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Striking a Balance in the Cash Balance Plan Debate

REGINA T. JEFFERSON†

INTRODUCTION

Traditional defined benefit plans have undergone increasing scrutiny by employers. As a result, many employers have converted their traditional defined benefit plans to cash balance plans. Several of these conversions have received widespread attention and have sparked a contentious debate in the pension community. Some believe that cash balance plan conversions are unfair to older plan participants because they reduce their projected retirement benefits. Others believe that employers should have the freedom to amend their plans in any manner they choose, as long as they do not reduce benefits that have already accrued. This article describes and analyzes the advantages and disadvantages of using cash balance plans as primary

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retirement savings vehicles, and proposes an approach that strikes a balance between the concerns of employers and employees when traditional defined benefit plans are converted to cash balance plans.

A. Trends in the Private Pension System

The composition of the private pension system has changed significantly since the passage of the Employee Retirement Income Security Act (ERISA) of 1974. When ERISA was enacted, traditional defined benefit plans were the most common type of retirement plan, and defined contribution plans primarily were used as supplemental savings arrangements. Recently, however, employers have increasingly established defined contribution plans as primary retirement savings vehicles. From the employer's perspective, this trend can be explained by the fact that defined contribution plans are less expensive and less administratively burdensome to maintain than defined benefit plans. From the employees' perspective, the popularity of defined contribution plans can be explained by simpler benefits, and by the ability of workers to change employment without experiencing significant reductions in their retirement benefits. The latter characteristic is especially appealing in today's labor market, where the average employee is expected to hold numerous jobs before reaching retirement.

1. Pub. L. No. 93-406, 88 Stat. 829 (1974). ERISA completely revised the legal framework of the qualified pension plan as it had previously existed. The most significant innovations of ERISA concerned participation, vesting, and funding standards. Jurisdiction over employee benefits under ERISA was divided among the Internal Revenue Service, the Department of Labor, and the Pension Benefit Guarantee Corporation.


3. In 1975, 103,000 defined benefit plans were in existence. The number of defined benefit plans peaked in 1983 to 175,000 but then decreased to 113,000 in 1990. In contrast, the total number of defined contribution plans increased from 208,000 to 599,000 between 1975 and 1989 and remained at 599,000 in 1990. See Celia Silverman et al., Employee Benefits Research Institute, EBRI Databook on Employee Benefits 139 (1995) [hereinafter EBRI Databook].

4. This characteristic is referred to as portability. See infra, note 5.

The shift from defined benefit plans to defined contribution plans can be explained by other factors as well. Since 1974, pension regulation has disproportionately impacted defined benefit pension plans, making them more expensive and more difficult to maintain than defined contribution plans. Additionally, growth in industries that have not typically favored defined benefit plans has also affected the demand for these plans. Consequently, assuming that labor trends remain constant, as baby boomers approach retirement more employers are likely to rethink the efficiency of establishing and maintaining traditional defined benefit plans as the workforce ages. Aging employees, however, are more likely to place greater value on traditional defined benefit plans because of the level of security these plans provide.

The fastest growing type of defined contribution plan is the 401(k) plan. The 401(k) plan gets its name from the section of the Internal Revenue Code that regulates it. The average American holds 9.2 jobs from the age of eighteen to thirty-four, with more than half of these jobs being held between the ages of eighteen and twenty-four.


7. See id.

8. Larry Sher, What Are Cash Balance Pension Plans?: Retirement in the Balance, CONTINGENCIES, Sept./Oct. 1999, at 18. As the traditional defined benefit plan becomes more expensive and the workforce ages, employers will have to compete for younger employees who will earn more under defined contribution plan models. Because of the sheer size of the baby boom generation, it is important to discuss the cohort of the “baby boomer” generation in determining economic and social policy. Boomers are now in their prime working years, ranging in age from thirty-six to fifty-four in 2000, but will soon be entering retirement. See AM. ASS'N RETIRED PERSONS, AGING BABY BOOMERS: HOW SECURE IS THEIR ECONOMIC FUTURE? 4 (1994).


401(k) plan allows employees to contribute portions of their salaries to a qualified retirement plan, rather than to receive them as current compensation in the year in which they are earned. In most 401(k) plans, contributions are made on behalf of only those employees who elect to participate.\textsuperscript{12} As a result, low-paid employees who are covered exclusively by such plans, but who cannot afford to make contributions, often receive little or no benefits when they retire.\textsuperscript{13}

Although 401(k) plans are appealing to employers and employees alike, the use of these plans as primary rather than supplemental retirement savings vehicles, has serious implications for future retirees and for the private pension system. The use of 401(k) plans as primary retirement savings vehicles shifts the risk of benefit shortfall from employers to employees. This is because, unlike in defined benefit plans, there is neither a minimum guaranteed benefit nor Pension Benefit Guaranty Corporation (PBGC) protection.\textsuperscript{14} Furthermore, some 401(k) plans require that participants not only decide whether to contribute, and the level of contribution to make, but also the manner in which the funds in their accounts are to be invested.\textsuperscript{15} These plans, referred to as participant-directed plans, expose inexperienced investors to even greater risks than their employer directed counterparts.\textsuperscript{16} Thus, notwithstanding their popularity, 401(k) plans do not provide the same level

\textsuperscript{12} See MICHAEL J. CANAN, QUALIFIED RETIREMENT PLANS 229-30 (1999) (providing a definition of cash or deferred arrangement plans).

\textsuperscript{13} For this reason many employers that maintain 401(k) plans also maintain defined benefit plans. See GAO REPORT 1996, supra note 6, at 4-6 (finding that 60% of employees with income less than $25,000 per year have no pension coverage, and subsequently must rely on Social Security as their only retirement security); Karen Ferguson, \textit{401(k) Plans Benefit the Wealthy}, USA TODAY, Nov. 25, 1997, at 13A; see also Regina T. Jefferson, \textit{Comment to Pensions and Savings—In What Form?}, in FRAMING THE SOCIAL SECURITY DEBATE 107 (R. Douglas Arnold et al. eds., 1998).

\textsuperscript{14} See Medill, supra note 10, at 11 (noting the risks of investment success or failure rest with the individual in a participant-directed 401(k) pension plan).


\textsuperscript{16} See generally Regina T. Jefferson, \textit{Rethinking the Risk of Defined Contribution Plans}, 4 FLA. TAX REV. 607, 611-12 (2000) (describing the risk of benefit shortfalls inherent to 401(k) plans such as a lack of PBGC protection and fiduciary liability on the part of the employer).
of retirement income security as traditional defined benefit plans.\textsuperscript{17}

B. Types of Plans

The Internal Revenue Code classifies pension plans as either defined benefit or defined contribution.\textsuperscript{18} In a defined benefit plan, the retirement benefit is expressed as an annual benefit, payable at the retirement age specified in the plan. The retirement benefit is determined by a formula that is usually based upon the employee's service and compensation.\textsuperscript{19} The employer is responsible for funding the plan at a level sufficient to pay the promised retirement benefits to plan participants at their retirements, regardless of the investment performance of the plan assets. To fund the plan, the employer makes annual contributions to an aggregate trust that holds all of the plan's assets; there are no individual accounts. In order to protect plan participants in the event of employer insolvency, most employers who sponsor defined benefit plans are required to insure the accrued retirement benefits through the PBGC.\textsuperscript{20}

In contrast, in a defined contribution plan each participant is assigned an individual account. The

\begin{itemize}
\item \textsuperscript{17} Approximately twenty-five million employees are covered by a participant-directed plan. See Marlene Givant Star, Participants in a Quandary About Plan Options, PENSIONS & INVESTMENTS, Oct. 17, 1994, at 19. Participation in participant-directed plans increased 45% from 1983 to 1993. See Michael J. Canan, Qualified Retirement and Other Employee Benefit Plans § 16.3, at 787-88 (1996 practitioner ed.).
\item \textsuperscript{18} See ERISA § 3(34), 29 U.S.C. § 1002(34) (1994) (defining "a 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, and any income ... which may be allocated to such participant's account"); id. § 3(35), 29 U.S.C. § 1002(35) (1994) (defining "defined benefit plan" as a "pension plan ... which is not an individual account plan and which provides a benefit derived from employer contributions which is based partly on the balance of the separate account of a participant"). For a detailed discussion of the differences between defined contribution and defined benefit pension plans, see Daniel I. Halperin, Retirement Security and Tax Equity: An Evaluation of ERISA, 17 B.C. INDUS. & COM. L. REV. 739, 775-76 (1976).
\item \textsuperscript{19} See Langbein & Wolk, supra note 2, at 42-43 (citing Peter T. Scott, A National Retirement Income Policy, 44 TAX NOTES 913, 919-20 (1989)).
\item \textsuperscript{20} See 29 U.S.C. §§ 1301-71 (1994). Section 1302(a) explains that one of the reasons for creating the PBGC was "to provide for the timely and uninterrupted payment of pension benefits." Id. at § 1302(a)(2).
\end{itemize}
participant is not guaranteed a specific amount at retirement; instead, the benefit payable at retirement is determined by the balance of her individual account. The account balance reflects both employer and employee contributions and the investment earnings on those contributions. If investments are unfavorable, neither the employer nor the PBGC is required to make additional contributions. Therefore, in a defined contribution plan, the participant alone bears the risk of poor investment performance. Thus, as a defined benefit plan the cash balance plan provides significantly more retirement income security for plan participants than traditional defined contribution plans. This is especially true relative to self-directed defined contribution plans in which there are no guaranteed benefits, and in which there is no input from the employer regarding the investment decisions that ultimately determine the adequacy of the retirement benefits.

Employers who desire to provide greater retirement security for their workers, but do not want the administrative and financial burdens of offering traditional defined benefit plans, are more likely to establish standard defined contribution plans, or alternatively, hybrid plans that combine characteristics of both defined benefit and defined contribution plans. Although hybrid plans have qualities of both types, they are classified either as defined benefit or defined contribution plans. The cash balance

21. For this reason, defined contribution plans are frequently referred to as individual account plans.

22. The account balance can also include forfeitures which occur when employees leave before their accrued benefits become fully vested.


24. Keville, supra note 23, at 553-54.


plan is an increasingly popular hybrid plan.\textsuperscript{27} It has many of the features of a defined contribution plan, but in reality is a defined benefit plan.\textsuperscript{28}

In a cash balance plan each participant is assigned a hypothetical account, and the retirement benefit is expressed in terms of a lump sum. To fund the expected retirement benefit, the employer makes annual contributions to the hypothetical accounts. The plan applies guaranteed annual credits to determine the expected retirement benefits.\textsuperscript{29} The annual credit is a proxy for interest earnings in a defined contribution plan.\textsuperscript{30} In order to ensure that there is a real rate of return over a participant's working life, the annual credits are often expressed in terms of either a variable rate, such as the Treasury rate, or some other amount indexed for inflation.\textsuperscript{31} Although participants in cash balance plans appear to have individual accounts in which their retirement benefit accrue, in reality, the plan does not maintain individual accounts. The actual benefit paid at retirement is the actuarial equivalent of the participants theoretical account balance. In cash balance plans, the accrued benefits, may or may not be fully pre-funded.\textsuperscript{32} However, as is the case with all defined benefit plans, the retirement benefits in cash balance plans are guaranteed by the employer and by the PBGC.

\begin{itemize}
    \item \textsuperscript{27} The cash balance plan operates very much like the profit sharing plan in terms of the contribution formula, but the retirement benefit itself is based on specific provisions of the plan document rather than the actual experience of each account. See Plan Administration: IRS Updating COBRA Regulation to Provide New Guidance, Consultant Says, 19 Pens. & Ben. Rep. (BNA) 592, 592 (Apr. 6, 1992); Edward A. Zelinsky, The Cash Balance Controversy, 19 VA. TAX REV. 683, 693 (2000).
    \item \textsuperscript{28} See Forman & Nixon, supra note 25, at 392 (explaining that corporations convert to cash balance plans to avoid backloading).
    \item \textsuperscript{30} See Elizabeth E. Drigotas, Cash Balance Plans: An Overview, TAX MGMT. FIN. PLAN. J., May 16, 2000, at 3.
    \item \textsuperscript{31} See Amoroso, supra note 29 (using the Consumer Price Index as an example interest rate indicator).
    \item \textsuperscript{32} See U.S. GEN. ACCT. OFF., CASH BALANCE PLANS, IMPLICATIONS FOR RETIREMENT INCOME 11 (2000) [hereinafter GAO REPORT 2000] (noting that the trust fund for a cash balance plan is not required to, and often will not have, assets equal to the sum of all the individual account balances); Jim Davis, The Individual Advantage Plan: Balancing the Needs of Older and Younger Employees, BENEFITS PERSP., Fall 2000, at 2.
\end{itemize}
There has been some effort to promote cash balance plans that have the elective contribution characteristic of 401(k) plans. Some of these arrangements even have employer matching and self-direction features. These plans, sometimes referred to as "second generation cash balance plans," present a host of considerations that are different from those presented by first generation cash balance plans. Second generation cash balance plans of this type are uncommon in the United States and therefore are not considered in this article.

It is not the inherent characteristics of cash balance plans that have attracted the level of attention these plans have received recently, but rather the particularities of several highly publicized conversions of traditional defined benefit plans to cash balance plans. As a result, despite the volumes that have been written about cash balance plans, the discussion has been limited. Much has been written about the effects of certain plan conversions, but little has been written about the inherent strengths and weaknesses of cash balance plans themselves.

It is unlikely that the shift toward individual account plans will change in the near future. Therefore, if defined benefit plans survive in the current pension climate where

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34. See id.

35. See id. The lack of literature in the United States about second generation cash balance plans is noteworthy. Cf. id. (describing the popularity of second generation cash balance plans in Canada).


37. See Alvin D. Lurie, If Fate of Defined Benefit Plans Hangs in the Balance, Cash Balance Plans Might Be Just the Thing to Save Them, 1 J. TAX'N EMPLOYEE BENEFITS 227, 228 (2000).
401(k) plans are increasingly popular, it most likely will be by means of hybrid arrangements, such as cash balance plans. Thus, it is important to fully explore the role of cash balance plans as primary retirement savings vehicles.

