Cash Balance Pension Plans and Claims of Age Discrimination

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Summary

Both federal courts and Congress have recently addressed the issue of whether cash balance pension plans violate federal laws that prohibit age discrimination. The relevant age discrimination provisions are found in the Employee Retirement Income Security Act (ERISA), the Internal Revenue Code (IRC), and the Age Discrimination in Employment Act (ADEA). Two distinct claims have been made: (1) that cash balance plans inherently violate the age discrimination provisions because the rate of benefit accrual is decreased on account of age and (2) that the conversion of traditional defined benefit plans to cash balance plans violates the ADEA because of the negative impact on older workers.

While a majority of courts have held that cash balance plans violate the age discrimination provisions, some have found that the plans are not discriminatory or have dismissed the claims for procedural reasons. In a case that has received significant attention, *Cooper v. IBM Personal Pension Plan*, 457 F.3d 636 (7th Cir. 2006), the Seventh Circuit reversed one of the district courts and found that IBM's cash balance plan was non-discriminatory.

The Pension Protection Act of 2006 (P.L. 109-280) sets out new standards that a cash balance plan must meet in order to comply with the age discrimination provisions. These new standards apply only to periods beginning on or after June 29, 2005, and leave the age discrimination issue unsettled under prior law.

This report describes cash balance plans, discusses the claims that cash balance plans do and do not violate the pre-Act age discrimination provisions, and provides an overview of P.L. 109-280, as it applies to this issue.

Contents

Contacts

This report examines the issue of whether a type of defined benefit pension plan, the cash balance plan, violates federal laws that prohibit age discrimination. The discrimination provisions are found in the Employee Retirement Income Security Act (ERISA), the Internal Revenue Code (IRC), and the Age Discrimination in Employment Act (ADEA).[1] Although employer participation in the private pension system is voluntary, any offered plan must satisfy the legal requirements. The failure to do so may result in civil and criminal liability and the loss of favorable tax treatment for plan contributions and disbursements. Furthermore, ERISA and the ADEA create substantive rights for plan participants that they can seek to have judicially enforced.

This report briefly describes a typical cash balance plan and discusses the claims that such plans violate the federal laws that prohibit age discrimination, as existed prior to the Pension Protection Act of 2006. It concludes with a discussion of relevant provisions in the Act, which was signed into law on August 17, 2006. The Act's provisions apply only to periods beginning on or after June 29, 2005, and leave unsettled the law for earlier periods.

Types of Pension Plans

Defined Benefit and Defined Contribution Plans

There are two categories of pension plans under federal law: defined benefit plans and defined contribution plans. In a defined benefit plan, an employee is promised a specified future benefit, traditionally an annuity beginning at retirement. The amount of the annuity is generally determined by a formula that factors in the employee's years of employment and the average salary of the employee's highest salaried years. Other factors, such as age, may be included. To fund the plan, the employer makes contributions to the common pension fund that are actuarially expected to grow through investment to cover the promised benefits. The employer bears the risk that the investments will not provide adequate funds and is responsible for any shortfalls. If the plan is terminated, the benefits are insured (up to a certain limit) by the Pension Benefit Guaranty Corporation. An employee who terminates employment before retirement will generally receive any vested benefits as an annuity at normal retirement age.

In a defined contribution plan, the employee is promised that the employer will currently make a specified contribution to the employee's pension account. The contribution is commonly a percentage of the employee's salary. Due to the risk of investment, the value of the account at the time of retirement is unknown. The employee bears the investment risk, and the benefits are not insured by the Pension Benefit Guaranty Corporation. An employee who terminates employment before retirement may generally receive any vested benefits as a lump-sum payment at the time of termination.

In the past several decades, plans have been developed that modify the traditional defined benefit plan. These plans are referred to as *hybrid plans* because they are defined benefit plans that conceptualize the benefits in a manner similar to defined contribution plans. One type of hybrid plan is the cash balance plan.

[1] ERISA was enacted in 1974, P.L. 93-406, and is codified at 29 U.S.C. § 1001 *et seq*. The Internal Revenue Code is found in Title 26. The ADEA was enacted in 1968, P.L. 90-202, and is codified at 29 U.S.C. § 621 *et seq*.

Cash Balance Plans

Cash balance plans are defined benefit plans that look like defined contribution plans because the employee's promised future benefits are stated as the individual's account balance. The account is hypothetical (*i.e.*, each employee does not actually have an account) and is used to conceptualize the amount of benefits the employee has accrued. The account reflects employer contributions that are a percentage of annual compensation (called *pay credits*) and interest earned on those contributions (called *interest credits*). These interest credits typically continue even if the plan participant ceases employment. The interest rate may be fixed or tied to an index rate and is specified in the plan. The plan may use other factors in its benefit formula, such as age and length of service.

