was passed, which added the following provisions:

(A) [T]he present value shall be calculated—

(i) by using an interest rate no greater than the applicable interest rate if the vested accrued benefit (using such rate) is not in excess of $25,000, and (ii) by using an interest rate no greater than 120 percent of the applicable interest rate if the vested accrued benefit exceeds $25,000 (as de-

PBGC rates are the same, then the amount of the benefit is the same as the cash balance plan account balance.[93] However, in this case, as with many programs, the interest credit rate was higher than the prescribed rate used by the PBGC. This phenomenon is known as the "whipsaw" effect.[94] This means that the interest credits were greater than the discount, resulting in over $13,000 in additional benefits. Indeed, the court in *Lyons* explicitly acknowledged that if the company had only used the lower PBGC rate as the interest credit rate, this problem would not have occurred.[95] What the court did not mention is that this would lead to a lower benefit for every worker in the company.

Georgia-Pacific argued that the minimum interest rate provision of section 203(e) of ERISA[96] and section 417(e) of the Internal Revenue Code (I.R.C.)[97] "applies only in the context of determining whether consent of a participant is required as a prerequisite to making an immediate distribution of benefits."[98] Georgia-Pacific asserted that because Mr. Lyons' distribution was voluntary, these sections did not apply. The court, however, rejected this analysis, reversing the lower court. The court held that in accordance with Treasury Regulation 1.411(a)-11, Lyons' benefit was to "be calculated by determining what would have been the normal retirement benefit had the participant not elected to take an early lump-sum distribution, and then discounting that amount to present value using the PBGC rate prescribed in ERISA § 203(e)."[99]

Georgia-Pacific also argued that it was exempted from liability by two favorable IRS determination letters that certified the plan for favorable tax treatment.[100] In fact, one of these letters was requested specifically in response to changes to the plan made as a result of the publica-

termined under subclause (i)). In no event shall the present value determined under subclause (II) be less than $25,000.

(B) Applicable Interest Rate—For purposes of subparagraph (A), the term "applicable interest rate" means the interest rate which would be used (as of the date of the distribution) by the Pension Benefit Guaranty Corporation for purposes of determining the present value of a lump sum distribution on plan termination.

Tax Reform Act of 1986, Pub. L. No. 99-514, § 1139(b), 100 Stat. 2487 (codified as amended at 26 U.S.C. § 417(e) (1994)). There is a similar provision for ERISA. *See* Tax Reform Act of 1986, Pub. L. No. 99-514, § 1139(c), 100 Stat. 1287–88 (codified as amended at 29 U.S.C. § 1053(e) (1994)); *see also Lyons*, 221 F.3d at 1242–43.

93. For instance, if the interest credits were 5% annually, and the PBGC discount rate was 5% annually, the credits and discounts would cancel each other out and the employee would receive the balance in his individual account. *See, e.g.*, Esden v. Bank of Boston, 229 F.3d 154, 165 (2d Cir. 2000).

94. Alvin D. Lurie, *Caught in the Jaw of the Saw: A Bum Rap for Cash Balance Plans*, TAX NOTES, Oct. 23, 2000, at 549, 549 [hereinafter Lurie, *Bum Rap*].

95. *Lyons*, 221 F.3d at 1251–52.

96. 29 U.S.C. § 1053(e) (1994), *amended by* 29 U.S.C. § 1053(e) (Supp. II 1997). For the text of the statute, see *supra* note 92.

97. 26 U.S.C. § 417(e) (1994).

98. Brief for Appellee at 19, Lyons v. Ga.-Pac. Corp. Salaried Employees Ret. Plan, 221 F.3d 1235 (11th Cir. 2000) (No. 99-10640).

99. *Lyons*, 221 F.3d at 1252.

100. Brief for Appellee at 9–10, 12–13, *Lyons* (No. 99-10640).

tion of IRS Notice 96-8.[101] The company reasoned that the IRS must have determined that the distribution provisions for personal accounts complied with the I.R.C. provisions that are modeled after section 203(e) of ERISA as part of their inspection of the plan. The court, however, ignored this determination letter at the request of the IRS, who argued that in its analysis, "it 'may have erroneously overlooked the plan provision' for lump-sum payments."[102] The court also observed that the determination letter is limited to certification of favorable tax treatment and does not insulate the Plan from liability to employees.[103]

2. *The* Esden *Case*

Esden v. Bank of Boston[104] also dealt with the "whipsaw" effect. In that case, the plaintiff worked for the bank for almost seventeen years. During her final year of employment, the bank converted its pension plan from a traditional defined benefit plan to a cash balance plan. When Esden left the company in December of 1990, her pension was 100% vested and she opted to take a lump-sum settlement. Her sixteen years of participation in the old plan yielded $3,771.93, the present actuarial equivalent of the amount she would have received had she chosen an annuity starting at age sixty-five.[105] This amount was not in dispute.