C. This Article

The first part of this article describes and analyzes the structure of cash balance plans. The article identifies the advantages and disadvantages of using cash balance plans as primary retirement savings vehicles, without addressing the issues raised by conversions of traditional defined benefit plans to cash balance plans, which are discussed later in the article. The article concludes that policies should be adopted that encourage the establishment of cash balance plans over defined contribution plans, especially 401(k) plans, in order to provide greater protection to plan participants.

The second part of the article identifies and explains the competing interests of employers and employees when traditional defined benefit plans are converted to cash balance plans. The article maintains that if cash balance plans are allowed to develop without undue constraints, they could be useful in strengthening the private pension system. However, the article argues that the establishment of cash balance plans should not be encouraged if appropriate measures are not taken to adequately protect affected plan participants at plan conversion.

The third part of the article explores possible solutions to some of the more pressing problems surrounding cash balance plan conversions. The article proposes: (1) the adoption of more stringent notification and disclosure requirements to ensure that affected plan participants are fully aware of the significance of changes to their expected retirement benefits when traditional defined benefit plans are converted to cash balance plans, and (2) the establishment of safeguards that prevent plan participants from experiencing the worst of defined benefit and defined contribution plan coverage as a result of plan conversion. Hopefully, the adoption of the proposals presented in this article will help policymakers come to an equitable and expeditious resolution of the cash balance plan conversion controversy.
I. THE DEVELOPMENT OF CASH BALANCE PLANS

Although cash balance plans recently have received widespread attention in connection with several highly publicized cases, cash balance plans are not a new development.\textsuperscript{38} The earliest cash balance plan was established fifteen years ago by the Bank of America, after the company determined that a defined contribution plan would be more effective in retaining its employees than the traditional defined benefit pension plan it had maintained.\textsuperscript{39} Although the bank believed that a defined contribution plan was preferable to its defined benefit plan, the bank recognized that switching to a defined contribution plan would have been an unpopular decision among senior employees. This was because changing to a defined contribution plan would have significantly lowered the expected retirement benefits of older employees.\textsuperscript{40} The bank was also concerned that establishing a defined contribution plan would shift the investment risk from the employer to the employees, thereby leaving plan participants unprotected against adverse market conditions.\textsuperscript{41} Additionally, the bank was aware that changing to a defined contribution plan would require it to terminate the existing defined benefit plan and thereby incur substantial tax liabilities.\textsuperscript{42} Consequently, the cash balance plan was designed as an innovative way for Bank of America to offer a plan in the style of an individual account plan, without

\textsuperscript{38} Recent conversions to cash balance plans by major corporations have included those of IBM, Bell Atlantic, Cigna Corporation, Eastman Kodak, and SBC Corporation. See Statement of Sen. Leahy, \textit{supra} note 36, at 5.

\textsuperscript{39} See Amoroso, \textit{supra} note 29; see also Jefferson, \textit{supra} note 16, at 617 n.35 and accompanying text (discussing the reasons Bank of America chose not to convert to a traditional defined contribution plan). Bank of America is considered the first recognized cash balance plan conversion, occurring in 1985, though the General Accounting Office in its 2000 report on cash balance plans states that the earliest known conversion occurred in 1925; See \textit{LANGBEIN & WOLK, supra} note 2, at 61; \textit{GAO REPORT 2000, supra} note 32, at 14.


\textsuperscript{41} Amoroso, \textit{supra} note 29, at 339.

\textsuperscript{42} When a plan terminates, the employer is required to pay income and excise taxes on the surplus assets. Additionally, the accrued benefits of the affected participants must be immediately 100\% vested, and participants must be provided annuities or lump sum payments. See infra Part IV.B.3.
having to bear the costs that switching to a defined contribution plan would have entailed.\textsuperscript{43}

Since the first plan was established, the number of cash balance plans has risen dramatically.\textsuperscript{44} Today, cash balance plans exist in all sectors of the economy and cover nearly 2.1 million employees.\textsuperscript{45} As many as 19% of the Fortune 1000 companies offer these types of plans to their employees.\textsuperscript{46} Cash balance plans are especially popular among the financial services, health care, and manufacturing industries.\textsuperscript{47}

The increasing number of cash balance plans reflects the overall trend toward individual account retirement plans and away from traditional defined benefit plans.\textsuperscript{48} From 1980 to 1985, the number of employees covered by traditional defined benefit plans dropped by 0.8% per year.\textsuperscript{49} In contrast, during the same period of time, defined contribution plan coverage increased by as much as 5.8%.\textsuperscript{50} From 1990 to 1995, the average number of defined benefit plans continued to decline by 2.3% per year, while the number of defined contribution plans rose by 1.9% per

\textsuperscript{43} See Amoroso, \textit{supra} note 29, at 339.

\textsuperscript{44} The number of cash balance plans offered by companies with pension assets between $1 billion and $5 billion increased from 6% to 17% in 1999. The number of companies with pension assets of more than $5 billion increased from 6% to 9% in 1999. During that same period of time, the number of cash balance plans doubled among companies with assets of $100 million to $250 million. See Ricki Fulman, \textit{Greenwich Study: Large Plans See Big Hike in Use of Cash Balance Plans}, 28 \textit{PENSIONS \\& INVESTMENTS}, May 1, 2000, at 130.

\textsuperscript{45} See GAO \textit{REPORT 1996}, \textit{supra} note 6, at 7.

\textsuperscript{46} See GAO \textit{REPORT 2000}, \textit{supra} note 32, at 13; see also Alex Arcady \& Francine Mellors, \textit{Cash Balance Conversions: Assessing the Accounting and Business Implications}, \textit{J. OF ACCOUNTANCY}, Feb. 1, 2000, at 22-28 (providing more information on the rate at which cash balance plans have been established).

\textsuperscript{47} See GAO \textit{REPORT 2000}, \textit{supra} note 32, at 5.

\textsuperscript{48} Over the last fifteen years there has been a gradual shift away from defined benefit plans toward defined contribution plans. See RICHARD IPPOLITO, \textit{PENSION PLANS AND EMPLOYEE PERFORMANCE: EVIDENCE ANALYSIS AND POLICY} 4-5 (1997) (noting that the share of workers covered by a defined benefit plan dropped from 83% to 50% from 1979 to 1996). See \textit{supra} Part A of Introduction.


\textsuperscript{50} See id. at 2.
year. As a result of these patterns, defined contribution plans have now acquired a significant share of the pension market. They are particularly popular among small to mid-sized firms, where they are the dominant plan type.

No single factor explains the shift from defined benefit to defined contribution plans; rather, there are numerous events that have contributed to this development. First, employment shifts in the economy have impacted the demand for defined benefit plans. Large unionized firms in the manufacturing industry have historically selected traditional defined benefit plans as their primary retirement savings instruments. However, the number of unionized firms has declined precipitously in recent years. As a result, the number of defined benefit plans has also declined. Furthermore, the number of small, non-unionized companies in the service sectors has been on the rise. Employers in this sector of the economy typically select defined contribution plans as their primary retirement savings vehicle because they are simpler and therefore less costly to administer. Another reason smaller companies are more inclined to select defined contribution plans is that these plans do not expose employers to the risk of poor investment performance. Accordingly, the expansion of smaller companies in the service industry has increased the demand for defined contribution plans.

Second, regulation affecting defined benefit plans has been more frequent and more burdensome over the last fifteen years than regulation affecting defined contribution plans. As a result, the cost of maintaining traditional

51. See id.
52. See IPPOLITO, supra note 48, at 5 (stating that defined contribution plans are particularly popular among firms with less than 1000 employees).
53. See Keville, supra note 23, at 541.
54. See IPPOLITO, supra note 48, at 5.
55. See id.
56. See infra Part II.A.
57. See Defined Benefit Plans: Employers Offer No Replacements in More Than One-Third of Terminations, BENEFITS TODAY, July 1992, at 223; see also Vineeta Anand, IRS Cuts Some Slack on Retirement Rules, PENSIONS & INVESTMENTS, Jan. 10, 1994, at 4 (noting the passage of the Omnibus Budget Reconciliation Act of 1993); Keville, supra note 23, at 539 n.74 and accompanying text (noting legislation placed a larger burden on defined benefit plans than defined contribution plans). The American Academy of Actuaries conducted a survey of employers that found that termination of defined benefit
defined benefit plans has increased disproportionately relative to that of defined contribution plans. Therefore, employers concerned about the cost of maintaining retirement plans for their employees are more inclined to adopt defined contribution plans than defined benefit plans.

Third, since the legislation establishing 401(k) plans became effective, there has been a sharp increase in their number. The 401(k) legislation was adopted in 1978, and became effective in 1981. Although the legislation codified the position that employers had taken for almost three decades, 1981 was the first time these arrangements were sanctioned by the Internal Revenue Service. Because 401(k) plans are cheaper, simpler, and more portable than other retirement savings plans, they have flourished at the expense of both defined benefit and other defined contribution plans.

II. THE PROTECTION OF BENEFITS IN CASH BALANCE PLANS

Neither ERISA nor the Internal Revenue Code defines cash balance plans. However, the Treasury Regulations describe them as "defined benefit plan[s] that define benefits for each employee by reference to the amount of the employee's hypothetical account balance." As explained above, in cash balance plans, the hypothetical accounts

plans are occurring in part because of excessive government regulation. See Jerry Geisel, Weighty Rules Crush Pension Plans, BUS. INS., Mar. 22, 1993, at 3.


59. GAO REPORT 1996, supra note 6, at 4-6 (finding that approximately one in four workers that are covered by some form of pension coverage participate in a 401(k) plan).


61. See Funding: Reich Calls for Pension Reform to Reduce Growing Plan Underfunding, supra note 9.

62. See Press Release, U.S. Dep't of Labor, supra note 5 and accompanying text.

63. Treas. Reg. § 1.401(a)(4)-8(c)(3)(i) (as amended in 1993). "Section 414(k) of the Code addresses the requirements for a combination of defined benefit and defined contribution arrangements, which some have referred to as a form of hybrid plan. However, section 414(k) does not address cash balance and similar hybrid arrangements where one formula has components of both." GAO REPORT 2000, supra note 32, at 10 n.8.
increase with annual pay credits, which are determined in the same manner as contributions to defined contribution plans, such as profit sharing plans.\textsuperscript{64} The plan guarantees the payment of annual interest credits, which are functionally equivalent to investment earnings in traditional defined contribution plans.\textsuperscript{65}

Although cash balance plans incorporate some of the features of defined contribution plans, they nevertheless remain a part of the defined benefit plan system. As a result, they retain many of the positive characteristics offered by traditional defined benefit plans, such as guaranteed benefits, non-elective participation, and annuitized payments.\textsuperscript{66} For this reason, many pension consultants believe that employees covered by traditional defined benefit plans do better when their plans are replaced with cash balance plans than when their plans are replaced with standard defined contribution plans.\textsuperscript{67}

A. Guarantees

There is greater protection of the expected retirement benefit in cash balance plans than there is in defined contribution plans because the employer, rather than the employee, assumes the primary investment risk. Additionally, the availability of PBGC insurance provides significantly greater protection of the expected retirement benefits in cash balance plans.\textsuperscript{68}

\begin{itemize}
  \item \textsuperscript{64} In a profit sharing plan, there may be an indefinite contribution formula, but there must be a predetermined and definite formula for distribution of contributions made to the plan among the participants at some fixed point in time, such as death or disability. See CANAN, supra note 12, at 93.
  \item \textsuperscript{65} See Forman & Nixon, supra note 25 at 394.
  \item \textsuperscript{66} Davis, supra note 32, at 2.
  \item \textsuperscript{67} See Vineeta Anand, Looks Deceiving: It Quacks Like a DC Plan, but It's Not One, 22 PENSIONS & INVESTMENTS, May 31, 1999, at 22 ("Under IRS rules, workers at a company with a 401(k) plan that converts its defined benefit plan to cash balance get a bigger benefit than if the employer had terminated the defined benefit plan and set up a second defined contribution plan.").
  \item \textsuperscript{68} However, the employer stands to benefit from this arrangement as well when the plan's actual investment return exceeds the rate stated in the plan, because the employer will make reduced future contributions. See John L. Utz, Cash Balance Plans—The Basics, in THE BROUHAHA OVER CASH BALANCE PLANS—REAL VS. PERCEIVED ISSUES: A Nontechnical Evaluation of the Issues Surrounding Cash Balance Plans 4 (2000); see also Jefferson, supra note 16, at 644.
\end{itemize}
Also, because cash balance plans are defined benefit plans, the retirement benefits are determined by an accrual formula, and are definite in amount.\textsuperscript{69} Thus, the use of salary scale projections allows participants to determine their expected retirement benefits. This information gives participants a better opportunity to prepare for their retirements, and to increase their personal savings when necessary. In contrast, in defined contribution plans the investment experience of the plan can vary drastically from year to year, causing participants' expected retirement benefits to differ significantly from the benefits they actually receive.

Notwithstanding their similarity to defined contribution plans, however, cash balance plans do not expose participants to market fluctuations in the same manner as defined contribution plans. In cash balance plans, guaranteed annual investment returns effectively become a minimum retirement benefit.\textsuperscript{70} If the actual investment return of the plan assets is less than the guaranteed rate of return, the employer is liable for the difference.\textsuperscript{71} For example, if a cash balance plan guarantees an annual return of 8\% and the actual investment return of the plan is 6\%, the employer would be responsible for the 2\% difference.\textsuperscript{72} Consequently, in cash balance plans participants are protected against the risk of adverse market conditions, and against any other factors that could contribute to shortfalls in their expected retirement benefits.\textsuperscript{73}

Additionally, because cash balance plans are classified as defined benefit plans, there is insurance protection against employer insolvency. When defined benefit plans terminate with insufficient assets, § 4022 of ERISA provides that the PBGC shall guarantee the payment of all

\textsuperscript{69} See Jefferson, supra note 16, at 676.

\textsuperscript{70} See supra text accompanying notes 25-28.

\textsuperscript{71} See Forman & Nixon, supra note 25, at 397.

\textsuperscript{72} But a flat rate of return does not protect participants against inflation. A variable rate indexed for inflation insures that participants receive a real return over their working lives. The employer normally will have assumed an investment return for something higher, such as 10\% in the plan, so that there is some cushion. Thus, if the actual return is 10\%, the plan would experience a gain.