In a cash balance plan, the employer currently contributes to the general pension fund. The employer bears the risk that the fund's investments will provide the promised benefits. In the event of plan termination, the benefits are partially insured by the Pension Benefit Guaranty Corporation. An employee who terminates employment before retirement may generally receive the current value of any vested benefits as a lump-sum payment at the time of termination.

Plan Conversions

During the past two decades, numerous employers have either converted or considered converting their traditional defined benefit plans to cash balance plans. A conversion to a cash balance plan involves amending the original plan and is not treated as a plan termination.

Anti-cutback Rule

A conversion is subject to the rules that apply to any plan amendment. An important rule is that once a benefit is accrued, it may only be decreased in limited circumstances and with prior approval by the Treasury Secretary.[2] An amendment may not eliminate or reduce an early retirement subsidy with regard to service that has already been performed.[3]

Although a plan amendment may not decrease benefits that are already accrued, it may reduce future benefit accruals because these benefits have not yet been earned. Any amendment that significantly reduces the rate of future benefit accrual requires clearly written notice to affected participants.[4]

Claims of Age Discrimination

There have been claims that cash balance plans and/or the conversion to such plans violate the laws prohibiting age discrimination. The age discrimination provisions are found in ERISA, the IRC, and the ADEA, although plan participants are able to bring legal actions only under ERISA

[2] ERISA § 204(g)(1), 29 U.S.C. § 1054(g)(1); ERISA § 302(c)(8), 29 U.S.C. § 1082(c)(8); IRC § 411(d)(6); IRC § 412(c)(8).

[3] ERISA § 204(g)(2), 29 U.S.C. § 1054(g)(2); IRC § 411(d)(6).

[4] ERISA § 204(h)(1), 29 U.S.C. § 1054(h)(1).

and the ADEA. All three provisions were added by the Omnibus Budget Reconciliation Act of 1986 (OBRA).[5] Although the language differs slightly, they are intended to be interpreted in the same manner.[6] They are:

ERISA § 204(b)(1)(H) [29 U.S.C. § 1054(b)(1)(H)] and IRC § 411(b)(1)(H):

> [A] defined benefit plan shall be treated as not satisfying the requirements of this paragraph [relating to benefit accrual] if, under the plan, an employee's benefit accrual is ceased, or the rate of an employee's benefit accrual is reduced, because of the attainment of any age.

ADEA § 4(j)(1) [29 U.S.C. § 623(i)(1)]:

> [I]t shall be unlawful for an employer, an employment agency, a labor organization, or any combination thereof to establish or maintain an employee pension benefit plan which requires or permits-
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> (A) in the case of a defined benefit plan, the cessation of an employee's benefit accrual or the reduction of the rate of an employee's benefit accrual, because of age.

Two distinct claims have been made that cash balance plans or the conversions to such plans violate the law.[7] The first claim is that the plans violate the age discrimination provisions because the rate of an employee's benefit accrual is reduced on account of age. The second claim is that the conversions to the plans violate the ADEA because older workers are treated unfavorably compared with younger workers. The Pension Protection Act of 2006 (discussed below) has significantly affected these claims by adding new requirements that plans must meet to comply with the above statutes. The Act applies only to periods beginning on or after June 29, 2005. Because the majority of cash balance plans existed during periods prior to June 29, 2005, the pre-Act law continues to be relevant to the extent that the legal status of plans during these periods is uncertain. The uncertainty is due to two reasons. First, there is conflicting case law on whether plans violate the pre-Act age discrimination provisions. Second, in 1999, the IRS, responding to the growing controversy over cash balance plans, placed a moratorium on approving the plans.[8] In January 2007, the IRS lifted this moratorium but stated that it would not consider age discrimination issues on plan conversions occurring before June 29, 2005.[9]

The next sections discuss the basic age discrimination claims and how various courts have dealt with these claims. The final section of this report discusses the Pension Protection Act.

Violation of the Age Discrimination Provisions

The age discrimination provisions in ERISA, the IRC, and the ADEA prohibit an employee's rate of benefit accrual from being decreased on account of age. Prior to the Pension Protection Act,

[5] P.L. 99-509.

[6] H. Rep. 99-727 at 378-79; P.L. 99-509, § 9204(d).