The source of Esden's claim was her one year of participation in the cash balance plan. For this period, she received an additional lump sum of $1,547. In accordance with the provisions of the cash balance plan, this sum was the actuarial equivalent of projecting her cash balance to age sixty-five at a rate of 4%, and then converting this amount into an annuity.[106] However, because the minimum investment rate Esden could have received had she not opted for the lump sum was actually 5.5% and not 4%, she brought suit, claiming a violation of section 203(e) ERISA, sections 411 and 417 of the I.R.C., and several Treasury Regulations.[107]

Esden argued that she was penalized for taking the lump-sum payment, which is prohibited by ERISA, and that the I.R.C. provides specific procedures for lump-sum calculations, which Bank of Boston failed to follow. The Second Circuit reversed the lower court ruling that had found that the plan was in compliance, holding that the calculations were erroneous and that ERISA was enacted to create "substantive rights for pension plan participants and expressly created private causes of action

101. *See id*. at 12–13.
102. *Lyons*, 221 F.3d at 1252.
103. *Id.*
104. 229 F.3d at 159 (2d Cir. 2000).
105. *Id.*
106. *Id.* at 161.
107. Esden v. Bank of Boston, 182 F.R.D. 432, 433 (D. Vt. 1998), *rev'd* 229 F.3d 154 (2d Cir. 2000). Specifically, Esden sought protection under three sections: 26 C.F.R. § 1.401 (1993); 26 C.F.R. § 1.411(a) (1988); 26 C.F.R. § 1.417(e)-1(d) (1994). *Id.*; *see also Esden*, 229 F.3d at 158 n.2.

in federal court to vindicate those rights."[108] In so doing, the court emphasized the need for the protection of pension participants above and beyond traditional tax penalties.[109]

I. Retirees Fight Back

In response to the tactics employed by Bank of Boston and many other employers, some employees are fighting back in the media as well as the courts.[110] Over the past two years, there has been a significant amount of material printed about the plight of the cash balance plan worker in magazines ranging from *Tax Notes* to *Time*.[111] In addition, some employees were so upset with the developments that they established a website to express their views, to serve as a resource on pending litigation, and provide information on employees' rights.[112] Without a doubt, this sector of the voting population, mostly baby-boomers, influenced the recent legislation before Congress.

Cash balance plans have been the source of much concern for the courts, the legislature, and the American public. Many are uncomfortable with the seemingly new methods of calculation and accrual associated with such plans. However, as the background illustrated, these features are actually well-established components of defined benefit and defined contribution plans, merely combined into a hybrid.

III. ANALYSIS

A. The Application of Interest Credit Rates

The common thread between *Lyons* and *Esden* is the struggle over calculation factors. In *Esden*, the company used a lower than allowable interest credit rate when projecting the future value of the individual account. In *Lyons*, however, the company used the appropriate interest credit rate, but attempted to use a higher discount rate than the one allegedly mandated by ERISA. In both cases, the companies designed their plans "so that whenever a participant elects a lump-sum distribution, the benefit received will always be her Current Cash Balance Account."[113] Both companies justified their actions by arguing that the ex-

108. *Esden*, 229 F.3d at 177.

109. *See id.*

110. *See* Franklin, *supra* note 40, at 125 (employees of IBM were able to persuade the company to include more employees in the grandfather clause it set up for their cash balance conversion).

111. *E.g.*, Daniel Eisenberg, *The Big Pension Swap*, TIME, Apr. 19, 1999, at 36; Forman, *supra* note 44, at 141; Franklin, *supra* note 40, at 123.

112. *See* GOT THE "CASH PENSION" BLUES, *at* http://www.cashpensions.com (last visited Oct. 15, 2000) (site includes facts on the pension plans of many Fortune 1000 companies and a sophisticated list of resources, including the names and addresses of every member of the United States House of Representatives and the Senate).

