Cash Balance Plans: Are Wear-Away Transitions Legal under the ADEA?

We last discussed in this space what we see as the strange politics of cash balance plans ("PensionCabal.com—Ruminations on the Cash Balance Crisis," 12 *Benefits Law Journal* 4, Winter 1999). We here return to cash balance plans, but this time to address one of their knottier technical issues: Are "wear-away" transition formulas legal under the Age Discrimination in Employment Act (ADEA)?

Many commentaries have argued persuasively that wear-aways are legal under Section 4(a) of the ADEA, under the Supreme Court's ADEA decision in *Hazen Paper Co. v. Biggins,* 507 U.S. 604 (1993). We here suggest a different line of argument, under a little-discussed aspect of another Supreme Court case, *Lockheed Corp. v. Spink,* 517 U.S. 882 (1996), as well as the Seventh Circuit's decision in *Lunn v. Montgomery Ward,* 166 F.3d 880 (7th Cir. 1999).

Background

Cash balance transition issues arise when an employer converts a traditional defined benefit pension plan formula, such as a final-average-pay formula, to a cash balance formula. At the time of the transition, participants have typically earned some benefit under the old formula, which by law cannot be eliminated or reduced. (Code §411(d)(65); ERISA §204(g).) With this constraint in mind, employers have used a variety of transition formulas to bridge between old and new benefits. Under the wear-away approach, each participant's benefit under the (new) cash balance formula is offset by his or her frozen benefit under the old plan formula. From the participant's point of view the *net* effect is benefit growth of zero until the new benefit "catches up" with the old benefit. The period of zero net growth during the catch-up period gives "wear-away" its name.

The following simplified example shows why wear-away raises an issue under the ADEA. Consider two employees, O and Y, ages 50

and 40 respectively. Except for age, O and Y are identical for plan purposes: Each has the same number of years of service (10); pay ($50,000); and rate of salary growth (3 percent per year). Each has earned the same benefit under the plan's old, final-average-pay formula: a life annuity commencing at age 65 of $10,000 per year.

The employer in this example amends the plan by replacing the old formula with a cash balance formula, in which each participant has a notional "account balance," funded by a contribution of 5 percent per year, plus earnings credited at 6 percent per year. To keep things simple, we assume that 6 percent is also the "applicable interest rate" under Section 417(e) of the Code. (Each "account balance" is of course maintained only on paper as a way of expressing the plan formula. A cash balance plan is a defined benefit plan under Section 414(j) of the Code. Participants' benefits are thus earned without individual accounts and without respect to the actual investment experience of the plan's assets.)

The employer in our example designs a wear-away transition as follows: Each participant's already-earned age-65 annuity under the old formula is converted to its lump-sum equivalent. The amount of this lump sum is the participant's starting "account balance" under the new formula. Assuming a 6 percent interest rate, and an annuity factor of 8 for the age-65 annuity, this means that Employee O (age 50) has a starting account balance of $33,381, and Employee Y (age 40), a starting account balance of $18,640. Y's starting account balance is smaller than O's because of the time value of money. That is, it takes a smaller starting account balance for Y than for O to reach the same age-65 annuity of $10,000, because Y's account balance has a longer time to grow (25 years) than does O's (15 years).

Each O's and Y's account balance under the new formula is offset by his or her starting account balance. The net benefit growth of each is zero until the new account balance equals the old. But as we have seen, O's starting account balance is larger than Y's because O is older than Y. The account balance of each under the *new* formula grows at identical rates in identical amounts, so O's new account balance will take longer to catch up than Y's new account balance. Under the assumptions of this example, Y's account balance under the new formula will reach the amount of her starting account balance ($18,640) after 5 years (at age 45). By contrast, Employee O's account balance under the new formula will not reach his starting account balance ($33,381) until sometime after 8 years (age 58).Y has net benefit growth of zero for 5 years, Employee O, for 8 years.

Recall that Y and O are identical except for age. Under one school of thought, it is thus asserted that O earns zero net accruals for a longer period than does Y *only* because O is older than Y.