[7] This report discusses whether cash balance plans or the conversions are inherently discriminatory. While not addressed, specific plan designs or conversions could violate the age discrimination rules for reasons unique to that plan or conversion. They could also violate other ERISA or IRC provisions, such as the anti-cutback rules.

[8] Approximately 1,200 determination letter applications have been subject to the moratorium. *See*, I.R.S. News Release IR-2006-193 (Dec. 21, 2006).

[9] I.R.S. Notice 2007-6, I.R.B. 2007-3 (Jan. 16, 2007).

two basic issues were raised with respect to these provisions: (1) whether the provisions applied to employees challenging the plans who were generally younger than normal retirement age and (2) how to interpret the phrase "rate of benefit accrual."

Application of the Age Discrimination Provisions

In general, the employees claiming age discrimination with respect to cash balance plans have been younger than normal retirement age. Some employers have argued that the age discrimination provisions do not apply to these employees because the legislative history shows that Congress only intended for the age discrimination provisions to require benefit accrual for employees who continued working past normal retirement age.[10] In response, employees have emphasized that the statutes' plain language is not limited to employees older than normal retirement age,[11] the ADEA applies to everyone who is at least 40,[12] and ERISA gives standing to any plan participant without reference to age.[13] Courts considering these claims have come to various conclusions.[14] The Pension Protection Act does not address this issue.

Rate of Benefit Accrual

The second issue with respect to the age discrimination provisions has been how to determine an employee's "rate of benefit accrual" under a cash balance plan. Those claiming discrimination have argued that the phrase is defined with reference to an annuity that begins at normal retirement age ("age 65 annuity"). The argument has been based on three ideas: cash balance plans are a type of defined benefit plan, the "accrued benefit" of a defined benefit plan is defined as being "in the form of an annual benefit commencing at normal retirement age,"[15] and an accrued benefit that is defined in a different form must be converted into such an annuity.[16] The claim has been that this framework requires the benefits in a cash balance plan, conceptualized as an account balance, be converted into an age 65 annuity in order to test for age discrimination. When the benefits are expressed as an age 65 annuity, the cash balance formula appears to violate the pre-Act age discrimination provisions because the rate of benefit accrual decreases as the employee's age increases. This is because of the interest credit and the effect of compounding interest—as an employee's age increases, the rate of benefit accrual decreases because the contributions made in each subsequent year have less time to earn interest, resulting in a decreasing impact on the amount of the age 65 annuity.

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[10] *See* H. Rep. 99-727 (OBRA conference report); 131 Cong. Rec. 18868 (July 11, 1985) (statement by Senator Grassley); 132 Cong. Rec. 32963 and 32975 (Oct. 17, 1986) (statements by Representatives Jeffords, Roukema, Clay, and Hawkins); heading to IRC § 411(b)(1)(H) which reads "Continued Accrual Beyond Normal Retirement Age."

[11] The Treasury Department adopted this view in its explanation of regulations that were proposed in 2002. *See* 67 Fed. Reg. 76123, 76124 (Dec. 11, 2002). These regulations have been withdrawn.

[12] ADEA § 12, 29 U.S.C. § 631.

[13] ERISA § 502, 29 U.S.C. § 1132.

[14] *See* Sunder v. U.S. Bank Pension Plan, 2007 U.S. Dist. LEXIS 11331 (D. Mo. 2007); Richards v. Fleetboston Fin. Corp., 427 F. Supp. 2d 150, 158-62 (D. Conn. 2006) (finding that the age discrimination provisions apply to employees under normal retirement age); *but see* Eaton v. Onan Corp., 117 F. Supp. 2d 812, 826-29 (S.D. Ind. 2000), and Tootle v. ARINC Inc., 222 F.R.D. 88, 93 (D. Md. 2004) (determining that the statute was intended to protect only workers who had reached the normal retirement age); *see also*, Campbell v. BankBoston, 327 F.3d 1, 10 (1st Cir. 2003) (stating in dicta that it was unclear whether the provisions applied to younger workers).

[15] ERISA § 3(23)(A), 29 U.S.C. § 1002(23)(A); IRC § 411(a)(7)(A)(i).

[16] *See* IRC § 411(c)(2)(B); 26 CFR § 1.411(a)-7(a)(1)(ii).

Those claiming the plans are not discriminatory have responded that there is nothing that requires an age 65 annuity be used to test for age discrimination because the phrase "rate of benefit accrual" is not defined in the statutes and the term "accrued benefit" has various usages in ERISA and the IRC. They have argued that instead of using an age 65 annuity, the rate should be tested using the amount that is in the employee's hypothetical account because that is how benefits are expressed in cash balance plans. Under this argument, the "rate of benefit accrual" refers to the rate at which the contributions are made to that account.[17] When the rate of benefit accrual is expressed in this manner, cash balance plans do not inherently violate the age discrimination provisions because the rate at which contributions are made to the account over the employee's years of service is generally constant or increases if the plan is weighted for age.