113. *Esden*, 229 F.3d at 161.

isting legislation did not apply to cash balance plans. And in both cases, the court applied calculations designed for defined benefit plans to calculate the present value of a hybrid account. These cases are illustrative of the need for new legislation dealing specifically with hybrid pension plans. And, because of the pitfalls identified below, this legislation would not apply "normal retirement benefit" calculations to a cash balance plan.[114]

B. Biting the Hand That Feeds You

There are several dangers with the rulings in *Lyons v. Georgia-Pacific Corp. Salaried Employees Retirement Plan*[115] and *Esden v. Bank of Boston*.[116] First, many companies may take these determinations as a sign that they can only pay interest rates on investments equal to the PBGC. In both cases, the companies only ran into problems with their cash balance plans when they decided to pay a higher rate of return than that mandated by ERISA. If the companies had elected to pay an interest rate equal to the lower PBGC rate, rather than, as in *Lyons*, .75% greater than the PBGC, they would have been in full compliance with ERISA and not subject to liability.[117] So, it seems as though companies that pay competitive interest rates to their employees' retirement plans are being punished for their generosity.

C. The Signal Sent by Lyons *and* Esden

Both of these decisions, while improving the retirement benefits of the few that are parties of current class action lawsuits, will negatively impact current and future participants in cash balance plans. For instance, any company that currently sponsors a cash balance plan with interest credits exceeding the PBGC will read the *Lyons* and *Esden* decisions and likely take measures to avoid similar litigation. The only two ways to avoid such litigation are either to pay the higher amount to those electing a lump-sum distribution—a rather costly, and in many cases, unforeseen endeavor—or to drop the interest credit rate to the PBGC rate.

The *Lyons* court, after explicitly stating in at least two different parts of the opinion that this problem can only be avoided "by reducing or eliminating the difference between the statutory discount rate . . . and the interest credit rate,"[118] went on to dismiss the argument that companies will be encouraged to modify their plans. In a footnote, almost im-

114. I.R.C. § 411(a)(9) "defines 'normal retirement benefit' as 'the greater of the early retirement benefit under the plan, or the benefit under the plan commencing at normal retirement age.'" *Esden*, 229 F.3d at 162 (citing I.R.C. § 411(a)(9) (1994)).

115. Lyons v. Ga.-Pac. Corp. Salaried Employees Ret. Plan, 221 F.3d 1235 (11th Cir. 2000).

116. *Esden*, 229 F.3d at 154.

117. *Lyons*, 221 F.3d at 1238.

118. *Id*. at 1248.

mediately after proclaiming interest rate reduction as the primary solution, the court simply determined that "[t]here is nothing in the record or elsewhere that has been brought to our attention indicating that all or most employers will [lower their interest credit rate]. . . ."[119] However, the *Lyons* court was silent with respect to other options for companies who wish to avoid liability without having to pay the higher "normal retirement benefit."[120]

Similarly, in *Esden*, the court specifically acknowledged the convenience of a cash balance plan that provides for interest credits equivalent to the PBGC rate. The court held that "[i]t follows that a plan which provides for interest credits at the section 417(e) applicable rate may pay out the cash account balance as the actuarial equivalent of the accrued benefit."[121] Once again, this is the only guidance the court offers, likely leading many companies to conclude that this is the only way to avoid future litigation. Given the consistency of the *Lyons* and *Esden* decisions, the courts are exceedingly shortsighted if they believe that companies will not respond to their decisions and heed their advice.

D. Whom Will It Affect and How?

The impact of reducing interest credit rates will no doubt be significant. For instance, in the case of the fifty-one-year-old Mr. Lyons, the .75% difference in the interest credit and the discount rate, projected to age sixty-five, translated into an additional $13,000 in present value benefits. In just fourteen years, the difference in benefits became substantial. The discrepancy would no doubt be even more dramatic if the individual was a twenty-five-year-old worker who is currently participating in a cash balance plan. For this hypothetical employee, if the company were to drop its interest credit rate to the PBGC mandated rate, there is a forty-year period in which she will lose out on the .75% additional interest credit.

Many proponents of the application of "normal retirement" calculations to cash balance accounts argue that companies will feel pressure to not reduce retirement benefits. They argue that all benefits are voluntary, but companies will continue to offer them in order to gain the "favorable tax treatment" associated with IRS and ERISA–approved plans.[122] In addition, companies will offer even higher interest credits in order to recruit new, energetic talent. They argue that given the recent,

119. *Id*. at 1248 n.22.
120. *Id*. at 1251 (construing 26 C.F.R. § 1.417(e)-1 (1994)).
121. *Esden*, 229 F.3d at 165.
122. H.R. REP. NO. 93-807, at 18 (1974), *reprinted in* 1974 U.S.C.C.A.N. 4670.

record-low unemployment rates, retirement benefits will continue to increase as employers seek new ways to stay competitive.[123]

However, this logic is faulty given that proposed notice requirements are insufficient to ensure employees will understand the benefit changes, and even if they are provided with all of the pertinent information, many younger employees show little interest in retirement benefits.

