

# THE FUTURE OF CASH BALANCE PLANS: INHERENTLY ILLEGAL OR A VIABLE PENSION OPTION?

## I. INTRODUCTION

Private pension plans are a vital benefit to any employee, but can be very costly to employers. As a result, many employers have sought ways to reduce the cost of such plans in order to avoid eliminating them completely. One relatively cost effective and flexible alternative, the cash balance plan, has been causing controversies in the pension community. These plans have sparked lawsuits alleging not only age discrimination against older workers,<sup>1</sup> but also accusing the plans of miscalculating lump sum distributions when an employee terminates the plan before normal retirement age.<sup>2</sup> In order to explain why cash balance plans are causing such a stir—and if they can or should be a viable pension option—this Comment must first explain exactly what a cash balance plan is, and why employers find them so attractive. Secondly, this Comment will briefly discuss some of the age discrimination issues facing cash balance plans, and will then pursue an exploration of lump sum valuation problems involved with the plans, focusing on the recent decision of *Berger v. Xerox Corp.*<sup>3</sup> Finally, proposals introduced to keep cash balance plans a viable option for employers will be addressed and explained.

## II. TYPES OF RETIREMENT PLANS

First of all, there are two distinct classifications of pension plans: defined benefit plans, which pay out a certain amount based on a predetermined formula; and defined contribution plans, which provide an account for each employee based on amounts contributed to the account.<sup>4</sup> A cash balance plan is, by definition, a defined benefit plan,<sup>5</sup> yet differs in many

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1. See *Eaton v. Onan Corp.*, 117 F. Supp. 2d 812, 812 (S.D. Ind. 2000); *Cooper v. IBM Corp.*, 274 F. Supp. 2d 1010, 1010 (S.D. Ill. 2003).

2. See *Berger v. Xerox Corp.*, 338 F.3d 755, 755 (7th Cir. 2003).

3. *Id.*

4. Craig C. Martin & Amanda S. Amert, *Cash Balance Plans Reassessed in Light of Discrimination and Funding Litigation*, 59 BUS. LAW. 453, 453 (2004); see also *Lyons v. Georgia-Pacific Corp.*, 221 F.3d 1235, 1237 (11th Cir. 2000); 29 U.S.C. § 1002(34) (1994) (defining an “individual account plan” or “defined contribution plan” as a “pension plan which provides for an individual account for each participant and for benefits based solely upon the amount contributed to the participant’s account”); 29 U.S.C.A. § 1002(35) (1994) (defining a “defined benefit plan” as “a pension plan other than an individual account plan”).

5. *Berger*, 338 F.3d at 757.

ways from the traditional defined benefit plan. In the traditional defined benefit plan and in a cash balance plan, an employee is entitled to an annuity based on that employee's earnings history and number of years of service to the employer upon retirement.<sup>6</sup> Traditional defined benefit plans, however, most typically use a "final average" formula to compute benefits, where the amount of the retired employee's annuity is determined based upon his or her final years of service to the employer.<sup>7</sup> Accordingly, a final average formula generally equals a determined percentage multiplied by the years of employment multiplied by the average of final compensation.<sup>8</sup> Final average compensation is usually determined using the employee's salary during the final three or five years prior to retirement.<sup>9</sup> As a result, final average defined benefit plans are considered "backloaded" because it is the employee's *final* years of service that are used to determine benefits.<sup>10</sup> Excessive backloading is prohibited by pension law, such that an actual postponing of accrued benefits is illegal.<sup>11</sup> However, the amount of backloading that is inherent in traditional defined benefit plans is perfectly legal.<sup>12</sup> This type of backloading is particularly helpful to older and loyal workers because they have a higher number of years of service, and the highest salaries typically come during later years of employment.<sup>13</sup> However, employers must increase the amount contributed to provide for the annuities of older workers who are nearing retirement age because these annuities are those which will be paid out in the nearest future.<sup>14</sup> In essence, it is these final years that are most valuable to the employee and at the same time, most costly to the employer.<sup>15</sup>

Consequently, as the Baby Boomer generation nears retirement age, many employers have begun to look for alternatives to these expensive traditional pensions.<sup>16</sup> One such attractive and common alternative is the de-

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6. Edward A. Zelinsky, *The Cash Balance Controversy*, 19 VA. TAX REV. 683, 687 (2000).

7. *Id.*

8. Jonathan B. Forman & Amy Nixon, *Cash Balance Pension Plan Conversions*, 25 OKLA. CITY U. L. REV. 379, 387 (2000).

9. *Id.*

10. Zelinsky, *supra* note 6, at 688.

11. *Id.* at 720. If severe backloading were permitted, a plan could effectively defy vesting rules, which require that the plan benefits become non-forfeitable after a certain period of employment. For example, a defined benefit plan could have benefits accruing at a very small rate until the final year before retirement, when the largest portion of the benefit would be earned all at once. If this were the case, an employee who terminated employment just one year before the age of retirement would effectively lose *all* of his or her benefits, which would have been fully earned if the employee had remained in employment for only one more year. *See id.*

12. *Id.*

13. *Id.* at 688.

14. *Id.*

15. *Id.* To illustrate, suppose both a 25 year-old employee and a 60 year-old employee earn the same annual salary and are entitled to the same benefit at retirement. The present value of that benefit to the 25 year-old employee would be much less than the value to the 60 year-old employee because it would have to be discounted over many more periods. Similarly, the employer would have to contribute a much smaller amount presently to fund the 25 year-old employee's plan because it would have many more periods over which to grow. *Id.* at 690-91.