One case to examine this issue, *Cooper v. IBM Pers. Pension Plan*,[18] has received significant attention. In 2003, a U.S. district court held that IBM's cash balance plan violated ERISA § 204(b)(1)(H). The court began by noting that although ERISA did not explicitly address whether an age 65 annuity should be used to test cash balance plans for age discrimination, the term "accrued benefit" was expressed for defined benefit plans as an age 65 annuity under ERISA § 3(23).[19] The court concluded that because a cash balance plan was a type of defined benefit plan, an age 65 annuity must similarly be used to express its benefits.[20] The court noted that the terms "accrued benefit" in ERISA § 3(23) and "benefit accrual" in ERISA § 204(b)(1)(H) were not identical, but discounted its significance by finding the different terms merely reflected correct grammatical usage and pointing out that the term "accrued benefit" was used in the subsection immediately prior to ERISA § 204(b)(1)(H), which also dealt with age discrimination.[21] The court found that when the age 65 annuity was used to determine whether the rate of benefit accrual decreased on account of age, the plan violated ERISA because of the interest credit component.[22] This was because the continued crediting of interest made the expected benefit greater for younger employees than for older employees, because younger employees had more years in which to earn interest. Although the case dealt only with the IBM plan, the court's reasoning indicated that cash balance plans were inherently discriminatory.

In August 2006, the Seventh Circuit reversed and remanded the case. The court found that the fact that younger employees had more time to accrue interest on their account balances than older employees did not translate into age discrimination. In determining that IBM's cash balance plan was age-neutral, the court found that the terms "benefit accrual" and "accrued benefit" were not synonymous and that "rate of benefit accrual" did not have to be determined based on an age 65 annuity.[23] The rate of "benefit accrual," according to the court, refers to what the employer

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[17] This argument treats cash balance plans similar to defined contributions plans, which also express the benefits as an individual's account. ERISA § 3(23)(B), 29 U.S.C. § 1002(23)(B). Defined contribution plans do not violate the age discrimination provisions so long as "allocations to the employee's account are not ceased, and the rate at which amounts are allocated to the employee's account is not reduced, because of the attainment of any age." ERISA § 204(b)(2)(A), 29 U.S.C. § 1054(b)(2)(A); IRC § 411(b)(2)(A); ADEA § 4(j)(1)(B), 29 U.S.C. § 623(i)(1)(B).

[18] IBM Pers. Pension Plan v. Cooper, 457 F.3d 636 (7th Cir. 2006), *rev'ing* 274 F. Supp. 2d 1010 (S.D. Ill. 2003), *cert. denied*, 2007 U.S. LEXIS 1140 (U.S. Jan. 16, 2007).

[19] *See* IBM, 274 F. Supp. 2d. at 1016.

[20] *See id.* at 1021-22.

[21] *See id.* at 1016, 1021-22. ERISA § 204(b)(1)(G) reads, in part, "a defined benefit plan shall be treated as not satisfying the requirements ... if the participant's accrued benefit is reduced on account of any increase in his age or service."

[22] *See id.* at 1021-22.

[23] *See* IBM, 457 F.3d at 638-40.

contributes to an employee's account, whereas "accrued benefit" refers to the monetary gain between contribution and retirement.[24] The court also defended IBM's plan by comparing the age discrimination provisions for defined benefit and defined contribution plans.[25] Under the age discrimination provision for defined contribution plans, a continued crediting of interest would be acceptable. The court reasoned that because the IBM plan would have unquestionably met the requirements of the age discrimination provision for defined contribution plans, and because the structure and function of both age discrimination provisions were similar, the continued receipt of interest aspect of IBM's cash balance plan should not be considered discriminatory.[26] The court also rejected the plaintiff's proposition that IBM's plan was age discriminatory because employees received more favorable benefits under the prior plan.[27] The court explained that IBM was free to make this decision, provided it did not reduce an employee's vested interests.[28] In November 2006, the plaintiffs filed a petition for review with the Supreme Court, [29] but the Court denied the petition on January 16, 2007.[30]

A majority of courts, including the only other appellate courts to have considered this issue, reached a similar conclusion to the Seventh Circuit's decision in *Cooper* and have found that "rate of benefit accrual" is determined based on an employer's contributions to a plan, not a difference in an older employee's retirement benefit (*i.e.*, an age 65 annuity).[31] However, some district courts in the Second Circuit have disagreed.[32] For example, in *Citigroup Pension Plan*,[33] the court found that "rate of benefit accrual" depends on the amount of an employee's retirement benefit (an age 65 annuity) rather than the amount of an employer's contributions to an employee's hypothetical account. The court disagreed with *Cooper* and concluded that using the same methodology for finding age discrimination in defined benefit and defined contribution

[24] *See id.*

[25] *See* footnote 16 and supporting text.