1. Insufficient Information

Widespread employee ignorance with regard to retirement security will likely ensure that interest rate credit reductions on cash balance plans will go unchallenged. Congress has heralded H.R. 1102 for its "mandatory notice" provisions that attempt to force companies to inform their employees about plan changes. While these types of notice requirements are comprehensive with respect to cash balance conversions, they provide little additional guidance for benefit rate changes.[124] In addition, these provisions only apply to "an amendment which has the effect of *significantly reducing* the rate of future benefit accrual."[125] Assuming that interest credit adjustments will constitute a significant reduction within the meaning of H.R. 1102, the plan sponsors are only required to provide examples of how the reduction may impact employees.[126]

In order to determine how the change will specifically affect the employee, she must do her own calculations based on the formulas and data provided. Unfortunately, many employees will not take the time to determine the impact on their individual account.[127] A recent GAO Report found that the majority of employees participating in a retirement plan lack the financial knowledge to determine the impact that plan changes will have on their retirement.[128] Thus, even if a bill similar to H.R. 1102 is passed, unless it provides for individualized, detailed information of the precise financial impact on retirement benefits, the majority of changes will not be understood.

2. Lack of Interest

Even if adequate notice is given, many young workers are not as interested in retirement benefits as their older counterparts and will not

123. For April 2001, the unemployment rate was 4.5%. BUREAU OF LABOR STATISTICS, DEP'T OF LABOR, MONTHLY UNEMPLOYMENT RATE, *available at* http://stats.bls.gov/datahome.htm (last visited May 11, 2001).

124. H.R. 1102 provides for "estimation tool kits" that include "sufficient information to enable an applicable individual to estimate the individual's projected benefits under the terms of the plan in effect both before and after the adoption of the amendment." H.R. 1102, 106th Cong. (2000).

125. *Id*. § 521(e)(1).

126. *See id*. § 521(e)(1)(D).

127. GAO REPORT, *supra* note 16, at 39.

128. *See id*.

squabble over alterations to the interest credit amount. For the great majority of young workers, high salaries and stock options are the primary concern.[129] According to the Bureau of Labor Statistics, the median tenure of an employee working for the same employer in the year 2000 was 3.5 years.[130] This figure drops to 2.6 years when studying employees age twenty-five to thirty-four years old.[131] In either case, this may indicate that many employees are leaving their present employer in search of other opportunities without meeting the five-year vesting requirement.[132] Therefore, they are forfeiting what are many times substantial retirement benefits in exchange for a more immediate pay-off through salary increases and stock options.

Even those employees who do stay long enough to vest their retirement benefits seem to express little interest in retirement security.[133] In fact, many Fortune 1000 companies that offer lump-sum payments have noted that employees often spend the money rather than reinvest it in a retirement vehicle.[134] A recent survey by the Congressional Research Service revealed that a mere "33 percent of recipients report having reinvested their lump sum distribution in another tax-qualified plan."[135] This indicates a disregard for retirement investments. In light of these statistics, an insert in next month's pay check stating that the interest credit on the cash balance plans will be aligned with the PBGC rate will receive little or no notice.

E. Applying the Normal Retirement Calculations to the Cash Balance Plan Defeats the Purpose of the Hypothetical Individual Account

One of the largest appeals of the cash balance plan is the hypothetical individual account. The simplicity of the account and the monthly statements charting the progress of the investment appeals to many workers. Most experts agree that "[a]n employee's hypothetical account balance is credited by the employer with hypothetical allocations and hypothetical interest earnings . . . . The hypothetical allocations and hypothetical earnings are designed to resemble actual contributions and earnings under a defined contribution plan."[136] The benefit of having this

129. Schultz, *supra* note 11, at A-1.

130. BUREAU OF LABOR STATISTICS, DEP'T OF LABOR, MEDIAN YEARS OF TENURE WITH CURRENT EMPLOYER FOR EMPLOYEE WAGE AND SALARY WORKERS BY AGE AND SEX, SELECTED YEARS, 1983–2000, tbl.1, *available at* http://stats.bls.gov/news.release/tenure.t01.htm (last modified Aug. 31, 2000).

131. *Id*.