16. Regina T. Jefferson, *Striking a Balance in the Cash Balance Plan Debate*, 49 BUFF. L. REV. 513,

defined contribution plan, which is cheaper and easier for the employer to maintain.<sup>17</sup> One reason for this is the passage of the Employee Retirement Income Security Act (ERISA)<sup>18</sup> in 1974, which placed greater regulations on defined benefit plans than on defined contribution plans.<sup>19</sup> Employees also appreciate defined contribution plans because of their portability and much simpler and easier to understand benefit structure.<sup>20</sup> Among defined contribution plans, the 401(k) has become the most common.<sup>21</sup>

In a defined contribution plan, the employer makes periodic payments to a pension trust which is divided among individual accounts in the name of each participant of the plan.<sup>22</sup> The employee is only entitled to the amount of the account at the time of retirement, which is not guaranteed to be a certain amount, but is instead determined by the investment performance of the account.<sup>23</sup> In contrast to a defined benefit plan, the employee, not the employer, decides how to invest such contributions for most 401(k) plans.<sup>24</sup> As a result of this feature, the investment risk falls fully on the employee instead of on the employer, as it does in a defined benefit plan.<sup>25</sup> With a 401(k), poor investment decisions mean that an employee with a defined contribution plan will receive a lesser pension benefit. With a defined benefit pension, on the other hand, if an employer makes poor investment decisions resulting in a low return on assets or even a loss, the employee is still entitled to the same pension amount.<sup>26</sup> This allocation of risk is an important distinction between defined contribution and defined benefit pensions.<sup>27</sup>

The cash balance plan is classified as a defined benefit plan, but it closely resembles a defined contribution plan.<sup>28</sup> The risk of investment remains on the employer, as the employee is entitled to a defined benefit, yet a cash balance plan provides the participant with a "hypothetical account balance" much like a defined contribution plan.<sup>29</sup> This "hypothetical account . . . is credited with a percentage of pay each year,"<sup>30</sup> and that account also earns interest credits each year. The employee can choose, upon retirement or upon leaving the company, to receive the account balance as a lump

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513 (2001).

17. *Id.* at 514.

18. Pub. L. No. 93-406, 88 Stat. 829 (1974).

19. Jefferson, *supra* note 16, at 515.

20. *Id.* at 514.

21. Susan J. Stabile, *Paternalism Isn't Always a Dirty Word: Can the Law Better Protect Defined Contribution Plan Participants?*, 5 EMPLOYEE RTS. & EMP. POL'Y J. 491, 492 (2001).

22. *Id.* at 494.

23. *Id.* at 494-95.

24. *Id.* at 494.

25. *Id.* at 497-98.

26. *See id.* at 498.

27. *Id.* at 497.

28. *Berger v. Xerox Corp.*, 338 F.3d 755, 757 (7th Cir. 2003).

29. *Id.* at 758.

30. Albert B. Crenshaw, *The Retirement-Funding Debate: Defining "Defined Benefit," "Defined Contribution," and the Big Pension Issue*, WASH. POST, Oct. 19, 2003, at F8.

sum or as a stream of payments in annuity form.<sup>31</sup> Even though these “hybrid” plans have many characteristics of a defined contribution plan, they are still subject to the regulations imposed upon defined benefit plans that are “in many regards rigidly binary.”<sup>32</sup> The “individual accounts, and the employer contributions and the interest credits to those accounts, are all hypothetical under a cash balance plan,”<sup>33</sup> and because of this, these plans are undeniably defined benefit plans. The issues that this classification causes for cash balance plans will be revisited and explained later in this Comment.

Cash balance plans are a relatively new phenomenon, as the first one was created in 1985, by Bank of America.<sup>34</sup> Like many other companies who have long funded traditional defined benefit pensions, Bank of America found the defined *contribution* plan to be attractive for many reasons. First of all, companies were attracted to the shift of investment risk onto the employee, so that declining market conditions would not affect the amounts that they would have to pay out.<sup>35</sup> Also, as the workforce was becoming more mobile, these companies realized that employees were attracted to the portability of such defined contribution plans, and employees enjoyed the relative simplicity of plans that allowed them to more easily understand the benefits that they would be receiving.<sup>36</sup> Employers also realized that defined contribution plans were a means to attract younger workers,<sup>37</sup> because these plans are more portable, and their benefit accumulation is spread more evenly over all of the years of employment—not focusing heavily on the last years of employment as traditional pensions do. Other larger scale economic factors have contributed to the decline in traditional defined benefit pensions and the subsequent rise in defined contribution plans, such as a decline in the number of large unionized manufacturing firms which have historically provided traditional pensions.<sup>38</sup> Smaller, non-unionized firms in the service sector have become more prevalent, and these companies—due to their size—have opted for the simpler, more efficient, and less risky defined contribution plan.<sup>39</sup> Also, as mentioned earlier, defined benefit plans have been regulated more heavily than defined contribution plans with the passage of ERISA, causing them to be even more costly.<sup>40</sup> For all of these reasons, 401(k) plans were established effectively in 1981, and have become an immensely popular form of defined contribution plan.<sup>41</sup>

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31. *Id.*

32. *Esden v. Bank of Boston*, 229 F.3d 154, 158 n.6 (2d Cir. 2000).

33. *Id.*

34. Jefferson, *supra* note 16, at 522.

35. *Id.*

36. *See id.* at 525.

37. Zelinsky, *supra* note 6, at 707.

38. Jefferson, *supra* note 16, at 524.

39. *See id.* at 524.

40. *See id.* at 524-25.

41. *Id.* at 525.

Despite all of the advantages of defined contribution plans, many employers, including Bank of America, still were not willing to make such a drastic change from their traditional defined benefit plans. For some of these employers, cash balance plans provided the ideal alternative. One reason employers preferred a cash balance plan over a defined contribution plan was the attractiveness of keeping any cash surplus generated under the plan resulting from outperformance of the market.<sup>42</sup> Unlike a defined contribution plan, where the employee is entitled to the balance of his or her account which completely depends on its performance in the stock market, a cash balance plan provides the participant with a defined and determinable benefit, no matter how the account performs. Of course, this means that the employer takes on the risks as well as the possible rewards with a cash balance plan,<sup>43</sup> but many larger employers who have sophisticated and highly competent investment firms at their service are more than willing to take on this risk for themselves.

Next, it is important to note that a switch from a traditional defined benefit plan to a defined contribution plan constitutes a termination of the plan.<sup>44</sup> This is important because, by law, a participant's accrued benefits under a plan are nonforfeitable upon termination of the plan.<sup>45</sup> Accordingly, employees who were not yet vested under the traditional defined benefit pension would be vested, and the employer would be obligated to pay these employees the amount in their accounts upon switching to a defined contribution plan. Naturally, this becomes a problem when the employees leave the firm after their old plan is terminated but before they would have actually vested under the old plan.<sup>46</sup> A switch from a traditional defined benefit plan to a cash balance plan, however, does not constitute a plan termination, and is instead considered a continuation of the same plan under a different method of computing benefits.<sup>47</sup> As a result, no previously forfeitable benefits become nonforfeitable simply because of the switch.