[26] *See* IBM, 457 F.3d at 637-40.

[27] *See id.* at 642-43.

[28] *See id.*

[29] *Id., petition for cert. filed*, No. 06-760 (Nov. 28, 2006).

[30] Cooper v. IBM Pers. Pension Plan, 2007 U.S. LEXIS 1140 (U.S. Jan. 16, 2007).

[31] *See, e.g.*, Drutis v. Rand McNally & Co., 499 F.3d 608, 614 (6th Cir. 2007); Register v. PNC Fin. Servs. Group, Inc., 477 F.3d 56 (3d Cir. 2007); Custer v. S. New Eng. Tel. Co., 2008 U.S. Dist. LEXIS 5067 (D. Conn. Jan. 24, 2008); Bryerton v. Verizon Communs. Inc., 2007 U.S. Dist. LEXIS 29488 (S.D.N.Y. 2007)(appeal pending); Walker v. Monsanto Co. Pension Plan, 2007 U.S. Dist. LEXIS 67704 (D. Ill. 2007); Tomlinson v. El Paso Corp., 2007 U.S. Dist. LEXIS 20766 (D. Colo. 2007); Buus v. WaMu Pension Plan, 2007 U.S. Dist. LEXIS 95729 (D. Wash. 2007); Hirt v. Equitable Ret. Plan, 2006 U.S. Dist. LEXIS 49145, *102-108 (S.D.N.Y. 2006)(appeal pending), No. 06 Civ. 4757 (filed Oct. 13, 2006); Tootle v. ARINC Inc., 222 F.R.D. 88, 93-94 (D. Md. 2004); Eaton v. Onan Corp., 117 F. Supp. 2d 812, 829-34 (S.D. Ind. 2000); *see also*, Campbell v. BankBoston, 327 F.3d 1, 10 (1st Cir. 2003) (where the court mentioned it was unclear how to determine the rate of benefit accrual).

[32] *See, e.g.*, Richards v. Fleetboston Fin. Corp., 427 F. Supp.2d 150, 163-67 (D. Conn. 2006), (court held that "rate of benefit accrual" was measured in terms of an age 65 annuity and explained its conclusion as a consequence of prior precedent in the Second Circuit requiring the treatment of cash balance plans as defined benefit plans and the plain statutory language of ERISA § 204(b)(1)(H)); In re J.P. Morgan Chase Cash Balance Litigation, 460 F. Supp. 2d 479 (S.D.N.Y. 2006)(court rejects reasoning in Cooper, indicates that the Seventh Circuit improperly treated cash balance plans as defined contribution plans); Parsons v. AT&T Pension Ben. Plan, 2006 U.S. Dist. LEXIS 93135 (D. Conn. 2006)(court states that term "rate of benefit accrual," as used in § 204(b)(1)(H)(i) refers to rate measured as a change in the annual benefit beginning at normal retirement age and that the term is "unambiguous" in this respect); *see also*, In re Citigroup Pension Plan ERISA Litig., 2006 U.S. Dist. LEXIS 89565 (Dec. 12, 2006), later proceeding, 2007 U.S. Dist. LEXIS 86145 (D.N.Y. 2007).

[33] *In re* Citigroup Pension Plan ERISA Litig., 2006 U.S. Dist. LEXIS 89565 (Dec. 12, 2006).

plans "ignored the plain language" of the age discrimination provisions, as well as the "critical distinctions" between the types of pension plans. The court went on to state that:

> If Congress had intended for "the rate of an employee's benefit accrual" to mean "the rate at which amounts are allocated to the employee's account," it would have copied those terms from the analogous provision [for defined contribution plans].[34]

Currently in the Second Circuit, appeals are pending in two cases, both of which found that cash balance plans are not age discriminatory.[35] If Second Circuit Court of Appeals affirms these decisions, critics have suggested that this may be the "nail in the coffin" for these types of age discrimination claims.[36] On the other hand, if the appellate court finds that these plans are age discriminatory, then this split in the circuits may entice the Supreme Court to take up the issue, something it declined to do in the *Cooper* case.[37]