132. According to one GAO REPORT, 72% of Fortune 1000 companies that have converted to cash balance plans have retained a five-year, all or nothing, vesting requirement. GAO REPORT, *supra* note 16, at 30 fig.9.

133. Schultz, *supra* note 11, at A-1.

134. GAO REPORT, *supra* note 16, at 31.

135. *Id.*

136. Lyons v. Ga.-Pac. Corp. Salaried Employees Ret. Plan, 221 F.3d 1235, 1238 (11th Cir. 2000) (citing I.R.S. Notice 96-8, 1996-1 C.B. 359).

balance is that an employee can easily monitor the progress of her personal account and her current retirement position. This is a stark contrast to the arcane formulas that are needed to calculate present benefits under traditional defined benefit plans.[137]

However, if one of the integral benefits is an at-a-glance account value, then why should the cash balance plan be subjected to the same tortured formulas that we use for traditional benefits?[138] If the *Lyons* and *Esden* courts are correct in applying the "normal retirement benefit" language to cash balance plans,[139] then at no time during the employee's active participation is the hypothetical account balance an accurate reflection of the current value of the employee's retirement benefits. Thus, the hypothetical account balance is reduced to an inaccurate approximation that will confuse even the most sophisticated participant. In every case, the balance would be subject to the same type of complex calculations that traditional defined benefit plans are subject to.[140] That is, of course, every case except one. If both the interest credit rate and the PBGC discount rates are the same, then the balance in the account accurately reflects the normal retirement benefit.[141] Therefore, employers will soon discover the only way to preserve the benefit of simplicity is to drop their interest credit rates in line with the PBGC discount rate.

F. Getting the Benefit of Double Interest

Another reason that "normal retirement" calculations are an ill-fit for the cash balance plan is that lump-sum distributees will reap the benefits of double investment.[142] First, according to "normal retirement" calculations, a departing employee will receive the present actuarial equivalent of their retirement benefit projected to age sixty-five.[143] So, if the interest credit rate is 6% and the discount rate is 4.5%, the employee reaps a benefit of 1.5% interest every year until the age of sixty-five. However, her money is not tied up in a retirement benefit account. She has withdrawn the lump sum and can reinvest it as she sees fit. So, not

137. For example, traditional defined benefit plans, which are typically based on an average of the three highest paid years multiplied by a years of service fraction, require employment of mortality tables and actuarial expertise in order to figure the current value of the retirement benefit. *See* Zelinsky, *supra* note 9, at 688; *see also* Lurie, *Enigma*, *supra* note 17 at 507 ("The mathematics underlying the operation of a pension plan is probably more sophisticated than most individuals could encounter in a lifetime. Behind even seemingly simple DB designs . . . lie arcane mathematical concepts governing present values, projected benefits, benefit accrual rates, actuarial cost factors, and plan funding alternatives.").

138. Lurie, *Bum Rap*, *supra* note 94, at 549.

139. *See, e.g.*, Esden v. Bank of Boston, 229 F.3d 154, 168 (2d Cir. 2000).

140. For an example of these calculations, see Zelinsky, *supra* note 9, at 687–91.

141. *Lyons*, 221 F.3d at 1251.

142. Brief for Appellee at 13, Lyons v. Ga.-Pac. Corp. Salaried Employees Ret. Plan, No. 99-19180, 2000 U.S. App. LEXIS 19180, at *1 (11th Cir. 2000); *see also* Lyons v. Ga.-Pac. Corp. Salaried Employees Ret. Plan, 66 F. Supp. 2d 1328, 1336 (N.D. Ga. 1999), *rev'd*, 221 F.3d 1235 (11th Cir. 2000).

143. *See, e.g.*, 26 C.F.R. § 1.411(a)-7 (1998).

only does she get the interest from her investment, but the capital that she has invested is also larger as a result of the "normal retirement" calculations. In addition, if she invests this lump sum into a suitable retirement vehicle, she will pay no tax on the distribution.[144] And as if that is not enough, her new employer will also likely have a retirement program she will be able to access.

The employee is not restricted to retirement investments, however. She may elect to use the proceeds of her lump-sum distribution to pay off high interest loans or pay off a mortgage. Under this scenario, she may actually be "earning" up to 20% on her investment if she is paying off a credit card debt.