Also, as in many business decisions, taxes play an important role in pension plan conversions. An employer who terminates an "overfunded" traditional defined benefit plan (that is, the plan has greater assets than it needs to pay its participants the benefits currently owed) in order to switch to a defined contribution plan is required to pay taxes that an employer who simply converts the plan into a cash balance plan is not required to pay.<sup>48</sup> The Internal Revenue Code<sup>49</sup> mandates large tax penalties for the termina-

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42. Zelinsky, *supra* note 6, at 714-15.

43. *Id.*

44. *Id.* at 710-11.

45. I.R.C. § 411(d)(3) (2002).

46. *See* Zelinsky, *supra* note 6, at 710.

47. *Id.* at 710-11.

48. Norman Stein, *Some Serious Questions About Cash Balance Plans*, CONTINGENCIES (Am. Acad. of Actuaries, Washington, D.C.) Sept./Oct. 1999, at 28, 30.

49. 26 U.S.C. § 4980 (2002).

tion of a plan, calling for a “surcharge” tax to be paid on any overfunded amounts in a terminated plan.<sup>50</sup>

For all of the foregoing reasons, cash balance plans entered the pension world with a bang. In 1985, a mere 1% of firms in the United States reportedly offered a cash balance plan. This number jumped to 22% in 1998 and up to 33% in 2002. Similarly, the percentage of firms offering traditional pensions declined from an incredible 89% in 1985 to only 50% in 2002,<sup>51</sup> and in 2003 more than three hundred companies had reported substituting cash balance plans for traditional defined benefit plans.<sup>52</sup> Firms have now become wary, however, of such conversions due to controversial rulings on the plans. Federal courts have found cash balance plans to violate both anti-age discrimination laws<sup>53</sup> as well as benefit valuation regulations.<sup>54</sup> The focus of this Comment will be on the valuation issues involved with cash balance plans, with an analysis of the recent ruling against Xerox Corporation’s plan by Judge Posner. However, first a brief discussion of age discrimination issues surrounding cash balance plans is warranted to gain an understanding of all of the problems facing these hybrid pension plans today.

### III. AGE DISCRIMINATION

The federal courts have split on the issue of whether cash balance plans violate age discrimination law.<sup>55</sup> In the recent high profile case against IBM Corporation, a federal district court ruled against the company’s plan, finding that it violated ERISA’s anti-age discrimination provisions.<sup>56</sup> In short, the district court found that IBM’s cash balance plan did not satisfy the statutory requirements for defined benefit plans.<sup>57</sup> The plan was found to violate ERISA’s age discrimination rules because of the way it calculated interest credits. The court decided that interest credits would always be more valuable for a younger employee because as the employee ages, the same contribution made in the previous year declines in value in terms of an annuity.<sup>58</sup> This is because a younger employee accrues interest credits over a longer period than an older employee, thereby earning an effectively larger interest credit when valued in annuity, or future interest, terms. There-

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50. Zelinsky, *supra* note 6, at 711-14.

51. Christine Dugas, *Proposal Aims at Shielding Older Workers’ Pensions*, USA TODAY, Feb. 2, 2004, at B2, available at [www.workplacefairness.org/index.php?page=newsletterarchive&id=39](http://www.workplacefairness.org/index.php?page=newsletterarchive&id=39).

52. *Inspector General to Look at Reports on IBM Lobbyist*, WALL ST. J., Sept. 11, 2003, available at <http://www.ibmemployee.com/Highlights030913.shtml>.

53. See *Cooper v. IBM Corp.*, 274 F. Supp. 2d 1010, 1010 (S.D. Ill. 2003).

54. See *Lyons v. Georgia-Pacific Corp.*, 221 F.3d 1235 (11th Cir. 2000); *Esden v. Bank of Boston*, 229 F.3d 154 (2d Cir. 2000); *Berger v. Xerox Corp.*, 338 F.3d 755 (7th Cir. 2003).

55. See *Eaton v. Onan Corp.*, 117 F. Supp. 2d 812, 812 (S.D. Ind. 2000); *Cooper*, 274 F. Supp. 2d at 1010.

56. *Cooper*, 274 F. Supp. 2d at 1010.

57. *Id.* at 1021.

58. *Id.* at 1021 (citing Zelinsky, *supra* note 6, at 733).

fore, the court found that the plan violated ERISA, which mandates that “the rate of an employee’s benefit accrual” not be “reduced because of the attainment of any age.”<sup>59</sup>

On the other hand, some federal courts have reached the opposite conclusion.<sup>60</sup> A district court in Illinois found that Onan Corporation’s cash balance plan did not violate age discrimination laws for two reasons. First, the court found that the age discrimination provisions in ERISA did “not apply at all to employees under the age of normal retirement,”<sup>61</sup> but that these provisions were only intended to protect those employees who chose to work *past* normal retirement age. Second, the court alternatively found that even if the ERISA age discrimination provisions did apply to employees under normal retirement age, there was still no requirement that “the rate of benefit accrual be measured *solely* in terms of change in the value of an annuity payable at normal retirement age.”<sup>62</sup> Therefore, if the rate of benefit accrual were measured by another method, such as by the change in the balance of each employee’s hypothetical account (a method which the defendants suggested), then the measure would not depend at all on age, and there would be no age discrimination.<sup>63</sup>

The First Circuit, in dicta, supported these two arguments, affirming a district court’s ruling that BankBoston’s cash balance plan did not violate age discrimination provisions.<sup>64</sup> Most recently, a district court in Maryland<sup>65</sup> declined to follow the reasoning of *IBM Corp. v. Cooper* and adopted the logic of *Eaton v. Onan Corp.*, finding that benefit accrual in a cash balance plan should be measured by the rate at which amounts are allocated and the changes over time in an individual’s account balance.<sup>66</sup> When examined in this manner, the company’s cash balance plan did not violate ERISA.

Also within the age discrimination issue is a controversy over “wear away” periods involved in the conversions of some traditional defined benefit plans into cash balance plans. “Wear away” refers to a transition period in which an employee’s entitlement is frozen until the amount calculated under the new cash balance plan is equal to the benefit the employee was entitled to under the old plan.<sup>67</sup> In other words, the employee’s pension benefit does not grow until his hypothetical cash balance surpasses the benefit already earned under the previous plan.<sup>68</sup> This has a more serious

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59. *Id.* at 1022; ERISA § 204(b)(1)(H), 29 U.S.C. § 1054(b)(1)(H) (2000); 26 U.S.C. § 411(b)(1)(H) (2002).