Claims that Conversions Violate the ADEA

Courts also have examined whether conversions to cash balance plans violate the ADEA under two additional discrimination theories: disparate treatment and disparate impact. A disparate treatment claim requires an employee to show that the employer intentionally discriminated against the employee on the basis of age. With a disparate impact claim, an employee must show that the employer's actions, while neutral on their face, actually had a disproportionate adverse impact on older workers. Here, the argument is that, compared with younger workers, older workers fare poorly when plans convert to cash balance plans. Disparate impact claims arise more often because of the difficulty of proving intentional discrimination by the employer in the adoption of or conversion to a cash balance plan. Although the recently passed Pension Protection Act of 2006 may preclude some future disparate treatment or disparate impact claims, some have argued that some claims may still be available.[38]

Disparate Treatment Claims

Proponents of the discrimination claims argue that a conversion to a cash balance plan that the employer knows will treat older workers less favorably than younger workers is evidence of intentional discrimination. Opponents respond that the fact employers may know that older employees will be treated less favorably under the cash balance plan is not evidence of individualized discrimination.[39] Further, opponents note that employers may refute the claim by

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[34] *Id*. at *48. It is important to note that following this decision, the court has reserved its ruling on a remedy in light of the pending appellate court decision in the Second Circuit. *See* In re Citigroup Pension Plan ERISA Litig., 2007 U.S. Dist. LEXIS 86145 (D.N.Y. 2007).

[35] Hirt v. Equitable Ret. Plan, 2006 U.S. Dist. LEXIS 49145, *102-108 (S.D.N.Y. 2006) appeal pending, No. 06 Civ. 4757 (filed Oct. 13, 2006); Bryerton v. Verizon Communs. Inc., 2007 U.S. Dist. LEXIS 29488 (S.D.N.Y. 2007)(appeal pending).

[36] Meredith Z. Maresca, *Undisclosed Fees and Employer Stock Drops Top 2007 ERISA Legal Cases*, Pension & Benefits Daily, Vol. 8, Num. 6 (Jan. 10, 2008).

[37] See Alvin D. Lurie, *Cash Balance Decisions Busting Out All Over*, Business Entities, Vol. 9, Iss. 6, Nov/Dec 2007.

[38] Fawn Johnson, *Pension Protection Act and Reversed Court Ruling Dooms Age-Related Suits, Practitioners Say*, Pension & Benefits Daily, Vol. 6, Num. 166 (Aug. 29, 2006).

[39] *See* Goldman v. First Nat'l. Bank of Boston, 985 F.2d 1113, 1119-20 (1st Cir. 1993) (holding that no inference of age bias exists based on an employer's decision to convert to a cash-balance pension plan).

showing there was a reasonable basis for the conversion other than age and that there are numerous reasons for an employer to convert to a cash balance plan, including attractiveness to employees and decreased costs of administering the plan.[40]

Disparate Impact Claims

Proponents of the discrimination claims under a disparate impact theory argue that although the conversion to a cash balance plan may be a facially neutral decision, it has a disproportionate adverse impact on older workers.[41] There are two primary claims that may be made. The first is that older employees lose the expected benefits of the traditional plan without gaining the benefits from the new cash balance plan. The formula under a traditional defined benefit plan is weighted towards longer-serving employees so that employees accrue significant benefits in their later years of employment. Thus, older employees may have worked for years under the traditional plan with the expectation that they would accrue significant benefits in their final years. However, because benefits under a cash balance plan are accrued at a more constant rate over the employee's years of service, these employees lose the opportunity for the increased accrual. At the same time, because the older workers are near retirement, they are unable to take advantage of the compounding interest feature of the cash balance plan.[42]

The second argument concerns the issue of "wear-away," which proponents of the discrimination claims argue disproportionately affects older workers. Wear-away occurs when the value of the employee's accrued benefits under the traditional plan exceeds the starting balance of the hypothetical account, which is provided in the terms of the plan conversion.[43] The employee is guaranteed the benefits that he or she accrued under the old plan. The employee will not accrue any additional benefits until he or she earns enough benefits under the cash balance plan so that the value of the hypothetical account exceeds the value of the benefits earned under the traditional plan. Thus, the level of the employee's benefits is basically frozen until that point is reached. Proponents argue that this wear-away hits older employees the hardest because they are more likely to have high starting balances. The Pension Protection Act of 2006 contains a provision to eliminate wear-away. However, the provision applies only to plan conversions occurring after June 29, 2005. Plans converted prior to this date may still be subject to wear-away claims.