\textsuperscript{73} Poor investment decisions or unfavorable plan experience are examples of such factors.
accrued benefits, up to the limit of a single employer plan.\(^{74}\) Thus, in a cash balance plan if an employer were unable to make the necessary contributions to fund the accrued benefits of plan participants, and the plan terminated with insufficient assets, the PBGC would be liable for the insured portion of the deficiency.\(^ {75}\)

In contrast, § 4022(b)(1) of ERISA specifically provides that PBGC protection is not available to individual account plans. Section 3(34) of ERISA defines individual account plans as plans in which the level of benefit for each employee fluctuates depending on the experience of the account.\(^ {76}\) Because the retirement benefit in defined contribution plans is dependent upon actual contributions made to the accounts, and upon the investment performance of each separate account, all defined contribution plans are excluded from ERISA's insurance program.\(^ {77}\) Therefore, despite the appearance of having individual accounts, cash balance plan participants are protected against both market fluctuations and employer insolvency, whereas defined contribution plan participants are not.\(^ {78}\)

B. Participant Choice

In recent years, 401(k) plans have dominated new plan offerings in the private sector.\(^ {79}\) Section 401(k) plans require

\(^{74}\) The maximum insurable benefit is phased in over a period of five years and equals approximately $35,000 per year. See ERISA, § 4022, 29 U.S.C. § 1322 (1994); § 29 C.F.R. 4022.83 (2000); LANGBEIN & WOLK, supra note 2, at 901-02.

\(^{75}\) In May 1999, the PBGC Corporation had taken over cash balance plans from the following corporations: American Industries and Resources Corp., Sewell Manufacturing Co., Quadrex Corp., Golden Valley Health Center, and Dill Products Inc. See Anand, supra note 67, at 22. By December 1999, eight cash balance plans were reported as being taken over by the PBGC, adding to the list above the Caldor Corporation. See Vineeta Anand, Framing the Issues: PBGC Puzzles out Benefits for Shuttered Hybrids, 27 PENSIONS & INVESTMENTS, Dec. 13, 1999, at 36.

\(^{76}\) See ERISA, § 4021(b)(1), 29 U.S.C. § 1321(b)(1) (1994); see also id. § 3(34), 29 U.S.C. § 1002(34) (defining a defined contribution plan as a plan providing an individual account for each participant).

\(^{77}\) See id. § 4021(b), 29 U.S.C. § 1321(b) (describing the sections of ERISA that are not covered by the PBGC as an individual account plan).

\(^{78}\) See id. § 4022, 29 U.S.C. § 1322.

\(^{79}\) See Medill, supra note 10, at 7 (noting the dramatic growth of 401(k) plans in recent years).
participants to make elections between receiving amounts in cash, or having the employer contribute portions of their wages as deferred compensation to a qualified retirement plan. Under § 402(a) of the Internal Revenue Code, all elective contributions made to a qualified plan are made on a tax deferred basis. To further encourage participation in 401(k) plans, employers often will match the employees' elected contributions in some form or fashion. For example, the employer may match the first 1% of pay contributed by the employee with a 100% match and all additional contributions with a 50% match. Matching contributions are designed to attract younger and lower paid employees who might not participate at all in the absence of such incentives. Even with the prevalence of such incentives, however, less than one half of all workers who earn less than $15,000 per year contribute to their 401(k) plans. Low participation among the non-highly compensated employees can be a problem for employers because participation among the rank-and-file employees is necessary for plans to satisfy the applicable nondiscrimination rules. The failure to meet these requirements results in a plan losing its preferential tax status.

The availability of non-elective contributions is another positive feature of cash balance plans. The annual contributions made by employers to cash balance plans are typically made on behalf of all participants. Thus, employees are guaranteed benefits under cash balance

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82. See LANGBEIN & WOLK, supra note 2, at 332-37. The matching contributions are subject to nondiscrimination rules. See I.R.C. § 401(m) (1994 & Supp. III 1997); Treas. § 1.401(k)-1(b)(3) (as amended in 1995).

83. See id.

84. See EBRI DATABOOK, supra note 3, at 179.

85. A qualified 401(k) must meet minimum coverage requirements, see I.R.C. § 410(b) (1994), as well as the nondiscrimination requirements for CODAs. See id. § 401(k)(3)(C).

86. Employer contributions to a qualified retirement plan are not taxed to the employee until distribution; the investment earnings on the contributions are not taxed until they are distributed to the employee, and the employer receives a current income tax deduction for the contributions.

87. See Amoroso, supra note 29.
plans, whether or not they choose to participate. 88 This feature eliminates the concern about employees who do not participate, or who make de minimis contributions to their 401(k) plans. The non-elective quality of cash balance plans also ensures that the participation rate among non-highly compensated employees is as high as the participation rate among highly compensated employees. 89 Therefore, unlike in 401(k) plans, the success of cash balance plans does not depend on the individual's propensity, or ability to save. 90

Furthermore, the absence of the participant-directed feature that is prevalent among 401(k) plans also increases the likelihood that cash balance plan participants will receive the full value of their expected benefits at retirement. 91 Although employers that sponsor 401(k) plans are not required to allow participants to make investment decisions, many of them recognize that giving flexibility to plan participants permits employees to customize their retirement programs to accommodate their own savings objectives and risk tolerances. 92 Thus, much of the growth in the 401(k) area has been driven by plans that give employees such discretion. These plans, referred to as participant-directed plans, cover approximately twenty-five million employees and represent the fastest growing component of the private pension system. 93

In participant-directed 401(k) plans, participants decide not only whether to participate, and the level of compensation to contribute, but also the manner in which their accounts are invested. Because the pension law imposes no additional education or notification requirements on employers who sponsor participant-directed plans, some commentators have questioned the prudence of allowing inexperienced plan participants to

88. See Medill, supra note 10, at 11-12.
89. See GAO REPORT 1996, supra note 6, at 4-6.
90. See id.
91. See Forman & Nixon, supra note 25, at 413.
92. See Medill, supra note 10, at 24-26.
93. See Marlene Givant Star, Participants in a Quandary About Plan Options, PENSIONS & INVESTMENTS, Oct. 17, 1994, at 19. The number of participant-directed 401(k) plans has grown rapidly. Participation in such plans increased by approximately 45% from 1983 to 1993, and is attributable in large part to the creation of new retirement plans by small businesses. See CANAN, supra note 12, at 788.
make critical investment decisions regarding their plan assets.\textsuperscript{94}

The rationale for the employment based characteristic of the private pension system, as well as for tax advantages given employers who offer qualified retirement plans, is that considerable advantages are derived from saving in employer-sponsored arrangements, when compared to individual savings arrangements.\textsuperscript{95} It is believed that one reason employees fare better in employer-sponsored plans is that employers are more likely to select long-term investment strategies that maximize the investment earnings of plan assets.\textsuperscript{96} Also, an employer who invests large sums of money can benefit from economies of scale.\textsuperscript{97} As a result, the investment returns inside an employer-sponsored plan should be higher, and administrative costs should be lower than in outside retirement savings arrangements.\textsuperscript{98}

In participant-directed plans, however, it is the participant, not the employer, who makes the investment decisions about the plan assets.\textsuperscript{99} Because employers are not required to provide investment education, participants often make these decisions without the benefit of financial training. Typically, inexperienced investors disproportionately select low-risk, low-yield instruments, which fail to maximize their investment returns over the long-run.\textsuperscript{100} Thus, any advantages derived from economies of scale may

\begin{footnotes}
\begin{itemize}
\item \textsuperscript{94} See Jefferson, supra note 16, at 629 (arguing that inexperienced investors should not have sole control of their investment portfolios, but should be provided with investment guidance from professionals that understand the use of diversification and proper reading of market indicators).
\item \textsuperscript{95} See Langbein & Wolk, supra note 2, at 29-34 (explaining why pension plans are employer based).
\item \textsuperscript{96} See id. at 32. Another reason for the investment success of employees in employer-sponsored plans is wider participation.
\item \textsuperscript{97} Economies of scale explains why investment fees and other administrative costs should decrease as the size of the investment increases.
\item \textsuperscript{98} See Langbein & Wolk, supra note 2, at 32.
\item \textsuperscript{99} See Medill, supra note 10, at 24-26.
\item \textsuperscript{100} See Plan Administration: Diversification is Key to Success of Section 401(k) Investments, APSA Told, 17 PENSIONS & INVESTMENTS, July 16, 1990, at 1243.
\end{itemize}
\end{footnotes}
be diminished in participant-directed plans if the participants make poor investment decisions.\textsuperscript{101}

In contrast, in cash balance plans the employer and the trustees of the plan, rather than the individual plan participants, usually have investment control over the plan assets.\textsuperscript{102} These individuals are more likely to make investment choices that are sufficiently diversified to maximize returns over the long-run. As a result, participants in cash balance plans are more likely to benefit from the intended non-tax advantages of employer directed retirement savings arrangements.\textsuperscript{103}

C. Timing and Form of Payment

The form and timing of payments in cash balance plans also provide additional protection to plan participants. In traditional defined benefit plans, the normal retirement benefit is expressed as an amount certain, payable at retirement in the form of an annuity.\textsuperscript{104} Annuity contracts guarantee periodic payments for a specified period of time. Annuity payments can be made over a fixed number of years, referred to as an “annuity certain,” or made over the duration of one or more lives, referred to as a “life annuity.” Life annuities provide protection against unexpected longevity, and are the most effective method by which individuals can protect themselves against the risk of outliving their assets.\textsuperscript{105}

To illustrate the value of a life annuity, consider individual X, who is age sixty-five, owns a significant amount of assets, and is preparing for retirement. Further assume that this individual has no Social Security benefits,

no private pension payments, and no other source of income. Individual X desires to live in a manner that will allow her to have sufficient assets to live comfortably for the duration of her life. Obviously, if X knew her exact date of death and the rate of return on her investments, it would be a relatively simple exercise to determine how much she should spend annually in order not to deplete her assets before death. However, without this information it is difficult, if not impossible, to allocate her wealth so as to achieve this goal.\(^{106}\)

Although life expectancy tables are useful for this purpose, they are inexact.\(^{107}\) There is substantial variation in the life expectancies of individuals within groups and thus much uncertainty about the predictions for their remaining lives. For example, an average sixty-five year old man in the year 2000 can expect to live an additional 16.4 years, but an average sixty-five year old woman can expect to live an additional 19.6 years.\(^{108}\) However, 12% of men and 7.7% of women die prior to reaching age seventy, and as many as 18% of men and 31% of women live to age ninety or beyond.\(^{109}\) Therefore, despite the use of predictors, such as life expectancy tables, interest rate assumptions, and family histories, life annuities are one of the most practical ways of solving the wealth allocation problem for retirees.

In addition to solving the allocation problem, another benefit that life annuities provide is the assurance that the money will not be withdrawn prior to retirement and used for current consumption. Plans that provide payment in the form of lump sum distributions when employees leave the company prior to retirement allow individuals to spend their retirement savings long before retirement.\(^{110}\) Although the law permits participants who receive pre-retirement lump sum distributions to roll them over tax-free into other qualified retirement plans, or to individual retirement arrangement (IRAs), most individuals who receive lump sum distributions from their retirement plans do not

\(^{106}\) See id.

\(^{107}\) It is also helpful to know an individual's family history and current medical condition.

\(^{108}\) See BROWN, supra note 105.

\(^{109}\) See id.

\(^{110}\) A lump sum payment made prior to retirement would be the actuarial equivalent of the life annuity paid at the normal retirement age.
reinvest them in this manner.\textsuperscript{111} Obviously, when lump sum distributions are not reinvested in other retirement savings instruments, it is far more likely that the funds will be used for non-retirement purposes. As a result, there will be fewer remaining assets to grow tax-free as retirement savings.\textsuperscript{112}

The Congressional Research Service recently reported that only 33\% of recipients who received lump sum distributions reinvested them in other retirement savings vehicles.\textsuperscript{113} Not surprisingly, younger workers are far less likely than older workers to reinvest lump sum payments in other retirement savings arrangements when they receive them prior to retirement. As few as 27\% of workers between the ages of twenty-five and thirty-four reinvest their retirement funds in other qualified retirement savings vehicles, as compared to 42\% of those between the ages of forty-five and fifty-four.\textsuperscript{114} Data also shows that the propensity to roll-over varies with the size of the distribution.\textsuperscript{115} Distributions of larger amounts are more frequently rolled over than distributions of smaller amounts.\textsuperscript{116}

Regardless of age, almost all employees choose lump sum payments whenever they are available.\textsuperscript{117} One employer reported that participants leaving the company prior to retirement took lump sum payments even when the value of the annuity payments was significantly higher than the lump sum payments.\textsuperscript{118} Other employers reported that terminating employees asked them to distribute their lump sum payments directly to businesses, such as auto repair shops.\textsuperscript{119} These reports are troubling, but nevertheless consistent with studies on participant behavior. These studies reveal that in spite of substantial tax penalties, workers who receive lump sum distributions

\begin{footnotes}
\footnote{112. See I.R.C. §§ 72(t), 401(a) (1994 & Supp. IV 1998).}
\footnote{113. GAO Report 2000, supra note 32, at 31.}
\footnote{114. Id.}
\footnote{115. See EBRI Facts, supra note 111.}
\footnote{116. See id.}
\footnote{118. See GAO Report 2000, supra note 32, at 31.}
\footnote{119. See id.}
\end{footnotes}
are more likely to cash out the funds for current consumption. This is a serious social problem. As life expectancies increase, it is more important than ever for individuals to protect themselves against the risk of outliving their assets. For this reason, economists maintain that life annuities are an essential component of any retirement portfolio.

With respect to both timing and form of distribution the pension law is inconsistent regarding its treatment of pre-retirement distributions from tax-favored retirement plans. In some instances early distributions are discouraged with penalties, and in other pre-retirement situations they are not. Additionally, in some plans, annuity options are required, but in others they are not.

Generally, tax qualified defined benefit plans are not permitted to make distributions to employees while employment continues. Either at retirement, or at termination of employment, defined benefit plans are permitted to make payments in the form of lump sum distributions, or in a series of payments over a number of years. In contrast, 401(k) plans are permitted to make distributions of any amount, at anytime during employment, provided the participant has attained the age...