60. *See Eaton*, 117 F. Supp. 2d at 812; *Campbell v. BankBoston*, 327 F.3d 1, 10 (1st Cir. 2003).

61. *Eaton*, 117 F. Supp. 2d at 826.

62. *Id.* (emphasis added).

63. *See id.* at 824.

64. *See Campbell*, 327 F.3d at 10.

65. *Tootle v. ARINC, Inc.*, 222 F.R.D. 88 (D. Md. 2004).

66. *Id.* at 94.

67. *Campbell*, 327 F.3d at 8.

68. *Zelinsky*, *supra* note 6, at 702.

effect on older workers, who expect their pension benefits to be increasing the most during their later years of employment.<sup>69</sup>

Pension law requires that an accrued benefit not be decreased as the result of a change in pension plan.<sup>70</sup> However, wear away does not technically reduce any accrued benefit, but simply freezes the account balance for a certain amount of time.<sup>71</sup> Age becomes an issue, though, because the older an employee is, the longer his or her account balance may be frozen.<sup>72</sup> An older employee's accrued benefit will actually be larger than a younger employee's benefit due to the fact that it will be discounted for fewer periods from an age 65 annuity to reach its present value.<sup>73</sup> Therefore, all other things being equal, an older employee's account balance will be frozen for a longer time solely on account of his age, because the hypothetical cash balance will have a higher sum to reach. The younger employee will begin to earn new benefits under the new plan before the similarly situated older employee. While the older employee is obviously disadvantaged by such wear away provisions, it is not clear whether wear away is actually illegal. As previously noted, the accrued benefit is not impermissibly reduced. However, it is debatable if the *rate* of accrual has been illegally reduced on account of "the attainment of any age."<sup>74</sup>

#### IV. LUMP SUM VALUATION (WHIPSAW)

##### A. *Background on the Xerox Case*

The Seventh Circuit recently addressed the issue of valuating lump sum distributions to cash balance plan participants before normal retirement age.<sup>75</sup> On August 1, 2003, Judge Posner issued an opinion declaring Xerox Corporation's method of determining lump sum distributions made to participants prior to normal retirement age to be illegal.<sup>76</sup> Xerox's cash balance plan provided each participant with a benefit equal to 5% of his or her salary for every year of employment, plus annual interest accumulations (future interest credits) calculated using the average one year Treasury bill rate for the previous year plus 1%.<sup>77</sup> An employee's benefits under the plan will vest after five years of employment, meaning that after five years, the benefits become an actual entitlement to an "accrued benefit."<sup>78</sup> Exactly *what* the

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69. *Campbell*, 327 F.3d at 8.

70. 26 U.S.C. § 411(d)(6)(A); ERISA § 204(g).

71. *Zelinsky*, *supra* note 6, at 703.

72. *See id.* at 743-45.

73. *Id.*

74. *Id.* at 745; 26 U.S.C. § 411(b)(1)(H)(i).

75. *See Berger v. Xerox Corp.*, 338 F.3d 755 (7th Cir. 2003).

76. *Id.* at 763.

77. *Id.* at 758.

78. *Id.*; 26 U.S.C. § 411(a)(2)(A) (2002); 29 U.S.C. § 1053(a)(2)(A) (1994) (providing that "[a] plan satisfies the requirements of this subparagraph if an employee who has completed at least 5 years of service has a nonforfeitable right to 100 percent of the employee's accrued benefit derived from employer contributions").



participant is entitled to is “the benefit under the plan commencing at normal retirement age,”<sup>79</sup> and the normal retirement age is determined to be age 65.<sup>80</sup> Further, the “accrued benefit” that the vested employee is entitled to if he or she leaves employment prior to normal retirement age is statutorily defined as “the individual’s accrued benefit determined under the plan . . . expressed in the form of an annual benefit commencing at normal retirement age.”<sup>81</sup>

For an individual account plan, or defined contribution plan, the amount of the “accrued benefit” is easily and simply measured by the amount that is actually in the account at the time the employee terminates employment.<sup>82</sup> However, this calculation is more complicated for a defined benefit plan, where the entitlement is measured as a pension commencing at age 65, with the amount of that pension depending upon the percentage of salary and the number of years of employment.<sup>83</sup> This introduces a phenomenon known as “whipsaw,” in which the value of a lump sum distribution must be determined by projecting the cash balance forward and then discounting back to a present value.<sup>84</sup> The rate projected forward may be prescribed by the plan itself, but the discount rate is statutorily set.<sup>85</sup>

Under the Xerox cash balance plan, the departing employee was entitled to the hypothetical balance of the account *when the distribution was received*.<sup>86</sup> Therefore, if the employee decided not to receive the lump sum until normal retirement age (even though he has terminated employment), the balance in the hypothetical account would continue to increase by the future interest credits accumulated each year.<sup>87</sup> Keep in mind, however, that the account would no longer be increasing by a percentage of salary contributions, since employment would have ended. Only the interest credits cause the hypothetical account balance to increase.

The plaintiffs in the *Xerox* case consisted of those employees who chose to receive their lump sum distribution upon the termination of employment, not those who waited to receive their entitlement until normal retirement age.<sup>88</sup> Xerox provided these employees with a sum that the plaintiffs alleged was less than the amount to which they were entitled. The company computed the early lump sum distribution amount by adding interest at a rate exactly equal to the rate used to discount the balance to present value.<sup>89</sup> Effectively, this meant that the amount distributed was exactly the amount in the hypothetical account upon the date of termination of employment.

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79. *Berger*, 338 F.3d at 758; *see also* 29 U.S.C. § 1002(22); 26 U.S.C. § 411(a)(9).

80. 29 U.S.C. § 1002(24); *see also* 26 U.S.C. § 411(a)(8).

81. 29 U.S.C. § 1002(23)(A); *see also* 26 U.S.C. § 411(a)(7)(A).

82. 29 U.S.C. § 1002(23)(B); *see also* 26 U.S.C. § 411(a)(7)(A)(ii).

83. *Berger*, 338 F.3d at 758.