For this reason, wear-aways arguably raise two issues under the ADEA. First, some have charged that cash balance wear-aways violate the requirement of Section 4(i) of the ADEA that the rate of benefit accrual may not be reduced, nor the benefit accrual ceased, because of age. Under this argument, wear-aways would also appear to violate the substantially identical rules enacted under Section 411(b)(1)H) of the Code and Section 204(b)(1)(H) of ERISA. Second, some have argued that cash balance wear-aways violate the basic prohibition under Section 4(a) of the ADEA against age discrimination with respect to an employee's "compensation, terms, conditions or privileges of employment."

We first address the rate-of-benefit-accrual rule under Sections 4(i) of the ADEA, 411(b)(1)(H) of the Code, and 204(b)(1)(H) of ERISA.

Offset by External Factors Is Not a Reduction in the Rate of Benefit Accrual or a Cessation of Accrual

Is a wear-away transition a prohibited reduction in the rate of benefit accrual, or cessation of benefit accruals because of age under the rate-of-benefit-accrual rule?

For policy reasons, the answer should be no. Under ERISA, employees are not entitled to benefits generally, are not entitled to benefits under a defined benefit formula, and are not entitled to benefit increases on top of the accrued benefit.

Legislative history does not indicate whether transition formulas on top of otherwise permitted formulas fall under the prohibitions of the rate-of-benefit-accrual rule. Proposed Treasury regulations under Section 411(b)(1)(H) of the Code are silent on this question, as are proposed EEOC regulations under Section 4(i) of the ADEA.

In the absence of other guidance, as a legal matter we believe the question has been settled by the Supreme Court's decision in *Spink,* as well as the Seventh Circuit's decision in *Lunn*. These cases affirm unambiguously that wear-away formulas are legal under the rate-of-benefit-accrual rule.

The relevant issue in both *Spink* and *Lunn* was decided under Section 411(b)1)(H) of the Code. But in enacting the rate-of-benefit-accrual rule, Congress expressed its intent that the rule as expressed

in the Code, the ADEA, and ERISA, have the same meaning in all three statutes. (H. Conf. Rep. No. 112, 99th Cong. 2d Sess. 378-9 (1986).) Congress further directed the three responsible agencies—the Departments of Labor and Treasury, and the Equal Employment Opportunity Commission—to promulgate consistent regulations with respect to the rule under all three statutes. (Id. at 382; see also statement of Congressman Jeffords, 132 Cong. Rec. H. 11437 (Oct. 17, 1986).) The cases therefore apply equally to Section 4(i) of the ADEA, 204(b)(1)(H) of ERISA, and 411(b)(1)(H) of the Code.

Lockheed Corp. v. Spink

Paul Spink was initially excluded from participation in his employer's defined benefit plan because of his age (61) at date of hire. Following enactment of the Omnibus Budget Reconciliation Act of 1986 (OBRA 1986), which outlawed this practice, Mr. Spink was allowed to participate in December 1988, the effective date of the new law, but was not credited with the eight or so years of service between his dates of hire and participation. As a result of the years in which he accrued no benefit under the plan, his total accrued benefit was lower than it otherwise would have been.

Among other things, the Court held that retroactive participation was not required by OBRA 1986. But the Court also had a second, alternative holding. The Court expressly considered whether Mr. Spink's exclusion resulted in a prohibited reduction in his rate of benefit accrual under Section 411(b)(1)(H). The Court held that no such reduction resulted:

> A reduction in total benefits due is not the same thing as a reduction in the rate of benefit accrual; the former is the *final outcome of the calculation*, whereas the latter is one of the factors in the equation.

The *Spink* holding applies directly to the wear-away formula considered here. Recall that Employee O has a rate of accrual under the new cash balance formula equal to 5 percent of pay per year, plus credited earnings of 6 percent. His net benefit accrual under the new formula after eight years is zero, not because of the formula itself, but because of an external factor—offset by his old benefit. His zero benefit under the new formula after eight years is the "final outcome of the calculation." But his actual rate of accrual—one of the "factors in the equation"—is the same for O as for Y or any other plan participant. Under *Spink*, there is no violation of Section 411(b)(1)(H).