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121. See Langbein & Wolk, supra note 2, at 4-5.


124. I.R.C. § 72(t).

125. There are exceptions for payments on account of disability. See id. § 72.

126. Halperin, supra note 122, at 178. When accrued benefit exceeds $5,000, however, the code requires qualified defined benefit plans to provide participants an option of receiving their benefits in the form of an annuity or as a series of payments for life, beginning at the plan's normal retirement age. See GAO Report 2000, supra note 32, at 31 n.24; Jonathan Barry Forman, How Federal Pension Laws Influence Work and Retirement Decisions, 54 Tax Law 143, 166 (2000).
of fifty-nine and a half, or in the event the participant experiences financial hardship.\footnote{127}

The normal form of payment in a defined benefit plan is a qualified joint and survivor annuity (QJSA) for married participants.\footnote{128} A QJSA is an annuity payable for the life of the participant, with at least a 50% survivor benefit for the surviving spouse.\footnote{129} The equivalent benefit for an unmarried participant is a life annuity. In addition to the normal form of benefit, defined benefit plans may, and often do, offer other forms of distribution, such as annuity options with greater survivor benefits, or payments over a certain number of years. Lump sum payment options are less common among traditional defined benefit plans, but presumably they will increase since the aggregate demand for this form of payment is on the rise in all plans.\footnote{130}

Because they are considered defined benefit plans, cash balance plans are also required to offer benefits in the form of QJSAs for married participants and single life annuities for unmarried participants.\footnote{131} However, practically all cash balance plans offer both a lump sum form of payment at retirement or termination of employment, as well as an annuity payable at retirement, since portability is one of the touted advantages of cash balance plans.\footnote{132}

\footnote{127. If the plan provides for hardship distributions, the regulations establish a two part test for hardship. First, the employee must have an “immediate and financial need”; second, the distribution must be necessary to satisfy the financial need. \textit{See} Treas. Reg. § 1.401(k)-1(d)(2) (as amended in 1995). A significant exception to this rule is that profit sharing plans other than 401(k) plans can make distributions while service continues, subject to certain limitations. Gayle Stutzman Evans, \textit{Estate Planning with Qualified Plans and IRAs, in Basic Estate and Gift Taxation and Planning} (ALI-ABA Course of Study 2001).}

\footnote{128. \textit{See} I.R.C. § 401.11(A) (1994).}

\footnote{129. LANGBEIN & WOLK, \textit{supra} note 2, at 580, 586.}

\footnote{130. \textit{See id. at 170.}}

\footnote{131. \textit{See id.} § 401(a)(11) (1994) (recognizing that payments can also be made in a series of payments). Under federal pension law, a defined benefit plan is any plan that does not provide actual individual accounts. \textit{See id.} § 414(g) (1994). However, because the retirement benefits in a cash balance plan are defined in terms of a hypothetical account balance, it is necessary for the plan to specify an annuity conversion rate or method for determining the actuarial equivalent annuitized payment of the “account balance.” \textit{See Drigotas, supra} note 30.}

\footnote{132. Only 15% of the firms in a survey conducted by the GAO had lump sum payment options in their traditional defined benefit plan before conversion; however, after conversion, “95 percent of the firms allowed a lump sum distribution although 13 percent limited the option by offering it only at normal
surprisingly, cash balance plan participants overwhelmingly select lump sum payments. Nevertheless, in cash balance plans, a participant who desires annuitized payments has the opportunity to receive the additional protection that this form of payment provides. Annuity options may not be especially beneficial to individuals who terminate employment prior to retirement because they are better off leaving their funds in the plan. However, this form of payment is important to individuals who terminate employment at retirement and wish to protect themselves against the risk of outliving their assets.

Section 401(k) plans are not required to offer annuitized retirement payments. Lump sum distribution is the most common form of distribution in 401(k) plans. Only 27% of the 401(k) plans in existence in 1997 offered plan participants the option of choosing a life annuity at retirement. The figures for other types of defined contribution plans are similarly low. Consequently, over 70% of nearly fifty million defined contribution plan participants in the United States are unable to receive their retirement benefits in a manner that directly protects them against longevity.

Historically, traditional defined benefit plans have provided the second largest source of annuity income to retirees in this country. Social Security has provided the largest. Approximately 7.2 million of the 17.4 million individuals over the age of fifty-five who retired from private sector jobs receive annuity income from a private pension plan. The average annual annuity income for those receiving annuity income from a private pension was $9,714; the aggregate income for the group was $70 billion in 1994. Therefore, one implication of the trend away from using defined benefit plans to 401(k) plans for primary retirement savings vehicles is a decline in the availability of annuitized benefit payments. Furthermore, the prevalence of 401(k) plans means that there is a greater opportunity

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133. See EBRI FACTS, supra note 111.
134. See BROWN, supra note 105, at 16.
135. See id.
136. See id. at 6 (reporting the findings of the September 1994 Health and Pension Benefit Supplement to the current Population Survey).
137. See id.
for pre-retirement distributions on account of financial hardship. Taken together, these characteristics make it more likely that participants in cash balance plans will have greater retirement income security than participants in 401(k) plans.138

D. Disadvantages for Some Plan Participants

Notwithstanding the distinct advantages in cash balance plans relative to defined contribution plans, cash balance plans are less advantageous for some employees than for others because of the manner in which the cash balance plan benefits accrue.139 In general, cash balance plans provide better benefit value to younger participants than do traditional defined benefit plans. Conversely, older participants may be disadvantaged under the cash balance plan design. This is true for both converted and unconverted cash balance plans.140

The relative advantage for older employees in traditional defined benefit plans occurs because there is a determinable projected retirement benefit. In such plans, the rate of benefit accrual directly correlates to the interval between the time at which the benefit accrues and the participant's actual retirement date.141 The shorter the discount period, the more valuable the retirement benefit.142 Consequently, the value of the accrued benefits can vary significantly relative to the age and service of individual participants.143 This relationship causes older participants to fare better under traditional defined benefit plans than younger participants.

138. See supra Part II.B.
140. Davis, supra note 32, at 1 (noting that the cash balance plan’s individual account format is easier for both younger and older employees to understand).
142. Stein, supra note 139, at 29.
143. See id.
Furthermore, in traditional defined benefit plans older employees are advantaged because the retirement benefit generally is based on a final pay formula in which compensation and service are taken into account.\textsuperscript{144} The final compensation used in the accrual formula typically is determined by using average income; thus, an increase in compensation in any one year will increase the value of the benefit accruals for all prior years.\textsuperscript{145} As a result, in traditional defined benefit plans a substantial portion of an employee's retirement benefits can accrue in the final years of employment. It is not unusual for employees who spend their entire working lives with a single employer to accrue more than one half of their retirement benefits during their last years of employment, when their wages typically are highest.\textsuperscript{146} For this reason, the termination or conversion of traditional defined benefit plans can reduce disproportionately the expected retirement benefits of participants with greater service unless affirmative measures are taken to prevent this outcome.\textsuperscript{147}

To illustrate the effects of increased wages in later years, consider a plan with an accrual formula of 2\% of final pay times years of service, where final pay is the average of the highest five consecutive years of compensation. Assume a participant with ten years of service had compensation of $50,000 per year for the final five years of her employment. Prior to that time, assume that her annual compensation was less than $50,000. Under this plan's accrual formula, her accrued benefit would equal 2\% times ten years of service times $50,000, or $5000 per year. If in her last year of employment her compensation had risen from $50,000 to $75,000, her accrued benefit would equal 2\% times ten times $55,000, or $5500 per year. Therefore, the pay increase in her tenth year of employment increased the value of the accruals for the nine prior years of service, significantly.

In contrast, younger employees benefit more under individual account plan models, including cash balance

\textsuperscript{144} See id. at 29-30.
\textsuperscript{145} For example, a plan may use the highest three consecutive years to determine final compensation.
\textsuperscript{146} See Stein, supra note 139, at 29. For this reason some have argued that there is breach of contract when an employer terminates or converts a traditional defined benefit plan and fails to reward long-term service. See id.
\textsuperscript{147} See id.; infra Part V.
plans, than traditional defined benefit plans. This is because the retirement benefits accrue more rapidly in individual account plans. To illustrate, consider an employee who terminates at age forty-five with twenty years of service under a traditional defined benefit plan. Assume the plan has an accrual formula of 1% per year of service times compensation. Thus, the participant would have earned a 20% benefit based on compensation when she terminates employment. This benefit does not reflect projected salary increases. By comparison, if the contribution level of a defined contribution plan is calculated with reference to an expected retirement benefit, based upon projected salary increases, the percentage of contributions and the investment build-up on the contributions will be greater than if the plan had anticipated no salary increases. The increase will be reflected in the accrued benefit. Thus, the measurement of accrued benefits before retirement in individual account plans is more favorable to younger more mobile employees. However, older employees who continue to work after normal retirement age also stand to benefit more in cash balance plans because the actuarial value of the benefit does not decrease in later years.

Interestingly, employees who make mid-career changes may not be able to accrue sufficient years of service under a traditional defined benefit plan to take advantage of the full effect of the application of higher earnings. They also may not have sufficient time before retirement to accrue adequate benefits under a defined contribution plan, or cash balance plan, to fully benefit from the more rapid accruals in these plans. Therefore, an individual whose coverage changes mid-career from traditional defined benefit plans to cash balance plans may experience the worst of both worlds. This result, however, is not inevitable. Employers can avoid this effect when they convert traditional defined benefit plans to cash balance plans by using age weighted contribution formulas, or by introducing

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148. See Halperin, supra note 122, at 185-86.
149. See id.
150. See id.
151. See Drigotas, supra note 30, at 3 (explaining that the rate of accrual past normal retirement age ordinarily is higher in cash balance plans than in traditional defined benefit plans).
other measures designed to enable plan participants to accrue their full projected benefits.

III. THE CASH BALANCE PLAN CONTROVERSY

A. Plan Conversions

When employers amend their retirement plans there are specific requirements regarding benefit accruals that must be satisfied in order for the plan to continue receiving the tax benefits accorded to qualified retirement plans. One of these requirements prohibits employers from reducing retirement benefits that have already accrued. However, this rule does not prohibit employers from amending their plans to reduce future accruals. Therefore, plans may be amended prospectively to limit, for example, the number of years over which retirement benefits accrue, or to modify the structure of their accrual formulas.

Most of the cash balance plans in existence today resulted from such amendments. Cash balance plans generally have not been established by employers as their first retirement savings programs, or even as supplemental ones. Instead, cash balance plans have been used almost exclusively in connection with conversions from traditional defined benefit plans. Most of these plans were converted by either freezing the accrued benefits of the existing traditional defined benefit plan, or by amending their accrual formulas to cash balance plan accrual formulas.

Employers give numerous reasons for converting their traditional defined benefit plans to cash balance plans. Some employers report that their companies have converted to cash balance plans in order to harmonize their benefits

154. See id.
155. Less than 10% of cash balance plans were established by companies as their first pension plan, a supplement to an existing defined contribution, or as an addition to an existing defined benefit plan. See GAO REPORT 2000, supra note 32, at 15.
156. See Arcady & Mellors, supra note 46, at 24.
after mergers or acquisitions. Others have said that they converted their plans to be more competitive within a particular industry. Some employers have even suggested that they converted their plans because many of their employees have had 401(k) plans at other points in their careers and are thus more familiar with cash balance plan benefits than the benefits of traditional defined benefit plans. By far, however, the reason given most frequently by employers for their conversions is that the benefits in cash balance plans are easier to understand than those in traditional defined benefit plans. Employers explain that because benefits under cash balance plans are expressed in lump sum values rather than annuities, their employees better understand and appreciate the value of their retirement benefits.

However, because the conversion of traditional defined benefit plans to cash balance plans can significantly reduce future plan costs, as well as avoid the imposition of substantial income and excise taxes, it is difficult to believe that financial considerations are not among the primary reasons for many cash balance plan conversions. Thus, it would seem that employers and consultants who suggest that plan cost was not considered in their decisions to convert their traditional defined benefit plans to cash balance plans are either uninformed or insincere. The fact

157. That is to provide the same pension plan for employees that had been covered by different plans. See Vineeta Anand, Conversion Question: After Buying CBS, Viacom May Take Its Lead, 28 PENSIONS & INVESTMENTS, June 26, 2000, at 22.

158. See GAO REPORT 2000, supra note 32, at 17.


160. See id. (citing a PricewaterhouseCoopers survey based on ninety-five responses from companies that have converted traditional plans to cash balance plans, in which most of the reporting companies cited this as a reason for converting).

161. See supra Part II.C. This belief is confirmed by pension consultants who report that benefits accrued under traditional defined benefit plans are the most misunderstood and unappreciated benefits in a worker's compensation package. Davis, supra note 32, at 2.

162. See infra notes 195-201 and accompanying text.

that most cash balance plans are established as converted traditional defined benefit plans rather than as newly established plans supports this assertion.\textsuperscript{164}

Although reducing operating cost is a reasonable consideration for employers and company executives, the use of plan assets to improve the financial position of a company is extremely controversial. Since there is a prohibition against reducing past accrued benefits, future plan costs must be reduced in order to increase plan savings or create plan surpluses. However, reducing future accruals to save future plan costs at the expense of certain plan participants has raised many serious legal, policy, and equity concerns in connection with cash balance plan conversions.

B. The Controversy

Proponents of cash balance plan conversions argue that cash balance plans are responsive to the needs of younger, more mobile workers who are disadvantaged under the traditional defined benefit plan model.\textsuperscript{165} They espouse the employers' position that cash balance plans provide simpler and relatively more valuable retirement benefits for many workers.\textsuperscript{165} Proponents further maintain that the fact that employers bear the risk of shortfall in cash balance plans justifies any gain that they may realize on plan conversion.\textsuperscript{167}

\textsuperscript{164} See Forman & Nixon, supra note 25, at 407 (describing the cost savings available in converting defined benefit plans to cash balance plans). But see Watson Wyatt Report, supra note 49, at ii (finding the average employer saved only 1.4% in costs in converting a defined benefit plan to cash balance plan).