84. *Esden v. Bank of Boston*, 229 F.3d 154, 159 (2d Cir. 2000).

85. *Id.*

86. *Berger*, 338 F.3d at 758.

87. *Id.* at 759.

88. *Id.*

89. *Id.*

*B. Analysis of the Xerox Opinion*

“[I]n the case of any defined benefit plan, if an employee’s accrued benefit is to be determined as an amount other than an annual benefit commencing at normal retirement age . . . the employee’s accrued benefit . . . shall be the actuarial equivalent of such benefit.”<sup>90</sup> In other words, if a lump sum distribution is to occur at any time prior to actual normal retirement age, it is required, by law, to be equal to an annuity beginning at normal retirement age.<sup>91</sup> This means that the amount distributed to the departing employee before normal retirement age must actually include the future interest credits that would have accrued if the employee waited to receive his or her benefit until normal retirement age. Of course, this amount would then have to be discounted back to present value. This discount rate, in the case of the Xerox plan, was determined by the Pension Benefit Guarantee Corporation (PBCG), which is a government owned corporation that “administers and enforces” provisions of ERISA.<sup>92</sup> For pension plans today, however, the discount rate is determined by the thirty-year Treasury bill rate, or “the annual rate of interest on 30-year Treasury securities for the month before the date of distribution or such other time as the Secretary may by regulations prescribe.”<sup>93</sup>

Therefore, under the Xerox plan, a departing employee should, according to Judge Posner and ERISA, be entitled to the sum in his account (the cash balance) at the date of termination plus future interest credits on that amount (computed using the plan’s prescribed rate of the average one-year Treasury bill rate for the prior year plus 1%)<sup>94</sup> until the normal retirement age of 65, and then that value would be discounted back to present value using the PBCG rate. The Xerox plan instead computed the lump sum distribution by adding future interest credits to the account at a rate exactly equal to the PBCG rate used to discount back to present value.<sup>95</sup> Because the discount rate and the credit rate were equal, the lump sum distributed was effectively the cash balance in the account on the date of termination.<sup>96</sup>

As Posner points out, Xerox’s method of computing plan distributions may not always be advantageous to the company, but may, theoretically, actually work in favor of the employee.<sup>97</sup> Of course this would only occur when the PBCG rate is higher than the one-year T-bill rate plus 1%, in which case using the ERISA annuity method would result in an amount at distribution lower than the actual cash balance. Determining the amount of

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90. *Esden*, 229 F.3d at 163 (quoting 29 U.S.C. § 204(c)(3)); *see also* 26 U.S.C. § 411(c)(3).

91. *See Esden*, 229 F.3d at 163.

92. *Lyons v. Georgia-Pacific Corp.*, 221 F.3d 1235, 1238 n.3 (11th Cir. 2000) (quoting *Pension Benefit Guaranty Corp. v. LTV Corp.*, 496 U.S. 633, 636-37 (1990)).

93. 26 U.S.C. § 417(e)(3) (2002).

94. *Berger*, 338 F.3d at 758.

95. *Id.* at 760.

96. *Id.*

97. *Id.*

these future interest credits under the ERISA plan is not as straightforward as it may seem, however, because of the inevitable fluctuations in the T-bill rate.<sup>98</sup> Because of this, it would be impossible for the Xerox plan to precisely determine the amount of future interest credits that would accumulate until the employee reached age 65.

This complexity does not, of course, provide an excuse for the plan to choose its own rate, as the plan did. In fact, in Notice 96-8,<sup>99</sup> the IRS specifically addresses this issue by stating that if the defined benefit plan uses an interest rate to compute future interest credits that is no greater than the discount rate provided in section 417(e)(3),<sup>100</sup> which is the PBCG rate for the Xerox plan, then the projection would result in an impermissible forfeiture.<sup>101</sup> The Treasury Regulations go one step further and prescribe alternative methods for determining such future interest credit rates. The regulations require that if “the interest rate specified in the plan is a variable interest rate,” such as the one-year T-bill rate plus 1% rate used by Xerox, the plan must specify that future interest credits will be computed by using either “the current value of the variable interest rate” or “the average of the current values of the variable interest rate for the current period and one or more periods immediately preceding the current period (not to exceed five years in the aggregate).”<sup>102</sup> The District Court judge chose (and Judge Posner affirmed) the single-year method, which actually yielded a smaller lump sum than using a five-year average.<sup>103</sup> While Xerox did not complain about the choice between those two methods, the company certainly did not want to abandon their method of computing future interest credits by using the PBCG rate. This is because the PBGC discount rate varied from 4% to 6.5% during the 1990s, while the T-bill rate plus 1% rate varied from 4.4% to 9.7%. This meant that under the method Judge Posner imposes upon the plan, the future interest credit rate would be, on average, higher than the PBGC discount rate, causing the lump sum distribution to be higher than the amount of the cash balance that the Xerox plan was distributing under their method of matching the two rates—much higher, in fact, totaling around \$300 million.<sup>104</sup>

Because of the huge discrepancy between the two methods, Xerox certainly thought it worth its while to test the argument that the accrued pension benefit under the cash balance plan did not include these future interest credits. Their argument, which Judge Posner thoroughly attacked and even ridiculed, conceded that the departing employee had an “absolute, vested, indefeasible entitlement”<sup>105</sup> upon termination to a pension commencing at

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98. *Id.*

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

100. 26 U.S.C. § 417(e)(3) (2002).

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

102. 26 C.F.R. § 1.401(a)(4)-8(c)(3)(v)(B) (2000).

103. *Berger v. Xerox Corp.*, 338 F.3d 755, 760 (7th Cir. 2003).

104. *Id.* at 761.