Lunn v. Montgomery Ward

The issue was settled by *Spink*, but we believe there is some additional illuminating reasoning by the Seventh Circuit in *Lunn*. While the facts are different, *Lunn* reaches the same basic conclusion as *Spink*: The offset of a permitted accrual by something external to the accrual formula is not a prohibited reduction or cessation of benefit accruals under the rate-of-benefit-accrual rule.

The plan at issue in *Lunn* was a floor-offset arrangement. That is, the benefit under the defined benefit plan was offset by that under the defined contribution plan. Normal retirement age under the plan was 65, but under the defined benefit piece the annual benefit accrued for each year of service after age 65 at the same rate as before age 65. Thus, for service after age 65, Mr. Lunn's annual defined benefit continued to accrue, as before, at 1.5 percent of pay per year.

Mr. Lunn's complaint was with the offset formula. For any participant, the annual benefit under the defined benefit plan was offset by the *annuitized value* of the account balance in the defined contribution. As a result, for two participants who continued working after age 65, with the same pay and years of service, the offset was greater for the older than the younger, *solely* because of age. The reason is this: after age 65, the same account balance yields a larger annuity for an older employee than for a younger employee. This is because of the lower life expectancy for the older employee—fewer expected years of payout, larger payout amounts.

Notice that this arrangement is the mirror image of a cash balance plan offset. In the *Lunn* plan, increments in the defined benefit plan annuity were offset by increments in the annuitized value of the defined contribution plan account balance. In a cash balance offset, increments in the annual "contribution" towards the employee's "account balance" are offset by the lump sum value of the age-65 annuity. In both, the offset is larger for an older employee than a younger employee, all else being equal, solely because of age.

Mr. Lunn challenged the offset formula arguing, among other things, that it resulted in a reduced rate of accrual because of age, and was prohibited under ERISA Section 204(b)(1)(H).

The Seventh Circuit (per Judge Posner) disagreed. The court had two reasons. First, the court cited the Supreme Court's opinion in *Alessi v. Raybestos Manhatten, Inc.*, 451 U.S. 504 (1981). In *Alessi* the Court held that ERISA's vesting rules are not violated because of integration with workers' compensation benefits, and in dictum stated

the same principle for integration with Social Security and other types of benefits. The court reasoned that under *Alessi*, offsets are permitted even if the reduction is correlated with age.

The *Lunn* court had a second, policy-based reason. The court noted that under the plaintiff's argument, the defined benefit plan would confer "windfalls on employees who work beyond the normal retirement age." This is because for any two workers of equal pay and service, the older would have a smaller offset and a total larger benefit. Yet, argued the court, "from the Company's standpoint, the workers are identical and have been treated identically. They differ only in age, which is irrelevant to the company; the second worker is asking the company to give him an extra benefit solely on account of his age."

Looking at the rate-of-benefit-accrual issue specifically, the court noted that it was indeed illegal to cut the normal retirement benefit for an employee who continues to work past age 65. But the plan did not cut benefits. Rather, Mr. Lunn continued "accruing benefits in exactly the same way he had been doing before he turned age 65, until he retired." There was no violation of the rate-of-benefit-accrual rule, because his rate of accrual remained the same: "He was treated the same as all other workers. . . ."

The court further observed that ERISA Section 204(b)(1)(H) does not compel undertaking *greater* costs on behalf of employees on the basis of age: "Reverse age discrimination is not the theory of ERISA."

The technical and policy reasoning of *Lunn* applies to a cash balance wear-away. As a technical matter, under *Lunn* the offset does not affect the "rate of benefit accrual." The court held that Mr. Lunn's rate of accrual for Section 204(b)(1)(H) remained the same after age 65 as before, and that he was treated "the same" as other participants.

The policy reasoning of *Lunn* applies as well. ERISA does not compel the employer to provide more expensive benefits to older employees than younger. If an employer initially set out to provide more expensive benefits for older employees, by establishing a final-average-pay defined benefit plan, *Lunn* argues that these employees are not thereby entitled to such expensive benefits in perpetuity merely because of Section 411(b)(1)(H).