\textsuperscript{165} See Richard C. Shea et al., Age Discrimination in Cash Balance Plans: Another View, 19 VA. TAX REV. 763, 764 (2000) (arguing that traditional defined benefit plans disproportionately disadvantage younger employees by constraining worker mobility and forcing employees to stay with one employer because of the "backloading" inherent in defined benefit plans); cf. Zelinsky, supra note 27 (arguing that cash balance plan conversions are disadvantageous to older employees).

\textsuperscript{166} See supra Part I.

\textsuperscript{167} Langbein & Wolk, supra note 2, at 952 (citing Daniel Fischel & John H. Langbein, ERISA's Fundamental Contradiction: The Exclusive Benefit Rule, 55 U. CHI. L. REV. 1105, 1149-52 (1988)).
Critics of cash balance plan conversions argue that when plan savings occur on plan conversion, they are unjustly generated at the expense of certain workers. Some critics maintain that this result is particularly egregious since plan participants may have accepted lower wages in reliance on the receipt of their projected retirement benefits. Thus, opponents believe many conversions are merely an unobtrusive way for companies to reduce the retirement benefits of older workers while appearing to improve the plans they sponsor. Additionally, some opponents argue that the conversions of traditional defined benefit plans to cash balance plans are effectively plan terminations, and as such should be subject to similar constraints and tax treatment as those imposed when traditional defined benefit plans terminate.

168. See Statement of Karen W. Ferguson, supra note 36 (arguing that conversions to cash balance plans by corporations have adverse effects on older employees); Zelinsky, supra note 27 (arguing that cash balance plans are disadvantageous to older employees); Hybrid Pension Plans: Hearing Before the Comm. on Health, Education, Labor, and Pensions, 106th Cong. 146-48 (1999), available at http://www.aarp.org/wwstand/testimony/1999/092199.html (last visited Aug. 17, 2001) (statement of American Association of Retired Persons) (arguing that older workers will inevitably face reductions in plan benefits due to conversion to cash balance plans).

169. But see Vineeta Anand, Potential Reductions Weren't Disclosed, 20 PENSIONS & INVESTMENTS, June 26, 2000, at 13 (stating that “the majority of companies did not save pension costs by switching to cash balance plans in the short term”).

170. Jonathan Barry Forman, Senate Finance Committee Gives Green Light to Cash Balance Conversion, 89 TAX NOTES 141, 142 (2000) (noting that “for many years after the conversion, [employees] will not see any increase in the present value of their retirement benefit”); see supra Part II.D.

171. See infra notes 227-34 and accompanying text.

172. See Anand, Winners and Losers, supra note 163, at 20 (comparing and contrasting the differing viewpoints regarding cash balance plan conversion). Proponents of cash balance plans argue conversion to a cash balance scheme benefits all employees more than conversion to a defined contribution plan. See id.

173. See generally sources cited supra note 164. Currently, upon plan conversion, employers benefit from plan surpluses without the imposition of the
IV. THE CONTROVERSIAL ISSUES

A. The Impact of Plan Conversion on Older Workers

Because of their disparate impact on older workers, there is concern that cash balance plan conversions are particularly unfair to these employees. This concern has led to some of the most contentious debates regarding cash balance plan conversions. There are three different reasons older participants are more severely affected by cash balance plan conversions than younger participants. The first relates to the fundamental design of the cash balance plan. As described above, in cash balance plans annual interest credits accrue with the annual benefit credits. Accordingly, the more years remaining before retirement the greater the value of the interest accrual will be. Therefore, when annual contributions and the annual interest credits associated with them are converted into an accrued benefit payable at normal retirement age, the accrual rates of younger participants will be higher and those of older participants will be lower.

The effect of "wear-away" periods is the second age related issue raised by cash balance plan conversions. However, unlike the issue regarding the discount period,

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174. See Davis, supra note 32, at 1 (arguing for the implementation of an "individual advantage" design in order to correct the discrepancies in cash balance plans between older and younger employees).

175. Age discrimination in pension plans is prohibited by the Internal Revenue Code, the ADEA, and ERISA, which specifically provide that "a defined benefit plan shall be treated as not satisfying the requirements . . . if under the plan, an employee's benefit accrual is decreased, or the rate of an employee's benefit accrual is reduced, because of . . . age." I.R.C. § 411(b)(1)(H) (1994); 29 U.S.C. § 623 (1994); ERISA § 204 (B)(1)(H), 29 U.S.C. § 1054(b)(1)(h) (1994).

176. As is the case with all defined benefit plans, the accrued benefit under the plan is calculated as an annual benefit payable at normal retirement age. See I.R.S. Notice 96-1, 1996-1 C.B. 359.

177. This relationship prevents "backloading," which is the practice of designing a plan to accrue benefits disproportionately toward the end of an employee's working career. Backloading is viewed suspiciously because it has the potential to circumvent the vesting rules. See Forman, supra note 132, at 388-93 (discussing the implications of backloading in traditional defined benefit plans).

178. See Drigotas, supra note 30, at 115.
the wear-away problem relates specifically to plan conversion rather than plan design.\textsuperscript{179} A wear-away period prevents employees from accruing new benefits under a converted cash balance plan until the accruals in the cash balance accounts exceed the value of the benefits already accrued under the prior accrual formula.\textsuperscript{180} Participants who terminate employment during the wear-away period are entitled to receive the larger of the two benefits.\textsuperscript{181} Consequently, some participants may have to work several years before earning pension benefits beyond those already accrued at the time of conversion, while other participants working during the same period may immediately accrue benefits under the new accrual formula.\textsuperscript{182} Since older workers generally have accrued larger benefits before conversion, their wear-away periods tend to be longer than those of their younger counterparts.\textsuperscript{183} Wear-away periods created at plan conversion are also more burdensome for older workers because they coincide with their later years of employment. As a result, they are more likely to interrupt the compounding effect of higher pay and greater service on the benefit accruals of older workers.\textsuperscript{184}

Related to the wear-away issue are concerns about the manner in which the opening balances of the cash balance plans are calculated on plan conversion. When traditional defined benefit plans are converted to cash balance plans, an opening account balance is established for each participant.\textsuperscript{185} The balance is determined by calculating the lump sum present value of each participant's accrued benefit under the existing defined benefit plan as of the date of conversion. To calculate the present value of the accrued benefit, an interest rate assumption is used.\textsuperscript{186}

\begin{itemize}
\item \textsuperscript{179} See Arcady & Mellors, supra note 46, at 25.
\item \textsuperscript{180} See id.
\item \textsuperscript{181} See id. at 24; see also Forman & Nixon, supra note 25, at 403 n.106 (providing a detailed example of the effects of a wear-away period) (citing I.R.S. Notice 96-8, 1996-1 C.B. 359).
\item \textsuperscript{182} See GAO REPORT 2000, supra note 32, at 28.
\item \textsuperscript{183} Arcady & Mellors, supra note 46, at 24.
\item \textsuperscript{184} See GAO REPORT 2000, supra note 32, at 28.
\item \textsuperscript{185} LANGBEIN & WOLK, supra note 2, at 61-62; see also Arcady & Mellors, supra note 46, at 24.
\item \textsuperscript{186} The interest rate can differ from the interest rate assumed for funding purposes. However, the interest rate must be reasonable.
\end{itemize}
Employers have discretion in the selection of the interest rate assumption, and their selection can significantly affect the lump sum present value of the accrued benefits.\textsuperscript{187} The higher the investment rate assumption, the smaller the initial lump sum present value.\textsuperscript{188} If the interest assumption used to calculate the opening account balances is less conservative than the one used in connection with the funding of the existing defined benefit plan, there can be substantial savings for the employer.\textsuperscript{189} For instance, the lump sum present value of an accrued benefit payable in ten years calculated using a 20\% rate of return equals roughly one-half of the value determined using an interest rate of 12\%.\textsuperscript{190} Therefore, the selection of the assumptions used in calculating the opening account balances can exacerbate the disparate impact of the wear-away period on older workers.

Finally, a third issue raised by cash balance plan conversions that disproportionately affects older workers is the elimination, or reduction, of subsidized early retirement benefits.\textsuperscript{191} Early retirement incentive programs are structured in a variety of ways. Some plans offer early retirement programs based on years of service alone. For example, a "thirty and out" program would allow a worker with thirty years of service to retire with full benefits, regardless of age. Other plans combine age and service requirements. For example, under an age fifty-five and twenty year program, a forty-five year old employee with twenty years of service would be ineligible to receive early retirement benefits.

An early retirement benefit is calculated by computing a participant's accrued benefit payable at normal retirement, based upon her service and compensation as of the early retirement date. Then, using actuarial assumptions for interest and mortality, the normal retirement benefit is reduced to reflect the fact that

\textsuperscript{187} The rule of thumb that actuaries use is that a 25\% change in the interest rate assumption is a change in liabilities of approximately 6\% in a valuation period. \textsc{Stuart G. Schoenly}, \textit{Pension Topics} 18 (1991) (Society of Actuaries No. 460-24-91).

\textsuperscript{188} See \textsc{Forman & Nixon}, \textit{supra} note 25, at 403-04.

\textsuperscript{189} See \textit{id}.

\textsuperscript{190} For detailed discussion of present value see \textsc{Stephen B. Cohen}, \textit{Federal Income Taxation: A Conceptual Approach} 200 (1989).

\textsuperscript{191} See \textsc{Zelinsky}, \textit{supra} note 27, at 699.
payment will begin sooner, and will be made over a longer period of time. The normal retirement benefit will also be reduced because the assets supporting the payments will earn less investment income prior to distribution. The amount of the reduction depends on the interest rate assumption and the age of the participant. For example, when a 6% interest rate assumption is used, the percentage reduction of the early retirement benefit is approximately 10% per year. Therefore, an early retirement benefit payable at age sixty is reduced to 50% of the normal retirement benefit payable at age sixty-five.

It is customary for traditional defined benefit plans to offer early retirement programs. Moreover, employers who sponsor traditional defined benefit plans often subsidize the cost of their early retirement benefits, making these benefits more valuable than their actuarially equivalent normal retirement benefits. An estimated 80% of Fortune 500 companies offering traditional defined benefit plans subsidize their early retirement benefits in some manner. The subsidy for these buyouts can account for as much as 50% of the plan’s current funding cost.

Most cash balance plans do not provide subsidized early retirement benefits. In fact, when conversions of traditional defined benefit plans occur, employers typically eliminate or cut back their subsidized early retirement benefits. This decision can significantly reduce plan liabilities and result in the creation of even larger plan surpluses for the employer. Although the anti-cutback rule that applies to past accruals also applies to plan enhancements, such as subsidized early retirement benefits, the rule does not require that plans continue to allow participants to accrue

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193. See id. at 448.
194. See id.
196. See id.
197. See id.
199. Arcady & Mellors, supra note 46, at 28.
early retirement benefits after the date of conversion. The anti-cutback rule only requires that participants who satisfy the conditions for the benefit before or after the amendment receive the value of the benefit accrued as of the date of the conversion. Thus, after conversion, plans must continue to provide early retirement benefits with respect to benefits accrued before plan conversion, but they are not required to count service after the conversion date toward early retirement benefit accruals. Participants with greater service and closer to early retirement eligibility are impacted more severely when employers eliminate or reduce subsidized early retirement benefits because they have less time to make up the difference with personal savings. Obviously, individuals in this situation are more likely to be older employees.

B. The Recapture of Excess Plan Assets

1. The Fiduciary Rules. The recapture and use of surplus pension assets is another issue at the core of the cash balance plan controversy. One of the primary goals of ERISA is to establish higher fiduciary standards in order to provide greater protection for retirement benefits. Thus, the essence of ERISA’s fiduciary law stems from a duty of loyalty, designed to protect pension funds against internal defalcation. However, some have argued that cash balance plan conversions give plan sponsors inappropriate access to pension assets, thereby circumventing ERISA’s fiduciary laws.

Section 401(a)(2) of the Internal Revenue Code provides that prior to the satisfaction of all liabilities of the plan, it

203. See Langbein & Wolk, supra note 2, at 646-47 (discussing the foundation of ERISA’s fiduciary law).
204. See Lurie, supra note 37, at 9.
shall be impossible for any part of the pension trust to be used for purposes other than the exclusive benefit of plan participants and their beneficiaries. 205

This provision, referred to as “the exclusive benefit rule,” is one of the principle features of ERISA’s fiduciary law.206 The exclusive benefit rule reflects the duty of loyalty found in the common law of trusts. The rule explicitly requires that the employer, and other individuals who have discretionary control over the management of the plan, administer the trust solely in the interest of plan participants and their beneficiaries.207

ERISA contains another provision closely related to the exclusive benefit rule that also restricts the use of pension assets. The “noninurement rule,” found in § 403(c)(1), provides that plan assets should neither “inure” to the benefit of an employer nor be held for the purpose of anyone except plan participants and their beneficiaries.208 Unlike the exclusive benefit rule, which applies only while a plan is ongoing, the noninurement rule applies at plan termination.209 The noninurement rule states that on plan termination “the assets of a plan shall never inure to the benefit of any employer and shall be held for the exclusive [purpose] of providing benefits to participants in the plan and their [beneficiaries].”210

The prohibited transaction rules are also an integral part of ERISA’s fiduciary law. These rules prevent any “party in interest”211 from borrowing, transferring, or using plan assets in any manner. The definition of “parties in interest” includes employers and other plan fiduciaries. Additionally, § 4975(c)(1)(D) and (e)(2)(C) of the Internal Revenue Code specifically provides that it is unlawful for the assets of a pension plan to be used for the benefit of “an employer whose employees are covered by the plan.”212 To

207. LANGBEIN & WOLK, supra note 2, at 678-79.
209. See LANGBEIN & WOLK, supra note 2, at 953.
211. See ERISA, § 3(14), 29 U.S.C. § 1002(14) (1994) (defining term to include fiduciaries, service providers, plan sponsors, and substantial owners of sponsoring firms); LANGBEIN & WOLK, supra note 2, at 701-13 (discussing the prohibited transaction rules). See ERISA § 406(a), 29 U.S.C. § 1106(a) (1994).
give force to the prohibited transaction rules, § 4975 of the Internal Revenue Code initially imposes an excise tax of 5% on all prohibited transactions. If, however, the prohibited transaction is not corrected within a specified period of time, § 4975 imposes a tax of 100%.\footnote{213. Id.}