Two main arguments have been made against disparate impact claims under the ADEA, both in general and in the context of cash balance plans. First, opponents have argued that in individual

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[40] *See* Hazen Paper Co. v. Biggins, 507 U.S. 604, 610-11 (1993) ("In a disparate treatment case, liability depends on whether the protected trait (under the ADEA, age) actually motivated the employer's decision .... Whatever the employer's decision making process, a disparate treatment claim cannot succeed unless the employee's protected trait actually played a role in that process and had a determinative influence on the outcome....").

[41] *See, e.g.*, Godinez v. CBS, 81 Fed. Appx. 949 (9th Cir. 2003) (where employees claimed that a cash balance conversion had a disparate impact on older employees under the ADEA. The U.S. District Court for the Central District of California found that the plaintiffs had not provided evidence to show the plan's negative impact on older employees or statistical evidence to show that any negative impact was due to the employee's age).

[42] The plaintiff made a similar argument in *Campbell v. Bankboston*, 206 F. Supp 2d 70 (D. Mass. 2002), *aff'd*, Campbell v. Bankboston, 327 F.3d 1 (1st Cir. 2003). While the court did not consider the plaintiff's ADEA claim on the merits, the court mentioned that a disparate impact claim would not be permissible based solely on the fact that older workers would have less time to accrue interest on their retirement accounts than younger workers.

[43] For additional information on wear-away, see CRS Report RS22214, *Cash Balance Pension Plans: Selected Legal Issues*, by Jennifer Staman and Erika Lunder.

cases, plaintiffs had failed to exhaust the administrative remedies, specifically, by failing to file a timely complaint with the Equal Employment Opportunity Commission (EEOC).[44] Second, opponents have argued that the claims should be dismissed because under the ADEA it is not illegal for an employer "to take any action otherwise prohibited ... where the differentiation is based on reasonable factors other than age...."[45] In other words, the argument is that disparate impact claims cannot be brought under the ADEA.[46] This argument was supported by the fact that, in cases not dealing with cash balance plans, the majority of the federal circuits that considered the issue had not recognized disparate impact claims under the ADEA.[47]

The argument that disparate impact claims against cash balance plans should be dismissed (because such claims are not recognized under the ADEA) has been successful. However, there has been a major change in the law. In 2005, the Supreme Court held that disparate impact claims are allowed under the ADEA.[48] In *Smith v. City of Jackson*, the Court found that a salary plan that provided proportionately higher raises for employees with less work experience (who were typically younger in age) than for more experienced employees did not violate the ADEA. Although the Court found that the ADEA claim failed in this instance, the Court made clear that plaintiffs are not barred under the ADEA from bringing claims under a disparate impact theory of liability.

Pension Protection Act of 2006

P.L. 109-280

On August 17, 2006, President Bush signed into law the Pension Protection Act of 2006 (P.L. 109-280).[49] The Act clarifies, among other things, the legality of cash balance plans if a plan meets certain requirements. In regard to the age discrimination provisions, the Act amends ERISA, the IRC, and the ADEA and provides standards under which a cash balance plan will be inherently non-discriminatory.[50] These standards concern (1) the rate of benefit accrual, (2) the amount of interest credits, and (3) conversions to cash balance plans.[51] The IRS has recently issued proposed regulations that provide guidance as to how these standards are to be implemented.

The Act amends the benefit accrual requirements of ERISA, the IRC, and the ADEA. Under the Act, a plan is not considered age discriminatory if a participant's entire accrued benefit, as determined under the plan's formula, is at least equal to that of any similarly situated, younger

[44] *See, e.g.*, Campbell, 206 F. Supp. at 78. In *Campbell*, the court found the plaintiff's claim procedurally defective because, among other things, the plaintiff failed to file the claim with the EEOC before initiating the lawsuit.

[45] ADEA § 4(f), 29 U.S.C. § 623(f).

[46] *See, e.g.*, Campbell, 206 F. Supp. at 78; Eaton, 117 F. Supp. at 837.

[47] Disparate impact claims under the ADEA were not recognized in the First, Third, Sixth, Seventh, and Eleventh Circuits, but had been recognized in the Second, Eighth, and Ninth Circuits. *See* Smith v. City of Jackson, 544 U.S. 228, n.9 (2005).

[48] Smith v. City of Jackson, 544 U.S. 228 (2005).

[49] For a general description of the Act, see CRS Report RL33703, *Summary of the Pension Protection Act of 2006*, by Patrick Purcell.