But the true nature of the employee's "windfall"[145] can only be fully appreciated when compared with the unfortunate person who stays with the same company for the duration of her career. Certainly she will receive the yearly interest rate and principal credits. However, she will not have additional investment income from the lump-sum distribution or the benefits of a new employer like her co-worker. In addition, she will receive her interest credits based on the current value of the cash balance account. While her counterpart gets the larger pay off amount, then gets to invest that larger amount in another retirement vehicle, earning more interest from a higher principal amount, she receives none of these benefits. Finally, the worker who stays with the company will not gain access to her retirement benefits until she retires. Her benefits are restricted to long-term retirement. In essence, the second worker will be punished for her loyalty, while the first worker will be rewarded for withdrawing her benefits from the plan and moving to a new job.

Not only is this scenario disheartening for the loyal employee, but it also places a large burden on the employer. First, the employer does not have the benefit of investing the lump-sum assets that the employee has taken out of the retirement program.[146] Therefore, the employer has incurred a loss of capital that would generate the proceeds needed to pay interest credits to its fellow employees. In addition, the employer has the challenge of retaining employees in a highly competitive market while their peers are leaving and reaping the lump-sum distribution windfall.[147]

144. GAO REPORT, *supra* note 16, at 31–32.

145. Appellee's Brief, at 32, *Lyons* (No. 99-19180); *see also* Lyons v. Ga.-Pac. Corp. Salaried Employees Ret. Plan, 66 F. Supp. 2d 1328, 1336 (N.D. Ga. 1999), *rev'd*, 221 F.3d 1235 (11th Cir. 2000).

146. SOCIETY OF ACTUARIES, *supra* note 31, at 4. As the Society of Actuaries notes, "[I]n a cash balance plan a loss tends to occur when employees quit and take their lump sums, and a gain tends to occur when an employee continues employment." *Id*. at 4.

147. *See* Appellee's Brief, at 12, *Lyons* (No. 99-19180).

G. Do Current Laws Require Application of the "Normal Retirement Benefit" Calculations to Cash Balance Plans?

Even if a challenge to the application of the lump-sum calculations to cash balance plans were successful, many worry that the entire cash balance plan would then violate ERISA.[148] According to some experts, if future interest credits were not factored into lump-sum distributions, then the plan would violate age discrimination laws by "back-loading" retirement benefits.[149] However, these assertions assume that the test for such age discrimination is based on defined benefit standards. If the plan were evaluated under the defined contribution standards, which look to current contributions rather than projected annuities, the plan would comply with both ERISA and the I.R.C.[150] Better yet, a new standard specifically tailored to the new "hybrid" plans could be established to accommodate the inherent differences between "traditional" defined benefit or contribution plans and the cash balance plan.

As mentioned previously, until the early 1980s, the world consisted of only defined benefit and defined contribution plans. As such, applicable legislation was created to govern these two types of plans.[151] The cash balance plan was not even contemplated when much of the legislation governing pensions was created.[152] As the cash balance plan grew in popularity, Congress was slow to react, forcing the cash balance plans into the then existing, ill-fitting legislation. The U.S. Government chose one feature of the cash balance plan—guaranteed interest credits—and called it a defined benefit plan, subject to the strictures of that label.[153]

As the court in *Esden v. Bank of Boston* stated, "[t]he regulatory consequences of this classification are wide-reaching."[154] The plan was instantly subject to section 203(e) of ERISA and section 417 of the I.R.C., which mandated the use of the present value calculations at issue in both *Lyons* and *Esden*. This classification ignores the fact that a cash

148. *See* Zelinsky, *supra* note 9, at 740. Professor Zelinsky argues that, in accordance with I.R.S. Notice 96-8, the backloaded feature of cash balance plans would violate I.R.C. 411(b) if the future interest credits were not factored into the lump-sum distribution. *Id.* (construing I.R.S. Notice 96-8, 1996-1 C.B. 359.).

149. *See* Zelinsky, *supra* note 9, at 740.

150. *See id.*

151. Lurie, *Enigma*, *supra* note 17, at 503, 507.

152. In fact, the cash balance plan is only about fifteen years old and has only enjoyed its current popularity since the mid-1990's. *See* Kenneth R. Elliott & James H. Moore, Jr., *Cash Balance Pension Plans: The New Wave*, COMPENSATION AND WORKING CONDITIONS, Summer 2000, at 3, 3.

153. I.R.S. Notice 96-8, 1996-1 C.B. 359 ("[A] cash balance plan is a defined benefit pension plan that defines benefits for each employee by reference to the amount of the employee's hypothetical account balance."); *see also* GAO REPORT, *supra* note 16, at 10.