The accounting rules under the Financial Accounting Standards Board ("FASB 87") create tension with both the exclusive benefit rule and the prohibited transaction rules.\footnote{214. See Financial Accounting Standards Board, Employers' Accounting for Pensions (1985) (Statement No. 87, 1985).} Although employers are not permitted to directly use pension assets for the benefit of their companies, they are required by FASB 87 to report the pension earnings on their companies' financial statements.\footnote{215. Id.} Therefore, there is an inherent conflict in the different roles of the employer. On the one hand, as a fiduciary for the company, the employer is obligated to act in the interests of the corporate shareholders and produce pension surpluses to be reflected in the financial statements.\footnote{216. In the June 15, 1999 Wall Street Journal, Ellen Schultz stated that "[s]witching to Cash Balance Plans has fattened many pension plan surpluses. Of the 12 pension plans with the largest surpluses, 10 are cash balance type plans." Ellen Schultz, Accounts That Are in Surplus Because of Bull Market Yield Credit for Employer, WALL ST. J., June 15, 1999, at A1. In the same issue, US West's benefit director stated, "[f]or years, people saw the pension as a bucket of money you can't touch ... [but now companies] are looking to not leave the asset dormant, but use it to deliver better returns for the company." Id. The senior vice president of Bank of America, Corp. stated "[t]o the extent that we have pension income instead of pension costs, it improves our earnings." Id. } On the other hand, as an ERISA fiduciary, the employer is obligated to operate exclusively in the interests of plan participants and their beneficiaries, using the pension surpluses to increase benefits or secure the funding of the plan.\footnote{217. ERISA § 404(a)(1), 29 U.S.C. 1104(a)(1) (1994).}

Thus, when traditional defined benefit plans are converted to cash balance plans as a method of generating profits for the benefit of the company and shareholders, some would argue there is a breach of duty.\footnote{218. See Statement of Karen W. Ferguson, supra note 36, at 108.} However, even if one does not believe that ERISA's fiduciary rules prohibit employers from creating and using surplus plan assets in this manner, at a minimum, the use of qualified
plans to generate profits to enhance the financial position of the company entirely at the expense of plan participants who may have accepted lower wages in reliance on these benefits, would seem to contravene the spirit of ERISA's fiduciary law.\textsuperscript{219}

2. Overfunding in Traditional Defined Benefit Plans. Although employers are permitted to recapture surplus defined benefit plan assets on plan termination, the pension law strongly discourages employers from doing so. There are provisions designed to discourage both the creation of funding excesses and the recapture of those assets from traditional defined benefit plans. Some of these provisions were a part of pension law well before the passage of ERISA. These provisions raise questions about the extent to which employers should be permitted to benefit from funding surpluses that are created or increased after plan conversions.

Section 404 of the Internal Revenue Code reflects the pre-ERISA bias against overfunding. This section imposes a ceiling on the deductibility of an employer's annual contributions to a qualified plan.\textsuperscript{220} Employers are permitted to deduct only amounts that fall within permissible limits. An employer is never permitted to deduct amounts in excess of the full funding limitation. A plan is considered fully funded when the plan's assets equal the plan's accrued liabilities.\textsuperscript{221} Thus, a plan can become fully funded if the assets appreciate suddenly or if the experience of the plan relative to the actuarial predictions is unexpectedly favorable.

As a result of continued concern that the funding rules permitted employers to build-up excess assets in their pension plans, the Pension Protection Act of 1987 made significant changes to the full funding limitation.\textsuperscript{222} This

\textsuperscript{219}See infra notes 227-29 and accompanying text.
\textsuperscript{220}This limitation existed prior to the passage of ERISA. Although the primary focus of ERISA was to ensure that defined benefit plans were not underfunded, ERISA also addressed overfunding.
\textsuperscript{221}The accrued liability is the difference between the present value of the projected retirement benefits and the present value of the future normal cost of the plan, where the normal cost is defined as the cost of maintaining the plan for a given year. See I.R.C. § 412 (1994 & Supp. III 1997).
legislation placed greater restrictions on funding strategies by introducing the concept of "current liability." Under the current liability approach, contribution levels are limited by treating the plan as if it terminated. Accordingly, the plan's obligations are determined without regard to projections of future service and salary increases.

One of the rationales for the deductibility limitation was that contributions in excess of the deductible limits were likely to create funding surpluses. Funding surpluses are considered harmful primarily because they are believed to create incentives for employers to terminate their plans in order to recapture the excess plan assets. When recapture occurs, employees could be worse off than they would have been if there had been no plan at all, or if the plan had been less generously funded. This is because they may have accepted lower wages and saved less in reliance on their expected retirement benefits.

There are numerous theories that explain how lowered wages fund the cost of plan benefits. One view is that participants give up wages in an amount that equals the value of the benefits that accrue each year. Other theories...
maintain that the reduction in a participant’s wages equals the level payments needed to fund the projected benefit.\textsuperscript{228} Under this theory, a participant’s current wages would be reduced by the level amounts necessary to fund the amortized payments of the expected retirement benefit.\textsuperscript{229} While reduced wages and participant reliance are problematic in any plan termination, including plans that terminate with insufficient assets, they are particularly troublesome in over-funded plans because the assets are available but nevertheless not used for the benefit of plan participants, or for their beneficiaries.

Another reason for the limitation on deductions in pension plans is that Congress is unwilling to subsidize the cost of inappropriately large benefits through the favorable tax treatment of qualified pension plans.\textsuperscript{230} Thus, even in the absence of concerns about the possibility of reversion, policymakers do not believe that the public interest is best served by extending tax benefits to unlimited contributions. In tax qualified plans, annual contributions are not taxed until the employee receives them, and the income on the contributions is generated tax free.\textsuperscript{231} The purpose of the favorable tax treatment of qualified plans is to provide incentives for employers to maintain plans that enable low and moderate income employees to have adequate retirement savings. However, without deductible limitations, employers would be able to invest excessively large amounts in their plans, essentially amounting to tax free savings accounts.\textsuperscript{232} To further discourage overfunding in defined benefit plans, the Tax Reform Act of 1986 added a 10\% excise tax on nondeductible contribution to qualified plans.\textsuperscript{233} The tax is cumulative and applies to both the nondeductible contributions for the current year, as well as to contributions made in prior years which have not yet

\textsuperscript{228} See infra notes 297-99 and accompanying text.

\textsuperscript{229} For example, using the accrued benefit formula in the above example, assume that the projected benefit based on thirty-five years of service is $350, and the first year's amortization of this benefit is $315. As a result the employee's wages would have been reduced $315 annually. Consequently, after one year, if the plan terminates the employee theoretically would be entitled to receive a benefit almost four times greater than the $10 accrued under the plan. See id.

\textsuperscript{230} Jefferson, supra note 223, at 39.

\textsuperscript{231} I.R.C. §§ 72(t), 401(a) (1994 & Supp. IV 1998).

\textsuperscript{232} See LANGBEIN & WOLK, supra note 2, at 346.

\textsuperscript{233} I.R.C. § 4972(c)(1)(B) (1994).
become deductible.\footnote{See id; see also LANGBEIN & WOLK, supra note 2, at 390.} As a result, in some situations the excise tax can apply to a single contribution for a period of several years.

3. Reversions in Traditional Defined Benefit Plans. The principal statutory limitation on asset reversion in traditional defined benefit plans is found in § 4011(d)(2) of the Internal Revenue Code. This section provides that a reversion of excess assets is prohibited until all liabilities to participants and their beneficiaries are paid.\footnote{I.R.C. § 411(d)(2) (1994).}

The Treasury Regulations explain that employers are permitted to recover on plan termination any balance that is due to “erroneous actuarial computation.”\footnote{Treas. Reg. § 1.4011-2(b) (as amended in 1981).} The Internal Revenue Service interprets “erroneous actuarial computation” very broadly, so that effectively all assets in excess of plan liabilities are attributed to actuarial error. Thus, when overfunded defined benefit plans terminate, all of the surplus assets can revert to the plan sponsors.\footnote{Plan surplus assets can revert only after the payment of all accrued benefits. See 48 C.F.R. § 9904.412-50 (1999).}

Recaptured surplus assets are counted as income to the corporation and are subject to the corporate income tax.\footnote{See GAO REPORT 2000, supra note 32, at 12 (discussing the requirements related to the reductions in pension benefits).}

In addition, an asset reversion excise tax of up to 50% is levied on the same assets, if certain conditions are not met.\footnote{See ERISA, § 403(c)(1), 29 U.S.C. § 1103(c)(1) (1994 & Supp. V 1999). From an ongoing plan, amounts contributed by mistake can be recovered by an employer within a specified period. Id. § 403(c)(2)(A), 29 U.S.C. § 1103(c)(2)(A) (1994); see also Jefferson, supra note 223, at 13 (providing detailed analysis of the reversion requirements).}

Although there have been proposals to allow withdrawals of surplus assets from ongoing plans, under existing law, plan termination is a prerequisite for the recovery of surplus assets.\footnote{See 48 C.F.R. § 9904.412-50 (1999).}

This requirement makes it possible for Congress to regulate the asset recovery and to protect plan participants when assets are diverted away from pension plans. Employers are permitted to recover excess assets only when the plan documents explicitly provide for reversions, and the reversions do not conflict
with any other provision of the law.\textsuperscript{241} Also, in the event of plan termination, or partial termination, employers are required to vest all affected participants in their accrued benefits, to the extent that the benefits are funded. This rule was designed to discourage employers from using plan termination or mass lay-offs to prevent participants from vesting in their pension rights in an effort to save plan costs.\textsuperscript{242} Thus, for example, a participant who is 25\% vested normally would receive only 25\% of her accrued benefit if she terminated employment with the employer. However, if the plan terminated, the employee would be entitled to receive 100\% of her accrued benefit.

The asset reversion tax further discourages the termination of overfunded defined benefit plans.\textsuperscript{243} The asset reversion tax was introduced in 1986 as a flat rate tax of 10\% on all excess amounts recovered by employers from qualified plans.\textsuperscript{244} The reversion tax was later increased to 15\% in 1988.\textsuperscript{245} Later, the Omnibus Reconciliation Act of 1990 combined a flat rate excise tax with an optional provision for using a portion of the surplus to increase the accrued benefits of plan participants as a quid quo pro for reduced rates.\textsuperscript{246} The Act amended the 15\% rate to 20\%, conditioned upon the employer's transfer of 25\% of the total

\begin{itemize}
\item \textsuperscript{241}See LANGBEIN & WOLK, supra note 2, at 953.
\item \textsuperscript{242}Prior to 1990, the IRS used a bright line test to determine whether a partial termination had occurred. If the percentage of participants excluded from the plan equaled at least 50\% for any reason, it was considered a constructive partial termination. The Service abandoned the bright line test and now looks to see if there is a substantial rate of turnover. See LANGBEIN & WOLK, supra note 2, at 143. A partial termination occurs whenever a substantial number of participants is excluded from a plan. See id. The regulations prescribe a special rule that states “if a defined benefit plan ceases ... future benefit accruals under the plan ... is created or increased.” Treas. Reg. § 1.411(d)-2(b)(2); I.R.C. § 411(d)(2)(b) (1994); see also LANGBEIN & WOLK, supra note 2; Karen W. Ferguson & Karen D. Friedman, Center Clarifies Comments on Cash Balance Plan Conversions, TAX NOTES TODAY, Feb. 24, 2000, at 2000 TNT 37-61 (arguing that cash balance plans amount to partial terminations under the treasury regulations).
\item \textsuperscript{243}See I.R.C. § 4980 (1994).
\item \textsuperscript{244}See id.
\item \textsuperscript{245}See Pub. L. No. 100-647; I.R.C. § 6069(a) (1994).
\item \textsuperscript{246}The excise tax applies on plan termination as well as on partial plan termination. See generally Norman P. Stein, Reversions from Pension Plans: History, Policies and Prospects, 44 TAX. L. REV. 259 (1989) (evaluating pension reversions in regards to tax policy issues).
\end{itemize}
assets recaptured on plan termination to a qualified replacement plan. Alternatively, for the 20% rate, an employer can provide a pro-rata benefit increase to the accrued benefits of plan participants of at least 25% of the recovered assets.

Thus, the pension law has responded to concern about funding surpluses by permitting them on the one hand, but by denying current deductions for them and imposing an excise tax on the other. The combination of the deduction restrictions and the excise tax on nondeductible contributions has made overfunding much less likely to occur. Similarly, the law allows reversions, but the vesting rules and the excise tax on reversions have made the recovery of excess assets from qualified pension plans far less appealing for plan sponsors.

4. Pension Surpluses in Cash Balance Plans. Although limitations on deductibility and current liability restrictions remain a part of current pension law, the motivations for an employer to establish a retirement plan have changed. Pension plans are no longer viewed by plan sponsors as business expenses or as opportunities for large tax deductions, but rather as sources of revenue for their companies. Last year, the combined pension surplus, which is the amount by which pension assets exceed pension liabilities, reached more than $100 billion for the Dow Jones Industrial Association companies ("DJIA").

247. See Jefferson, supra note 223, at 74 n.195 and accompanying text.
248. See id.
249. Sections 404(a)(1) and (a)(3) disallow a deduction in the current year; however, any excess may be carried forward and deducted in succeeding years subject to the normal limitations on the maximum deductions. I.R.C. §§ 404(a)(1), 404(a)(3) (1994 & Supp. III 1997).
251. The three main components of a company's pension cost are the service cost, or the cost of benefits earned by workers during the current year, the interest expense on the deferred benefits, and the return on pension fund investments. At the DJIA companies, the expected return on pension fund investments of $34 billion last year alone was more than enough to offset interest costs of $23.7 billion and service costs of $8.3 billion. See Anand, Bottom Line, supra note 250. Some of these companies reported having pension income exceed total corporate income by as much as 10%. This figure was up from $24 billion in prior years. See id.
discussed above, when companies convert their traditional
defined benefit plans to cash balance plans, they frequently
increase pension income and create large pension
surpluses. For example, when IBM converted its
traditional defined benefit plan to a cash balance plan, it
increased its profits by $200 million dollars per
year. A study conducted by The Watson Wyatt Company showed
that as many as 40% of the companies that had converted
to cash balance plans had pension income. Of the twelve
pension plans in the private pension system that have the
largest surpluses, ten are cash balance plans.