[50] ERISA § 204(b)(5), 29 U.S.C. 1054(b)(5); IRC § 411(b)(5); ADEA Section 4(i)(10), 29 U.S.C. 623(i)(10).

[51] *See* 72 Fed. Reg. 73680 (Dec. 28, 2007).

individual.[52] "Similarly situated" is defined as an individual who is identical to the participant in every respect (except age), including length of service, compensation, position, and work history. The Act provides that benefits may be expressed in the form of an annuity payable at normal retirement age, a hypothetical account balance, or the current value of the accumulated percentage of the employee's final average compensation. Also, in determining a plan participant's accrued benefit, any subsidized portion of an early retirement benefit or retirement type subsidy is disregarded.

The Act also creates new rules for "applicable defined benefit plans," which include cash balance plans. Under the new rules, a cash balance plan will violate the age discrimination provisions of ERISA, the IRC, and the ADEA unless it meets an interest credit requirement.[53] A plan satisfies the interest requirement if the terms of the plan provide that any interest credit (or equivalent amount) for a plan year is at a rate that is not more than the market rate of return, and not less than zero. The Secretary of the Treasury is expected to provide guidance as to the calculation of the market rate, as well as permissible methods for crediting interest to a participant's account (*e.g.*, fixed or variable interest rates).[54]

The Act includes new requirements for plan conversions.[55] If a defined benefit plan is converted into a cash balance plan after June 29, 2005, the plan will not satisfy the age discrimination provisions unless each participant receives the sum of (1) the pre-conversion accrued benefit determined under the prior plan formula plus (2) the post-conversion accrued benefit determined under the cash balance plan formula. A newly converted plan must also credit a participant with the amount of any early retirement benefits or retirement-type subsidies if the participant has met the requirements for the benefit or subsidy under the prior plan.

The Act also makes clear that certain circumstances do not violate the age discrimination provisions. Under the Act, a plan will be considered non-discriminatory if the plan allows for certain offsets of benefits to the extent the offsets comply with ERISA, the IRC, and the ADEA.[56] A plan will also be treated as non-discriminatory if a disparity in plan contributions or benefits exists, so long as the disparity is in accordance with the IRC. Finally, the Act states a plan would still comply with the age discrimination standard even if it allowed for pre-retirement indexing of accrued benefits (pre-retirement indexing provides for adjustments in accrued benefit based on a recognized investment index or methodology). If a plan provides for indexing of accrued benefits, an employee's benefit amount may be protected from being devalued due to inflation.

In general, the new provisions regarding cash balance plans are effective for periods beginning on or after June 29, 2005. For plans in existence on this date, the new interest credit requirements

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[52] ERISA § 204(b)(5)(A), 29 U.S.C. 1054(b)(5)(A); IRC § 411(b)(5)(A); ADEA § 4(i)(10)(A), 29 U.S.C. 623(i)(10)(A).

[53] ERISA § 204(b)(5)(B)(i), 29 U.S.C. 1054(b)(5)(B)(i); IRC § 411(b)(5)(B)(i); ADEA § 4(i)(10)(B)(i), 29 U.S.C. 623(i)(10)(B)(i).

[54] I.R.S. Notice 2007-6, I.R.B. 2007-3 (Jan. 16, 2007). *See also* Joint Comm. on Taxation, 109th Cong, 2d Sess. Technical Explanation of H.R. 4, The 'Pension Protection Act of 2006,' as Passed in the House on July 28, 2006 and as Considered by the Senate on August 3, 2006, JCX-38-06, 155 (Comm. Print 2006).

[55] ERISA § 204(b)(5)(B)(ii), 29 U.S.C. 1054(b)(5)(B)(ii); IRC § 411(b)(5)(B)(ii); ADEA § 4(i)(10)(B)(ii), 29 U.S.C. 623(i)(10)(B)(ii).

[56] Joint Comm. on Taxation, 109th Cong, 2d Sess. Technical Explanation of H.R. 4, The 'Pension Protection Act of 2006,' as Passed in the House on July 28, 2006 and as Considered by the Senate on August 3, 2006, JCX-38-06, 155 (Comm. Print 2006).

apply to years beginning after December 31, 2007. The provision relating to plan conversions applies to conversions adopted after June 29, 2005. The Act expressly provides that nothing in it should imply that cash balance plans were age discriminatory prior to the Act's effective dates.[57] Thus, for periods not covered by the Act, the issue of whether cash balance plans are age discriminatory still remains and continues to be evaluated by the courts.

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[57] P.L. 109-280, § 701(d).