In short, employees are protected in what they have already earned under Sections 411(d)(6) of the Code and 204(g) of ERISA. Under *Lunn*, they are not entitled to more than this under Section 411(b)(1)(H) of the Code or 204(b)(1)(H) of ERISA.

Wear-Aways Meet ADEA Section 4(a) Because They Meet ADEA Section 4(i)

We have so far addressed wear-aways exclusively as a rate-of-benefit-accrual issue under Section 4(i) of the ADEA and the mirror sections of the Code and ERISA. Do wear-aways also implicate the basic prohibition against age discrimination under Section 4(a) of the ADEA?

We believe the answer is no. Many commentaries have argued persuasively that wear-aways do not violate Section 4(a) of the ADEA. Specifically, they have argued that wear-aways do not violate the ADEA's prohibition against disparate treatment on the basis of age, as set forth in *Hazen Paper Co. v. Biggins,* 507 U.S. 604 (1993).

While finding these arguments compelling, we wonder whether the issue might not be more easily addressed under Section 4(i) of the ADEA and the *Lunn* and *Spink* arguments set forth above.

The issue raised by a wear-away formula is the overall rate at which participants accrue benefit under the plan. Wear-away thus implicates Section 4(i) of the ADEA. As we argued above, wear-away satisfies Section 4(i) of the ADEA. This means that wear-away satisfies Section 4(a) of the ADEA as well. This is because in enacting Section 4(i), Congress intended that it be the exclusive ADEA rule applicable to benefit accruals.

This intent is stated in the statute, at Section 4(i)(4) of the ADEA, which states "compliance with the requirements of this subsection with respect to an employee pension benefit plan shall constitute compliance with the requirements of this section relating to benefit accrual under such plan." Legislative history to the enacting statute clarifies the intent of Congress that satisfaction of Section 4(i) constitutes satisfaction of Section 4(a). Specifically, the report of the conference committee states that the ADEA Section 4(i) rules "related to an employee's right to benefit accruals with respect to an employee benefit plan...shall constitute the entire extent to which ADEA affects such benefit accrual and contributions matters on or after the effective date." (1986 Conference Report at 382.) In short, wear-away satisfies the requirements of Section 4(i) of the ADEA and so satisfies the ADEA generally.

Conclusion

We have shown that a typical cash balance wear-away formula satisfies the rate-of-benefit-accrual rule of Section 4(i) of the ADEA,

as well as the nearly identical rules of Sections 411(b)(1)H) of the Code and 204(b)(1)(H) of ERISA. We reached this conclusion under the law and policy of *Spink* and *Lunn*, which hold that offset of an accrual formula by factors exogenous to the formula is not a prohibited reduction in the rate of benefit accrual. We have also suggested that these arguments under ADEA Section 4(i) may be a strong first line of defense to a claim against a wear-away transition made under ADEA Section 4(a).

Employers seeking to defend a wear-away transition of course have other arguments under both Sections 4(i) and 4(a) of the ADEA. We have here explored *Spink* and *Lunn* only because we have seen these cases discussed less than employers' other available defenses. For example, and as already noted, many commentaries have presented compelling arguments under *Hazen Paper Co. v. Biggins* that cash balance wear-aways do not violate the general prohibition against age discrimination under Section 4(a) of the ADEA. As another example, many commentaries have argued that the ADEA's sole theory is the so-called disparate treatment theory of discrimination. This means that to show prohibited discrimination plaintiffs must show (among other things) discriminatory animus on the part of the employer. Assuming that this is the case, and that this argument applies to ADEA Section 4(i) as well as 4(a), then another defense for the legality of wear-aways under both sections is the employer's lack of bad intent.

We believe that cash balance wear-away transitions satisfy the law and policy of the ADEA, ERISA, and the Code. We have here suggested only one more line of authority to support a benefits mechanism that is permissible, reasonable, and fair under all three statutes.

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