While the accounting rules permit companies to include
pension income as part of their overall profits, companies
are not permitted to siphon surplus pension assets to pay
for other business expenses. However, in some instances
employers have used excess pension assets for purposes
that advance their business objectives. For example, some
have used these funds to selectively enhance benefits in
connection with early retirement incentive programs as
part of their conversion program. Critics contend that
when employers use pension surpluses to pay for such
severance costs, they are in violation of ERISA’s prohibited
transaction rules, as well as the Internal Revenue Code’s
exclusive benefit rule. Also troubling is the fact that when
employers are permitted to use pension surpluses in this
manner without having tax consequences, there is
inconsistent treatment among employers who are similarly
situated. Employers who terminate overfunded defined
benefit plans and replace them with defined contribution
plans are required to pay income and excise taxes on the
recovered amounts. However, employers who convert
their defined benefit plans and replace them with cash
balance plans are not. Although there are inherent

252. See supra Part II.C.
253. See Ferguson & Friedman, supra note 242.
254. William Peek, Jr., Market Investment Produces More Income Than
255. See Ferguson & Friedman, supra note 242.
257. See Vineeta Anand, Winners and Losers, supra note 163, at 20 (noting
that at the time of conversion many employers encourage employees to leave by
establishing early retirement incentive programs).
259. See supra notes 232-34 and accompanying text.
differences between defined contribution plans and cash balance plans, these differences would not appear to justify such vastly different treatment.\textsuperscript{260}

When company profits are primarily behind an employer's decision to convert a well-funded traditional defined benefit plan to a cash balance plan, it would seem that concerns similar to those associated with funding surpluses in ongoing defined benefit plans would register with policymakers. Accordingly, there should be similar limitations and disincentives for such practices.\textsuperscript{261} Whether funding surpluses are created through plan conversion or aggressive funding strategies, there is the potential that the funds will be used for the benefit of the employer and the shareholders, rather than for the plan participants and their beneficiaries. From the employees' perspective it is irrelevant whether a shortfall in the expected retirement benefits results from plan termination or from plan conversion. In both situations, plan participants have reasonably relied on the receipt of their expected retirement benefits and the funds are available but are not being used for their intended purpose.

Furthermore, cash balance plan conversions can be viewed as the functional equivalent of plan terminations.\textsuperscript{262} From the perspective of the affected employees, there is plan termination because no vestige of the pre-existing defined benefit plan survives the cash balance plan conversion. Also, a substantial number of participants have been excluded from the plan. This position is supported informally by descriptive literature written about cash balance plan conversions in which employers refer to the pre-existing defined benefit plan as the "old plan."\textsuperscript{263} Therefore, arguably, cash balance plan conversions implicate application of the rules that were specifically designed to prevent the employer and other plan fiduciaries from using plan assets for their own benefit at the expense of plan participants. They also implicate the application of the rules that were designed to discourage employers from freely using surplus plan assets for their own benefit. As a

\textsuperscript{260} See supra Part B of Introduction.
\textsuperscript{261} See infra Part V.
\textsuperscript{262} Treas. Reg. § 1.411(d)-2 (1977).
\textsuperscript{263} See Saxinger, supra note 25, at 369; Forman & Nixon, supra note 25, at 401; Zelinsky, supra note 27, at 702-03.
result, some maintain that the conditions for imposing the 100% vesting rules, and the excise tax on asset reversions, are satisfied on plan conversion.\footnote{264. See Ferguson & Friedman, \textit{supra} note 242.}

Even if the rules are not technically satisfied, however, policymakers should have the same concern about preventing employers from enjoying tax-free savings accounts in conversion situations. Just as in the case of asset reversion, the creation of plan surpluses to increase company profits allows employers to use tax subsidized funds for purposes inconsistent with the goal of the pension program, and deprives employees portions of their retirement benefits. Thus, the same bias against creating and recapturing surpluses in traditional defined benefit plans should exist against allowing employers to convert their plans to cash balance plans solely for the benefit of the company and the shareholders. Accordingly, employers should be discouraged from converting their plans to cash balance plans unless appropriate measures are taken to protect affected plan participants.\footnote{265. See infra Part V.} Without such restrictions, the current treatment of cash balance plan conversions appears to be unfair and inconsistent with existing pension policy.\footnote{266. See Jefferson, \textit{supra} note 223, at 18-19 (discussing the controversial implications of asset reversion in defined benefit plans).}

\section*{C. Employee Communication}

In addition to the substantive issues raised by cash balance plan conversions, the issue of employee communication has also been a subject of much debate.\footnote{267. See Drigotas, \textit{supra} note 30, at 39 (discussing the IBM cash balance plan conversion and many employees’ belief that the plan changes were inadequately explained).} One of the primary complaints made by employees affected by cash balance plan conversions is that they were unable to obtain adequate information regarding the changes to their existing plan and the impact of those changes on their expected retirement benefits.\footnote{268. \textit{Hybrid Pension Plans: Hearing Before the Senate Comm. on Health, Educ., Labor, and Pensions}, 106th Cong. 27-35 (1999) (statement of Janet Krueger) (describing complaints held by many of the effected IBM employees due to the cash balance conversion).} A survey of employers who
had converted their traditional defined benefit plans to cash balance plans revealed that in most cases, participants were provided only general information about the changes to their expected retirement benefits, although in some instances the changes resulted in as much as a 20% reduction. Furthermore, only 25% of employers provided sufficient information to enable plan participants to compare the benefits that they had already accrued under the existing accrual formula to those they could expect to accrue under the new formula. As a result of these practices, many of the cases highlighted in the media have dealt with employees who were as unhappy about the way their employer communicated the changes as they were about the changes themselves.

The Senate Finance Committee's version of the Retirement Security and Savings Act of 2000 addressed the problem of insufficient information regarding plan amendments. It included a provision which mandated more disclosure with respect to plan amendments that result in significant reductions in participants' projected retirement benefits. The bill required that employers give participants written notice regarding plan amendments that would decrease the rate at which future plan benefits accrue, including the reduction of plan enhancements such as subsidized early retirement benefits. The bill specifically required that, in the event of conversion from a traditional defined benefit plan to a cash balance plan, employees receive information that allows them to determine the impact of the change on their future benefit.

269. Vineeta Anand, Potential Reductions Weren't Disclosed, 20 PENSIONS & INVESTMENTS, June 26, 2000, at 20 (reporting on a survey conducted by the UNIFI Network of 100 employers). The survey revealed that less than 33% of the employers modifying their traditional defined benefit pension plans gave employees detailed information about the changes. See id.

270. See id. at 20.


273. See id.
However, to date, legislation that requires employers to provide complete and accurate information specific to each participant after conversions occur has not been passed.\textsuperscript{275}

\section*{V. PROPOSAL}

The cash balance plan concept itself is not problematic. However, conversions of well-funded traditional defined benefit plans to cash balance plans can be problematic for the reasons discussed above.\textsuperscript{276} However, this result is not inevitable. The pension law could be changed to correct these deficiencies without discouraging the use of cash balance plans as alternative retirement savings instruments. The adoption of more stringent disclosure requirements and a floor on the reduction of participants' expected retirement benefits would eliminate some of the concerns surrounding cash balance plan conversions. This approach would ensure that plan participants receive retirement benefits that better approximate their expected benefits. Additionally, this approach would bring the treatment of cash balance plan conversions in line with other pension laws and policies.

\subsection*{A. Notification and Disclosure Requirement}

Although several cash balance plan conversions have received a great deal of attention as a result of well informed and technologically sophisticated employees who voiced concern about reductions in their accrued benefits publicly, these cases represent the exception rather than the rule.\textsuperscript{277} Generally, employees do not fully understand or appreciate the impact of cash balance plan conversions on their expected retirement benefits until they are ready to retire. Better employer communication could easily rectify

\begin{itemize}
\item \textsuperscript{274} See id.
\item \textsuperscript{275} See infra Part V.A.
\item \textsuperscript{276} See supra Part IV.
\item \textsuperscript{277} Recognizing that the IBM employees were exceptional, an online magazine awarded the IBM employees with the "Disgruntled Employees of the Year" award. The IBM employees were recognized for their successful fight against a new cash balance pension plan. See Daniella Sessa, IBM Employees Honored for Protest Against Cash Balance Pension Plans, WALL ST. J., Dec. 31, 1999, at B2.
\end{itemize}
this situation. Unfortunately, however, many employers and consultants view the employees' failure to understand fully the effect of plan conversion on their projected retirement benefits as a distinct advantage.\(^{276}\)

For example, the *Wall Street Journal* reported that an actuary from a leading consulting firm stated at a professional meeting that cash balance plan conversions were particularly desirable because they “mask a lot of changes.”\(^{277}\) On another occasion, the *Wall Street Journal* reported actuaries from another firm explained: “It is not until they are ready to retire that [the employees] understand how little they are actually getting.”\(^{278}\) These remarks undoubtedly capture the sentiment of some employers who desire to mislead their employees when they convert their traditional defined benefit plans to cash balance plans.\(^{291}\)

One of the effects of the sudden popularity of cash balance plans is that the regulations regarding cash balance plan conversions have not kept pace.\(^{282}\) There is little regulatory guidance and only limited notice given to employees in connection with cash balance plan conversions.\(^{293}\) Neither the Internal Revenue Service nor the Labor Department has issued official guidance on cash balance plan conversions, and consumer groups have just begun to understand the impact of these plans on employee

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278. See Stein, supra note 139, at 30.

279. See id. In contrast, when employers terminate overfunded traditional defined benefit plans and replace them with defined contribution plans, employees can readily compare their projected benefits under the two plans.


281. See Ellen E. Schultz et al., *Cash Balance System's Effect on Older Workers Stirs IRS, Congress, EEOC*, WALL ST. J., Sept. 20, 1999, at A1 (reporting that, after news leaked that IBM was considering a cash balance plan conversion, employees discovered that a “pension calculator” had been removed from the company's internal computer system, presumably, to make it more difficult for employees to compute the value of their pensions).

282. See supra Part II.B.

benefits. As a consequence, affected plan participants currently have no source for unbiased information to help them determine if they are better or worse off as a result of a plan conversion.

The need for accurate and complete information about the impact of the changes is particularly acute since individual participants sometimes have a role in the selection of their retirement benefits under cash balance plan conversion schemes. For example, some employers allow participants to choose to remain in the existing plan until they retire, or for a specified period of years. Thus, the participant would need to have more than a general description of her benefits under each accrual formula to make an informed decision. This information is also essential for plan participants to calculate the amount of additional personal savings they may need to supplement their retirement incomes, as a result of the conversion.

The disclosure requirements under present law do not speak directly to cash balance plans or to cash balance plan conversions. However, they do set minimum guidelines that employers must follow concerning the type of information they must provide participants about their plans. ERISA explicitly requires that participants be given written summaries of their plans, referred to as summary plan descriptions. The Department of Labor regulations further require that the summary plan descriptions be "sufficiently comprehensive to apprise the plan participants of their rights and obligations under the plan."

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284. The IRS has indicated that it is waiting for Congress to enact legislation before it makes any rulings on cash balance plan conversions. See Arcady & Mellors, supra note 46, at 28.

285. See GAO REPORT 2000, supra note 32, at 26 (finding that many plan participants are given a significant role in choosing plan benefits, but that little if any information is provided in order to aid the employees in making an informed decision).


287. See supra Part IV.C.

288. See supra note 284.

289. GAO REPORT 2000, supra note 32, at 37.

290. See id. There is significant variation in the quality of information explaining the cash balance plan formula to plan participants. See id.
Interestingly, one of the developments of the conversion controversy has been the proliferation of websites that provide such information. Some of the websites have been dedicated to communication with employees regarding a specific employer; others have been established to give more general information on cash balance plan conversions. Some of the websites provide an explanation of the calculation of projected benefits, and include the actuarial tables used in these calculations.\textsuperscript{291}

As discussed earlier, the Senate version of the Retirement Security Act of 2000 included several provisions that impact cash balance plans, including a requirement that employers give written notice when there is a significant reduction in their projected retirement benefit.\textsuperscript{292} The bill also required that employers give affected participants “benefit estimation tool kits” that would enable them to determine the impact of the conversion on their projected retirement benefits.\textsuperscript{293} Although this information is helpful to affected plan participants, this disclosure requirement is insufficient because it relies on a self-help approach.\textsuperscript{294} If employees are unable or unwilling to use the “kit”, they will not have accurate and complete information about their expected retirement benefits. This situation could adversely impact their retirement security.

When employers convert traditional defined benefit plans to cash balance plans, the company is required to disclose the financial impact of the conversion in its financial statements.\textsuperscript{295} Thus, actuaries must quantify the financial effects of the conversion, including any transition benefits or changes in eligibility requirements adopted to

\textsuperscript{291} In many cases these websites have been designed by the affected employees, themselves. See Drigotas, supra note 30, at 39.
\textsuperscript{292} See Forman, supra note 272.
\textsuperscript{293} See id. at 141.
\textsuperscript{294} See id.
\textsuperscript{295} A company’s conversion from a traditional defined benefit pension plan accrual formula to a cash balance plan accrual formula generally constitutes a negative plan amendment, for which the company would recognize on its financial statements a prospective reduction in service costs. For such a conversion, a company must amend the existing plan to provide for the new benefit structure. See Arcady & Mellors, supra note 46, at 25. In accordance with Statement No. 132 of the FASB, a company must make necessary disclosures in the notes of the financial statements. See id. at 27.
protect older employees. However, there are no comparable requirements for disclosure to affected plan participants.

Employers should be required to provide meaningful disclosure about how a conversion will affect plan participants and their retirement expectations. A properly designed disclosure requirement should hold employers responsible for the dissemination of information that compares the benefits that participants accrued under the existing accrual formula to those that they will accrue under the new cash balance plan formula. This information should be individualized and not general. Furthermore, all information regarding any potential reductions in the expected retirement benefits of affected plan participants should be definite and quantifiable, regardless of how small. If, as a result of different interest rate assumptions or other adjustments, the opening account balance in the cash balance plan is less than the lump sum present value of the accrued benefit, participants should be notified and the difference should be explained. Also, employers should be required to notify participants if they qualify for transitional benefits for older workers.