> A defined benefit plan under the law, the cash balance plan contains features that resemble a defined contribution plan. Cash balance plans are not specifically identified in the law. . . . The cash balance formula, like all defined benefit plan formulas, determines the amount of pension benefits to be paid rather than the amount to be contributed.

I.R.S. Notice 96-8, 1996-1 C.B. 359 (construing ERISA § 3(34)–(35), 29 U.S.C. § 1002(34)–(35) (1994)).

154. Esden v. Bank of Boston, 229 F.3d 154, 158 (2d Cir. 2000).

balance plan shares an important characteristic unique to defined contribution plans—cash balance plans, like defined contribution plans, feature a hypothetical individual account balance.[155]

Even guidance directly speaking to cash balance plans is inadequate. As the court in *Lyons* admitted, "[t]he fairest statement that can be made about ERISA § 203(e) on its face is that it is ambiguous about the issue before us."[156] The IRS may also share this confusion about the administration of cash balance plans. In the *Lyons* case, the court specifically ignored the favorable IRS determination letter that the Georgia-Pacific plan received in 1989 after they admitted that it may have based its decision on an incomplete review of the plan.[157] The court accepted the IRS's request to ignore "the letter, because it 'may have erroneously overlooked the plan provision' for lump sum payments."[158] A possible explanation for the IRS's mistake could be that the standards for cash balance plans were still evolving at the time of the review and continued to develop over the years.

This ambiguity persists, even after the IRS published Notice 96-8, speaking directly to the cash balance plan.[159] In the notice, the IRS acknowledged the need for "guidance concerning the application of sections 411 and 417(e) to single sum distributions under defined benefit pension plans that are cash balance plans."[160] The notice goes on to propose the application of I.R.C. § 417(e) to determine the present value of a lump-sum distribution of a cash balance account. This means that companies, when figuring out the lump-sum distribution, must apply the interest credits forward to the age of retirement, then discount that amount by the PBGC rate in order to arrive at the "normal retirement benefit," the same procedure that is applied to defined benefit plans.[161] However, the notice is only "proposed guidance . . . described . . . in order to permit advance public comment in anticipation of the publication of regulations that incorporate the proposed guidance."[162] In fact, five years have passed since the initial publication of this notice and there is still no regulation concerning the application of 417(e) to cash balance plans.[163] This deficiency continues to be a source of litigation, with *Lyons* and *Esden* serving as the two most recent examples.

155. Zelinsky, *supra* note 9, at 693.
156. Lyons v. Ga.-Pac. Corp Salaried Employees Ret. Plan, 221 F.3d 1235, 1246 (11th Cir. 2000).
157. *See id*. at 1252.
158. *Id*.
159. I.R.S. Notice 96-8, 1996-1 C.B. 359.
160. *Id*. at 1.
161. I.R.C. § 417(e) (1994).
162. *Id*.
163. Appellee's Brief, at 13, *Lyons* (No. 99-19180).

IV. RESOLUTION AND RECOMMENDATION

A. *The Need for Action*

As the conversion to cash balance plans becomes increasingly common,[164] current legislation will continue to prove inadequate. Perhaps the best solution is to enact completely separate legislation for hybrid pension plans that acknowledges the unique characteristics of these plans. That legislation must include a provision that resolves the "whipsaw" effect by making the Personal Account balance equal to the lump-sum distribution amount.[165] An alternative solution is to deter companies from offering lump-sum distributions. In either case, when the proposed legislation is debated, Congress must consider the practical effect cash balance regulation will have on companies and the average American worker.

B. *Recommendation: Elimination of the Calculations*

The first way in which Congress can resolve the "whipsaw" effect is to disassociate the "normal retirement" benefits calculation from cash balance plans.[166] This would allow companies to distribute the hypothetical account balance as the lump-sum distribution amount without further calculations. Congress must consider that if this accommodation is not made, many companies will simply lower their interest credit rate to come in line with the PBGC. This will have the long-term effect of substantially reducing the retirement benefits of millions of workers who contribute to these plans.[167] In an age where one of the biggest concerns is the ability of Social Security to provide for retired Americans, Congress would merely frustrate the problem by effectively reducing the amount of private company retirement benefits, thereby increasing the pressure on Social Security to provide for retirement. All of this would be in the name of satisfying a select group of transient employees who wish to cash out of their retirement plans while punishing the rest of the workforce.[168]

164. For the period from 1995–1999, the number of cash balance plans, established either as a result of conversion or as a new plan, increased almost fivefold compared to the amount established from 1990–1994. GAO REPORT, *supra* note 16, at 15 fig.5.