105. *Id.*

age 65 based on the cash balance in his account plus future interest credits accrued between the departure date and age 65. Xerox limited this entitlement, though, by making it contingent upon whether the departing employee demands a distribution prior to normal retirement age.<sup>106</sup> Because the employee's entitlement to future interest credits terminates when the employee elects to take a lump sum distribution, Xerox argued, the benefit that accrues is only the benefit on the date of distribution, or the cash balance in the account.<sup>107</sup> In its brief, Xerox stated its position that accrued benefits in its plan are not determined by reference to the cash balance in the account at normal retirement age, but instead are determined by the cash balance when a distribution is received. Although an employee who remains employed until age 65 is benefited by interest credits accruing to that date, according to Xerox, his account balance still remains the measure of his entitlement.<sup>108</sup>

This argument simply does not hold up. As Posner points out, Xerox is attempting to analogize its cash balance plan to a defined contribution plan. However, pension law clearly defines cash balance pension plans as defined benefit plans. Notice 96-8 explicitly clarifies this point and explains that the reason cash balance plans are not defined contribution plans is that "the benefits provided [in a cash balance plan] are not based solely on actual contributions and forfeitures allocated to an employee's account and the actual investment experience and expenses of the plan allocated to the account."<sup>109</sup> Furthermore, The Internal Revenue Code explicitly states that the employee's accrued benefit in a defined benefit plan is expressed in the form of an annual benefit commencing at normal retirement age,<sup>110</sup> and the Code then clarifies that the accrued benefit is measured by the amount in the account for plans that are *not* defined benefit plans.<sup>111</sup> Further, if the amount of the employee's accrued benefit is to be determined as an amount other than an annuity commencing at age 65, it must be the actuarial equivalent of that annuity, and no less.<sup>112</sup> For the lump sum distribution to be equal to the actuarial equivalent of the annuity, the plan must project the current cash balance forward at a rate that may be prescribed by the plan, and then that amount must be discounted back to present value at the statutory rate (the PBGC rate for the Xerox plan).<sup>113</sup>

The Xerox plan did go thru the motions of this procedure, as previously discussed, by projecting the balance forward at the same rate as the discount rate and then discounting to present value, but this certainly did not solve any of the plan's problems. Not only does this process indicate that Xerox does not believe in its own argument that the employee's accrued benefit is

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106. *Id.*

107. *Id.*

108. *Id.*

109. I.R.S Notice 96-8, 1996-1 C.B. 359, 361.

110. 26 U.S.C. § 411(a)(7)(A)(i) (2002).

111. § 411(a)(7)(A)(ii).

112. § 411(c)(3); *Esden v. Bank of Boston*, 229 F.3d 154, 159 (2d Cir. 2000).

113. *See Esden*, 229 F.3d at 159.

the amount of his cash balance on the date of distribution, causing the argument to be “empty semantic,”<sup>114</sup> but it also violates forfeiture rules. An employee’s accrued benefit must become vested and nonforfeitable at some point.<sup>115</sup> That is, the right to an accrued benefit must become an unconditional right at a particular time.<sup>116</sup> The Xerox plan permissibly specified that its employees’ benefits would vest, or become nonforfeitable, after five years of service.

The Xerox plan can be classified as a frontloaded cash balance plan because future interest credits are not conditioned upon future service.<sup>117</sup> This is illustrated by the fact that a departing employee may choose not to receive his distribution until normal retirement age, and the plan will continue to contribute interest credits to the balance. For such frontloaded plans, Notice 96-8 specifically states that an employee’s accrued benefit is based on the employee’s “hypothetical” account balance at normal retirement age, “including future interest credits to that age.”<sup>118</sup> The notice goes on to say that if the plan uses a variable interest rate, it “must prescribe the method” of computing “future interest credits in the calculation of [the] employee’s accrued benefit . . . preclud[ing] employer discretion.”<sup>119</sup> Treasury Regulations clarify that a right under the plan that is conditioned on a “subsequent event, subsequent performance, or subsequent forbearance”<sup>120</sup> that would cause the loss of that right is forfeitable at that time and that certain adjustments, “such as adjustments in excess of reasonable actuarial reductions,”<sup>121</sup> cause rights to be forfeitable. This means, according to Notice 96-8, that if future interest credits are calculated “using a rate that understates the [true] value of those credits,” or if the terms of the plan actually reduce the interest rate used to determine future interest credits, then an impermissible forfeiture has occurred.<sup>122</sup> By prescribing a rate that matched the PBGC discount rate, the Xerox plan effectively understated the true value of its future interest credits, presumably by \$300 million under the approach that the district judge chose and Posner approved.<sup>123</sup> Although the Xerox plan participants were offered the option of choosing a lump sum upon termination or a pension at normal retirement age, the lump sum is simply not the legally required “actuarial equivalent” of the pension because it excludes future interest credits. Because of this, the plan simply could not stand.

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114. *Berger*, 338 F.3d at 761.

115. 26 U.S.C. § 411(a)(2) (2002).

116. 26 C.F.R. § 1.411(a)-4T.

117. I.R.S. Notice 96-8, 1996-1 C.B. 359, 362. Cash Balance Plans may also be classified as backloaded, meaning that future interest credits are conditioned upon future service. However, as Notice 96-8 points out, most of these backloaded plans do not satisfy the accrual rules laid out in § 411(b)(1)(A), (B), or (C). *Id.* Determining whether those accruals have been satisfied is a topic beyond the scope of this Comment.

118. I.R.S. Notice 96-8, 1996-1 C.B. 359, 361.

119. *Id.*; 26 U.S.C. § 401(a)(25) (2002).

120. 26 C.F.R. § 1.411(a)-4T.

121. § 1.411(a)-4T.

122. I.R.S. Notice 96-8, 1996-1 C.B. 359, 361.

123. *See Berger*, 338 F.3d at 760-61.

Xerox tried to avoid the regulations of Notice 96-8 by claiming that their plan was not in fact a frontloaded cash balance plan, but was instead a hybrid cash balance plan.<sup>124</sup> Posner quickly dismissed this argument. He pointed to the fact that the only thing that makes this plan any different from an ordinary frontloaded cash balance pension plan is that the plan specifically states by its own terms that a lump sum distribution will not be the actuarial equivalent of the pension benefit to which the employee would be entitled if he remained in the company's employ or elected not to receive his distribution until normal retirement age.<sup>125</sup> Therefore, the supposedly hybrid nature of the plan actually makes it unlawful because this option conditions the receipt of future interest credits upon the form of distribution taken.<sup>126</sup> Remember, of course, that Treasury Regulations define a nonforfeitable accrued benefit to be an unconditional right, specifically a right that is not conditioned upon subsequent performance of any event.<sup>127</sup> Clearly, the Xerox plan's condition violated this regulation.