Employers are likely to resist a disclosure requirement such as this one on the basis that this level of notification is too burdensome and expensive. However, employees are currently unable to make informed decisions regarding their retirements without specific information about their own circumstances. Thus, the importance of the need justifies the additional costs and administrative burden. Furthermore, it is likely that the information contained in the actuarial evaluations of cash balance plans could easily be adapted for this purpose.

296. The company generally discloses the financial effects in the pension footnote as a single line item in the reconciliation of the beginning and ending balances of the pension benefits obligation. If the amendment has a material effect on the financial statements, the company discloses the nature of the amendment and its effects on the projected benefits obligation and pension cost in the notes to the financial statements. See id. at 27-28.

297. See Stein, supra note 139, at 31 (stating that employees often do not understand the proposed plan amendments and likewise are not provided with sufficient explanation in order to understand proposed changes in pension coverage).

298. See supra Part IV.C.

299. Actuarial evaluations are extensive reports of defined benefit plans. There is a requirement that these reports be made periodically.
B. Reduction of Retirement Benefits

1. Current Trends. As explained above, when employers convert traditional defined benefit plans to cash balance plans, mid-career employees may experience the worst of both plans. They may be unable to benefit from the effects of higher earnings under the defined benefit plan formula, and they may have insufficient time to accrue adequate benefits under the cash balance plan formula. Thus, their benefits would be earned under each plan at periods when their accrual rates are lowest. Because future accruals are not protected under current law by the anti-cutback rules, employers who convert their plans are not required to provide relief to participants placed in this situation.

Although not required, some employers voluntarily design their cash balance plans to mitigate the effects of changing plan types on mid-career employees. Approximately two-thirds of the companies that convert their traditional defined benefit plans to cash balance plans offer transitional benefits to offset some portion of the effects of plan conversion on older employees. For example, some companies may permit older workers to remain in the existing plan for five to ten years. This solution provides full relief to some, but only partial relief to those who retire after the period expires. Participants who retire after the transition period still may experience a significant reduction in their expected retirement benefits because the switch for them would occur later in their careers, at a point when presumably their salaries would be higher.

Another method used by employers to address the effects of mid-career changes in pension coverage is to provide certain employees extra pay credits adjusted for age and service. Usually, these benefits are provided for a
specified period of time. For example, one company provided additional pay credits for individuals age forty-five and older with at least ten years of service. 306 This approach requires an actuary to determine the amount of transition benefit necessary to replace reductions in the expected future accruals of the affected plan participants. 307 Under this type of scheme, however, there is no relief for employees who miss the cut-off period.

Relatively few companies have taken the more aggressive approach of guaranteeing no reduction in the expected retirement benefit for all affected plan participants. 308 This can be accomplished by either keeping participants under the prior plan, or by offering the participant the greater of the benefits earned under both plans until they retire or terminate employment. This type of guarantee can also be accomplished by giving plan participants a choice of having their benefits accrue under the existing formula, or under the new cash balance plan formula.

2. A New Minimum Standard. As discussed above, unless some type of remedial measure is used to mitigate the adverse effects of plan conversion on older employees, they generally experience significant shortfalls in their projected retirement benefits as a result of plan conversion. 309 Projected retirement benefits in traditional defined benefit plans are determined by multiplying the projected years of service by the projected final pay. The projected benefit, not the accrued benefit, is the amount that plan participants bargain for, and rely upon for retirement planning purposes. 310 Employees accept lower wages and reduce their personal savings in exchange for their projected retirement benefits. As a result, their personal savings are likely to be less than they would be if

307. See supra Part IV.A (explaining upon cash balance plan conversion that an opening account balance must be established for each individual plan participant).
308. See GAO REPORT 2000, supra note 32, at 35 (noting 9% of the cash balance plans surveyed by the GAO provided this guarantee).
309. See supra Part V.B.1.
310. See Jefferson, supra note 223, at 24.
they had not expected the benefits promised by the plan. Thus, when employers convert well-funded traditional defined benefit plans to cash balance plans there should be a minimum standard that establishes a floor on the reduction of projected retirement benefits in the plan. This would ensure that all plan participants receive amounts more representative of the benefits on which they have reasonably relied. Additionally, in situations where the conversions of traditional defined benefit plans to cash balance plans create or increase plan surpluses, there should be a requirement that some portion of the surplus be used to increase the projected benefits of plan participants.

A minimum standard for the protection of plan participants in cash balance plan conversions should also eliminate the use of wear-away periods. It is difficult to defend a practice that results in certain participants being excluded from current accruals indefinitely, while other participants accrue benefits under the same plan formula during the same period. Wear-away periods create a perception of unfairness that potentially threatens the integrity of the private pension system.

The ban on wear-aways should also include early retirement benefits accrued before plan conversion. It has been argued by some that the elimination or reduction of subsidized early retirement benefits significantly contributes to the wear-away problem. This is because after conversion, the initial account balance of a

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311. See supra Part IV.B.3; see also Jefferson, supra note 223, at 24 (citing RICHARD A. IPPOLITO, PENSIONS, ECONOMICS AND PUBLIC POLICY 10-11 (1986), for the proposition that employees reduce personal savings in reliance on future pension benefits).

312. See Ellen E. Schultz & Glen Burkins, Critics of Cash-Balance Pension Plans Will Testify Before Senate Panel Today, WALL ST. J., Sept. 21, 1999, at A3 (noting that both IBM and Athena, Inc. converted to cash balance plans and offered employees the choice to remain in the old plan or convert immediately to the cash balance plan).

313. See supra note 175. For purposes of age discrimination, the protected age is forty. Thus, employers are not permitted to disproportionately reduce the accrued benefits of plan participants age forty and above when they amend their plans. However, individuals age forty and above comprise the group most likely to be adversely affected by changes in the accrual formula when traditional defined benefit plans are converted to cash balance plans. For this reason, many believe that cash balance plan conversions are per se discriminatory.

314. See Forman & Nixon, supra note 25, at 404 (providing detailed analysis of wear-away as they apply to cash balance conversions).
participant's cash balance plan account is based upon the benefit payable at normal retirement age.\textsuperscript{315} Thus, the initial account balance does not reflect the value of subsidized early retirement benefit accrued before conversion.\textsuperscript{316} As a result, a wear-away period will occur for some employees because their opening account balances in the cash balance plan are less than the values of their accrued benefits including the early retirement benefits under the traditional defined benefit formula. Consequently, in some instances it could take several years before the balance of the cash balance plan equals the value of the accrued benefit under the traditional plan at the time of conversion.\textsuperscript{317}

Assuming the elimination of all wear-away periods, a minimum reduction standard should be established to prevent older employees from experiencing the worst of both plans, due to plan conversion. The minimum standard would apply whenever a participant's accrued benefit under the traditional defined benefit plan formula was less than the accrued benefit under the cash balance plan. The minimum standard would require that employers guarantee all plan participants affected by the plan conversion a benefit at least as large as the average of the accrued benefit under the old accrual formula and the accrued benefit under the cash balance plan. This requirement partially corrects the effect of mid-career conversions that skew more valuable benefits to younger plan participants. This requirement also places a floor on the reduction of older participants' expected retirement benefits after plan conversion.

Additionally, to the extent that plan conversion creates or increases a plan surplus, an employer should be required to use a portion of that surplus to increase on a pro rata basis the projected retirement benefits of all affected participants. For example a flat rate of 10% could be used for this purpose. The requirement that a portion of the surplus be used to increase benefits could be structured similar to the tax on reversions under § 4980, in which the employer is given the option of using 20% of the surplus to increase benefits under the terminated plan in exchange for

\textsuperscript{315} See supra notes 27-29 and accompanying text.
\textsuperscript{316} See supra Part IV.A.
\textsuperscript{317} See Forman & Nixon, supra note 25, at 404-05.
a lower reversion tax rate.\textsuperscript{318} The increase in benefits assures plan participants of receiving some portion of plan surpluses generated by the conversion. This result is appropriate because the surpluses arguably were paid for, at least in part, by the plan participants who accepted lower wages on the belief that they would receive their projected benefits when they retired.\textsuperscript{319} Furthermore, having a requirement that employers use a portion of the surplus that was created or increased as a result of plan conversion is also more consistent with the treatment of overfunded pension plans and reversions of excess assets on plan terminations.\textsuperscript{320}

To illustrate the proposed minimum benefit on plan conversion, assume an individual age sixty has thirty years of service when her traditional defined benefit plan is converted to a cash balance plan on January 1, 2001. Further, assume at the time of conversion this individual’s annual accrued benefit under the traditional defined benefit plan formula was $11,600, payable at age sixty-five. Using a salary scale projection of 4\%, further assume that her projected retirement benefit was $15,700 per year, under this formula. Also assume that a 6\% discount rate was used to determine her opening account balance under the cash balance plan formula of $9000. Accordingly, her projected benefit under the proposed minimum standard is at least $10,400 per year. The following chart summarizes this example:\textsuperscript{321}

\begin{tabular}{|c|c|c|c|c|c|}
\hline
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Defined Benefit Plan & & & & & \\
Accrued Benefit at Age 65 & $11,600 & $12,500 & $13,050 & $14,600 & $15,700 \\
Cash Balance Plan & & & & & \\
Accrued Benefit at Age 65 & $9000 & $9400 & $9700 & $10,100 & $10,400 \\
\hline
\end{tabular}

Under current law, if the employer instates a wear-away period, this participant would accrue no new pension

\textsuperscript{318} I.R.C. § 4980(d) (1994); see supra Part IV.B.3.
\textsuperscript{319} See supra Part IV.B.3.
\textsuperscript{320} The 10\% rate is consistent with the excise tax on nondeductible contributions under I.R.C. § 4972(a) (1994).
\textsuperscript{321} See Arcady & Mellors, supra note 46, at 26.
benefits during the five years subsequent to the plan conversion from November 1, 1999 to January 1, 2003. Thus, when she retires in 2003 she would receive a benefit of $11,600 per year, rather than her projected benefit of $15,700.

Under the proposal described above there would be no wear-away period. The participant would continue to accrue benefits after the date of conversion. Assuming the participant works until she reaches age sixty-five, her retirement benefit would be determined by averaging the two accrued benefits under both plans as of January 1, 2003. Therefore, her minimum retirement benefit would equal at least $13,050 per year. This represents a benefit amount that is less than it would have been under the traditional defined benefit plan accrual formula, but more than the accrued benefit under the cash balance plan accrual formula. Additionally, if the conversion of the traditional defined benefit plan to the cash balance plan created or increased a surplus, the participant's retirement benefit of $13,050 would be increased by her pro rata share of 10% of the surplus.

This result strikes a balance between what is optimal for the employer and what is optimal for the employee. This result would not appear to burden employers so severely that they would be discouraged from establishing cash balance plans. At the same time, this result provides significantly greater protection to the plan participants who are most vulnerable when their traditional defined benefit accrual formulas are converted to cash balance plan formulas. Also, the requirement that some portion of the surplus be used by the employer to increase the benefits of plan participants is responsive to concerns that reduced wages have funded the surplus. Finally, this result is more consistent with the treatment of overfunded plans and assets reversions because it prevents employers from creating and using funding surpluses without restriction.

322. \((15,700 + 10,400)/2 = 13,050\)

323. That is, she would have a minimum benefit of $13,050, which would actually be increased by her pro rata share of 10% from surplus.
Cash balance plans are hybrid plans designed to offer the best characteristics of both the traditional defined benefit plan and the defined contribution plan, while at the same time minimizing the less desirable features of each type of plan. Specifically, cash balance plans combine the portability and simplicity of defined contribution plans with the predictability and security of traditional defined benefit plans. Cash balance plans also eliminate the regulatory and administrative burdens of traditional defined benefit plans and the risk exposure of plan participants in defined contribution plans. As a result, cash balance plans are viable alternatives to traditional retirement savings arrangements.

However, the conversions of traditional defined benefit plans to cash balance plans are highly controversial. This is so not because of the inherent characteristics of cash balance plans but because of the disparate impact of plan conversion on older plan workers. Conversions of traditional defined benefit plans to cash balance plans can significantly reduce the expected retirement benefits of older plan participants. These employees often experience the worst of both plans when traditional defined benefit plans are converted to cash balance plans. This is because they are more likely to accrue their retirement benefits in each plan during periods when accrual rates are lowest. Another issue presented by cash balance plan conversions concerns the use of plan assets by the employer. When traditional defined benefit plans are converted to cash balance plans, plan surpluses frequently are created or increased as a result of the reduction of future plan cost. Because participants arguably have accepted lower wages in reliance on the receipt of their expected retirement benefits, and because the plan assets have received favorable tax treatment, the appropriate use of surplus plan assets created or increased in this manner raises many serious concerns.

Both proponents and opponents will acknowledge that employers have the legal right at any time to amend their retirement plans to use different accrual formulas, or even to completely terminate their plans without ever replacing them. Thus, the controversy over cash balance plans is not about whether employers can convert their traditional...
defined benefit plans to cash balance plans, but rather about that extent to which the rights and expectations of plan participant are protected when they do. Until this question is resolved, many employers who considered establishing cash balance plans as their primary retirement savings vehicles will be reluctant to do so because they fear negative publicity and the uncertainty of future regulation.

Notwithstanding the intensity of the debate surrounding cash balance plan conversions, it is possible to strike a balance between the interests of employers and those of employees when traditional defined benefit plans are replaced with cash balance plans. This can be accomplished by: (1) requiring that employers who convert their traditional defined benefit plans to cash balance plans provide sufficient notice to affected plan participants regarding the impact of the change on their projected retirement benefits; and (2) limiting the amounts by which the retirement benefit of affected plan participants can be reduced as a result of plan conversions. This proposed solution represents a compromise. It mitigates the effects of conversion on plan participants previously covered by traditional defined benefit plans but does not burden employers so severely that they would be discouraged from establishing or maintaining cash balance plans in the future.