165. *See, e.g.*, Appellee's Brief, at 1, *Lyons* (No. 99-19180).

166. *Id.*

167. *See supra* notes 135–40 and accompanying text.

168. In addition to reduced benefits, this course of action would have the effect of making lump-sum distribution more appealing to many Americans. According to the GAO REPORT on cash balance plans, 95% of the firms that convert to cash balance plans offer a lump-sum distribution option as part of the plan. GAO REPORT, *supra* note 16, at 31. This option can be devastating to the retirement planning of many Americans given that many workers simply spend the lump-sum distribution, rather than reinvest it for retirement. Companies note that "the firm was losing a key benefit of an employer-sponsored retirement plan, namely, the assurance that employees would have sufficient retirement income to be able to terminate work at an appropriate time." *Id*. Many Fortune 1000 companies cite this concern as a reason for not providing a lump-sum distribution option. *Id*.

C. Alternative Recommendation: Deter Lump-sum Distributions

If Congress is not willing to pass legislation that abolishes the "normal retirement" benefits calculations with respect to cash balance plans, another possible, but less desirable, solution is for Congress to enact legislation that deters employers from offering lump-sum distributions as a part of their retirement plans. This solution is less desirable because it will deprive workers of the financial flexibility provided by lump-sum distribution. Deterring lump-sum distributions, while it may seem radical, would allow employers to maintain the current higher interest credits while eliminating the worry that many employees will squander their distribution.[169] If Congress is concerned with the popularity of cash balance plan conversions, this legislation would essentially strip away one of the most desirable characteristics of the plan—mobility. This would in turn solve many of the problems associated with conversion.[170] Congress will also be reassured that employees are preparing for their retirement and will not rely on social security as their primary retirement tool.

D. Why Action Is Required

Many opponents of the cash balance plan question the need for definitive legislation. They argue that the cash balance plan is a defined benefit plan and should be managed under the existing legislation. To the contrary, the many claims that have resulted from disputes over the interpretation of the current statutes and the significant time that the appellate courts have spent deciphering these statutes illustrate the inadequacy of current legislation.[171]

H.R. 1102 and its progeny build on Internal Revenue and Treasury regulations that do not sufficiently address the intricacy of cash balance plans. The pending legislation, while providing guidance with respect to cash balance conversions, completely ignores the day-to-day operations of cash balance plans and is insufficient to resolve the issues presented in *Lyons*[172] and *Esden*.[173] Future legislation must include comprehensive guidelines regarding the specific administration of these types of plans and must resolve the issues that are better left for Congress than the courts. This new legislation is fitting given the prevalence of cash balance plans in the workplace, and if Congress decides to eliminate application of "normal retirement" benefits calculations to cash balance plans, it will help both employees and employers in America's quest for retirement security.

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169. *Id.*
170. Like "wear-away" and "whipsaw," for example.
171. *E.g.*, Esden v. Bank of Boston, 229 F.3d 154, 154 (2d Cir. 2000); Lyons v. Ga.-Pac. Corp. Salaried Employees Ret. Plan, 221 F.3d 1235, 1235 (11th Cir. 2000).
172. *Lyons*, 221 F.3d at 1235.
173. *Esden*, 229 F.3d at 154.

V. CONCLUSION

Perhaps the most interesting characteristic of the cash balance plan is that it serves simultaneously as a valuable retirement tool and a disruptive force in retirement planning. Proponents cite the high premium that transient, young workers place on plan mobility. In addition, the employee individual cash account provides a quick, understandable method to track the progress of the retirement plan without the use of a mortality table. This benefit is only meaningful, however, if the balance in the account accurately reflects the current lump-sum value.

On the other hand, employees and economists alike are disturbed with the large amounts of money that companies are making from these cash-balance conversions. They are equally concerned by the use of the hypothetical account balance as the lump-sum amount. Indeed, their argument that the "normal retirement benefit" amount must include projected interest credits is credible given the existing patchwork of legislation. But if one considers the unique characteristics of the cash balance plan, the need for specific legislation becomes clear.

While the recent activity of both the judiciary and the legislature may serve as a wake-up call for companies violating ERISA in the administration of their pension plans, the measures will do little to deter the conversion of traditional plans to cash balance plans. The cash balance plan is quickly becoming the standard in pension plans, and existing legislation is insufficient to address the "whipsaw" problem. If Congress fails to act, many companies will simply follow the suggestion of the courts and drop their interest credit rates, thereby reducing the retirement benefits of millions of workers.