So, the Xerox Plan's attempt to equate lump sum distributions to the amount of the cash balance at the time of distribution resulted in a judgment in which it owed nearly 14,800 former employees whose employment terminated between 1990 and 2000 approximately \$256 million.<sup>128</sup> Posner's verdict was rendered on August 1, 2003, and the U.S. Supreme Court denied Xerox's application for a stay on October 7, indicating only a slight chance that the Court would hear the case on appeal.<sup>129</sup> Subsequently, on November 14, Xerox reportedly reached an agreement with the former plan participants to settle the case for \$239 million.<sup>130</sup> The proposed settlement was contingent upon court approval, and the amount was to be paid from the plan's assets.<sup>131</sup> If plan assets were insufficient to pay the full amount, the Xerox Corporation itself would have to contribute, but it would not have to do this until 2005.<sup>132</sup> Obviously, Xerox abandoned the idea of appeal and decided to settle "to avoid any further uncertainty or legal expenses' stemming from the dispute."<sup>133</sup> Finally, the Southern District of Illinois issued an order of final approval of the settlement on January 22, 2004.<sup>134</sup> The court noted that the "delay, potential adverse tax issues, and the small uncertainty of further litigation" supported the minimal reduction (only \$17 million) in

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124. *Id.* at 762-63.

125. *Id.*

126. *Id.* at 763.

127. 26 C.F.R. § 1.411(a)-4T.

128. See Ellen E. Schultz, *High Court Deals Setback to Xerox Over Pension Case*, WALL ST. J., Oct. 9, 2003, at A6.

129. *Id.*

130. Press Release, Xerox Corp., Xerox Announces Proposed Settlement for Pension Lawsuit, at <http://benefitslink.com/pr/detail.php?id=37550> (Nov. 17, 2003).

131. *Id.*

132. *Id.*

133. Janell Grenier, *Cash Balance Plan Settlement*, Benefitsblog, at <http://www.benefitscounsel.com/archives/000745.html> (Nov. 15, 2003) (quoting Christa Carone, spokeswoman for Xerox Corp.).

134. *Berger v. Xerox Corp.*, 2004 WL 287902, at \*2 (S.D. Ill. Jan. 22, 2004).

the amount to be paid by Xerox.<sup>135</sup> Obviously, Xerox felt it had fought this battle as hard and as long as it could and decided to cut its losses before they got any greater.

#### V. PROPOSED REGULATIONS ON CASH BALANCE PLANS

This has left many businesses in a dilemma. The Seventh Circuit is not the only U.S. Court of Appeals that has ruled against employers in the same position as Xerox. The Eleventh Circuit ruled against Georgia-Pacific Corporation in August 2000,<sup>136</sup> and the Second Circuit ruled against Bank of Boston just one month later, in September 2000.<sup>137</sup> The Supreme Court denied certiorari in both cases,<sup>138</sup> and by denying Xerox's request for a stay, the Court indicated in 2004 that it was still not willing to hear such a case. Further, the split among the federal courts as to whether cash balance plans violate age discrimination rules<sup>139</sup> adds to the questionable legality of these pension plans.

As a result, the advance of cash balance plans has slowed. In 1985, the percentage of firms that had cash balance plans or similar pensions in place was merely 1%.<sup>140</sup> By 1998, this figure had increased to 22%, and in 2000, 32% of firms had cash balance plans.<sup>141</sup> In 2002, however, the percentage only increased to 33%,<sup>142</sup> showing that the trend has certainly slowed. To further delay cash balance plan development, Congress voted to block proposed regulations issued by the Treasury in December 2002. The Treasury is widely considered to be pro-employer on matters regarding pensions, and these December regulations were designed to assure that cash balance plans would not be subject to age discrimination rules.<sup>143</sup>

There are new proposed regulations in the works today—regulations which seem to strike more of a balance between employee and employer interests. The Treasury Department released a legislative proposal on February 2, 2004, originating as part of the Bush 2005 budget bill and currently included as part of the 2006 budget bill. Following its release, the Treasury actually withdrew its 2002 regulations, allowing Congress to focus solely on this new proposal.<sup>144</sup> The proposal would amend current pension law to hold

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135. *Id.* at \*1.

136. *Lyons v. Georgia-Pacific Corp.*, 221 F.3d 1235 (11th Cir. 2000).

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

138. *Georgia-Pac. Corp. v. Lyons*, 532 U.S. 967 (2001); *Bank of Boston v. Esden*, 531 U.S. 1061 (2001).

139. See *Eaton v. Onan Corp.*, 117 F. Supp. 2d 812 (S.D. Ind. 2000) (holding that Onan's plan did not violate age discrimination provisions); *Cooper v. IBM Corp.*, 274 F. Supp. 2d 1010, 1010 (S.D. Ill. 2003) (holding that IBM's cash balance plan violated age discrimination provisions of ERISA).

140. Dugas, *supra* note 51.

141. *Id.*

142. *Id.*

143. Ellen E. Schultz and Theo Francis, *Amendment May Prevent Cash-Balance Regulations Proposed by the Treasury*, WALL ST. J., Sept. 10, 2003, at A3.

144. Press Release, Treasury and IRS Withdraw Proposed Cash Balance Regulations, June 15, 2004, available at <http://www.ustreas.gov/press/releases/js1724.htm>.

that cash balance plans are not inherently age discriminatory, but at the same time would contain regulations to protect older workers in cash balance conversions.<sup>145</sup> The proposal would also eliminate whipsaw, so that employers would be able to legally equate a lump sum distribution prior to normal retirement age with the cash balance in the account.<sup>146</sup>

First, in order to protect older workers when an employer converts to a cash balance plan from a traditional defined benefit pension, the Treasury Regulations would impose a “hold harmless” period of five years after the conversion takes place. This means that the cash balance plan would have to continue accruals under the old pension formula for at least five years and maintain this amount as a minimum benefit. Therefore, the benefits earned under the new plan would be guaranteed to be at least as valuable as the benefits that would have been earned under the old plan, thereby eliminating the wear away of any benefits.<sup>147</sup> This regulation would be enforced by a 100% excise tax on any shortfall of benefits provided by the new plan, but not to exceed the plan’s surplus assets or the plan sponsor’s taxable income.<sup>148</sup> This tax would not apply if the employer gave workers a choice between the cash balance plan and the old plan or if it grandfathered in current workers.<sup>149</sup>

Secondly, the regulations would specifically state that cash balance plans satisfy anti-age discrimination laws if they treat older workers as well as younger workers, removing the uncertainty concerning this subject in current pension law.<sup>150</sup> This would require the plan to contribute to older workers pay credits that are at least as large as credits contributed to younger workers, and that interest credits continue to preclude employer discretion.<sup>151</sup> Certain transition strategies used in conversions would also be declared not to violate age discrimination laws under the regulations.<sup>152</sup>

Lastly, under the proposed regulations, the whipsaw effect would be eliminated. With this, a cash balance plan would be able to pay out a departing employee’s account balance as a lump sum distribution if the employee demanded a distribution before normal retirement age. The regulations would qualify this elimination, however, by requiring that the plan not compute future interest credits at an above-market rate.<sup>153</sup> Because of the whipsaw issue and the federal rulings requiring plans to project the account balance forward at the interest rate provided by the plan and then discount at

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145. See Press Release, Preserving Cash Balance Plans for Workers: Treasury Proposes Legislation to Protect Defined Benefit Plans and Ensure Fair Treatment of Older Workers in Cash Balance Conversions, Feb. 2, 2004, [hereinafter Treasury Press Release], available at <http://www.ustreas.gov/press/releases/js1132.htm>.

146. *Id.*

147. *Id.*

148. *Id.*

149. *Id.*

150. *Id.*

151. *Id.*

152. *Id.*

153. *Id.*



the rate provided by the Internal Revenue Code<sup>154</sup> when computing a lump sum distribution, plans have simply equated their future interest credit rate with the rate specified by the Code. This has resulted in overall lower plan interest rates, with the Code-provided discount rate serving as a ceiling for future interest credit rates.<sup>155</sup> This ceiling effect will disappear with the elimination of whipsaw, so that not only will employers benefit, but employees may, as well, as their balances grow more quickly under higher rates. The proposal allows for safe harbors regarding the market rate of return, and “prescrib[ing] appropriate conditions regarding the calculation of plan distributions.”<sup>156</sup> Because “above market-level” is not defined in the regulations, it is not yet clear what type of rates and investment options will be allowed to determine future interest credits in new plans.

The Treasury clarifies and repeatedly emphasizes that the regulations would be effective only prospectively from the enactment of the proposal. The proposal even specifies that the legislative history of the regulations will state that there will be “no interference” with pre-existing cash balance plans already in place under current law.<sup>157</sup> Therefore, these regulations would provide no relief for cash balance plans that are already in existence, and such plans would likely still be subject to the rulings of the courts in *Berger v. Xerox Corp.*, *IBM Corp. v. Cooper*, and other cases. This means that existing plans would be left without the clarity that is so desperately needed from existing pension law, while new plans would be much more easily and confidently implemented.

While it seems that the Treasury will be forced to address pre-existing cash balance plans in the future, at least these proposed regulations would allow the cash balance plan pension to remain a viable option from which employers may choose. While many consultants and pension experts are hesitant about how the regulations will actually work,<sup>158</sup> at least the Treasury is now providing a “constructive and reasonable starting point.”<sup>159</sup>

## VI. CONCLUSION

Cash balance plans, no matter how controversial they are, have serious advantages to both employers and employees. For employees, not only are cash balance plans relatively easy to understand, they are also better suited to today’s mobile workforce. This is because cash balance plan benefits are very portable and can move with the employee from job to job, and also because the benefits of a cash balance plan accrue more evenly over the employee’s “life-cycle.”<sup>160</sup> Also, the risk of investment remains on the em-

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154. 26 U.S.C. § 417(e) (2002).

155. Treasury Press Release, *supra* note 145.

156. *Id.*

157. *Id.*

158. Allen B. Crenshaw, *Tax Cuts and Savings Plans*, WASH. POST, Feb. 3, 2004, at A5.

159. Dugas, *supra* note 51 (quoting J. Mark Iwry, former Treasury benefits tax counsel).

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

ployer, unlike a 401(k) defined contribution plan. This can be an advantage for the employer at the same time, as the employer is able to keep any investment surpluses the plan may earn.<sup>161</sup> The employer also benefits from the simplicity of the cash balance plan, because employees are easily able to appreciate the value of their benefits,<sup>162</sup> causing the cash balance plan to make the employer more attractive to prospective employees and more satisfactory to current employees.

Furthermore, and perhaps even more importantly, cash balance plans are a good compromise between a traditional pension and a defined contribution plan. The law certainly does not require employers to provide *any* type of pension plan to its employees, much less recommend any specific type of plan.<sup>163</sup> As the Baby Boomer generation ages and the cost of traditional pensions grows dramatically, employers are looking for alternatives. While defined contribution plans are one such option, there are still many advantages of defined benefit plans for not only employers, but employees as well. Cash balance plans provide employees with some of the best of both worlds. On the one hand, cash balance plans compute and state the employee's benefit in much the same way as a 401(k) defined contribution plan. On the other hand, the employee is guaranteed the amount in his account, which can never decrease and is insured by the federal Pension Benefit Guaranty Corporation.

For these reasons, it is important that the Treasury is taking steps to improve the future of cash balance plans and at least begin discussion of the issues. Most of the laws on defined benefit pensions were written between 1974 and 1984, before cash balance plans were developed and with only traditional defined benefit pensions in mind.<sup>164</sup> Now that cash balance plans are on the scene, the law should be reevaluated and even modified to account for such changes. With its proposed regulations, this is exactly what the Treasury hopes to do. By clarifying the status of cash balance plans, the regulations aim to protect the entire defined benefits system.<sup>165</sup> The Treasury also aims to protect older workers in cash balance conversions and to remove the effective cap on interest rates in cash balance plans.<sup>166</sup> These proposals indicate a step in the right direction. At least the Treasury is now willing to address the plans, and Congress is willing to listen. Hopefully these regulations indicate that the two forces who have the power to make or break the future of cash balance plans will soon be able to reach a compromise to keep the plans a viable and legal pension option.

*Angela Boothe Noel*

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161. *Id.*

162. *Id.*

163. *Cooper v. IBM Corp.*, 274 F. Supp. 2d 1010, 1022 (S.D. Ill. 2003).

164. *Eaton v. Onan Corp.*, 117 F. Supp. 2d 812, 817 (S.D. Ill. 2000); *Esden*, 229 F.3d at 159.

165. Treasury Press Release, *supra* note 145.

166. *Id.*