

Second Circuit Holds That Cash Balance Pension Plans Do Not Violate ERISA's Prohibition on Age Discrimination

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The Second Circuit yesterday held that cash balance plans, a common form of pension plan, do not violate the Employee Retirement Income Security Act of 1974's ("ERISA") prohibition on age discrimination. Through yesterday's decision, which affirmed the district court decisions in *Hirt v. The Equitable Retirement Plan for Employees, Managers and Agents*, Docket No. 06-4757 (S.D.N.Y.), and *Bryerton v. Verizon Communications, Inc.*, Docket No. 07-1680 (S.D.N.Y.), the Second Circuit resolved a significant split among district courts in the Second Circuit. The Court joined the Third, Sixth and Seventh Circuits, which had previously addressed the issue, and significantly reduced the risk of liability to sponsors of cash balance plans.

BACKGROUND

ERISA recognizes two primary forms of retirement plans—defined contribution plans and defined benefit plans. A cash balance plan is a type of defined benefit plan that in the past two decades has become an integral part of corporate America's pension plan system, with over 1,900 cash balance and similar plans in existence as of 2005. One quarter of the total working population covered by defined benefit plans are cash balance plan participants.

In a cash balance plan, an employee's retirement benefit is reflected in a notional account. Generally, this notional account is made up of two credits: "pay credits" and "interest credits." Pay credits are based upon years of service, and are credited to an employee's notional account as a percentage of the employee's pay. (For example, an employee making \$50,000 annually who is entitled to a 5% pay credit will have \$2,500 credited to his or her notional account.) Interest credits are generally the same for all employees, and are credited to the notional account by applying a common interest rate to the account balances. Pay credits and interest credits are "deposited" into each participant's notional account on a regular basis. A participant earns pay credits as long as he or she remains an employee of the company. A participant continues to earn interest credits after he or she terminates employment and until he or she commences distribution of the retirement benefit.

ERISA § 204(b)(1)(H)(i) provides that "a defined benefit plan shall be treated as not satisfying the requirements of this paragraph if, under the plan, an employee's benefit accrual is ceased, or the rate of an employee's benefit accrual is reduced, because of the attainment of any age." In recent years, plan participants have relied on this provision of ERISA (among others) to challenge the legality of cash balance plans sponsored by numerous corporations, including AT&T, Citigroup, PriceWaterhouseCoopers and IBM.

These plaintiffs have argued that the term “benefit accrual” in ERISA § 204(b)(1)(H)(i) refers to the retirement benefit a participant would be entitled to receive at age 65 (the “age 65 benefit”). Thus, plaintiffs contend, cash balance plans must be analyzed by looking at the rate at which the participant’s “age 65 benefit” grows. Using this output-oriented approach, plaintiffs note that although two similarly-situated employees (with the same salary and same years of service) are entitled to the same pay credits and interest credits, a younger employee will have a larger “age 65 benefit” than an older employee—because the money contributed to the older employee’s notional account will have less time to earn annual interests credits under the plan than the money contributed to the younger employee’s account.¹

Plan sponsors have countered that under the plain terms of the relevant ERISA provision, “benefit accrual” does not refer to the end product—the “age-65 benefit.” Rather, it refers to the employer’s periodic contributions to the participant’s notional accounts (i.e., the pay credits and interest credits). Thus, any difference in the age-65 benefit that results from time and compound interest is not age discriminatory and does not violate ERISA.

Corporations accused of sponsoring age discriminatory cash balance plans face substantial monetary liability. For example, after a district court determined that an IBM-sponsored plan was age discriminatory, IBM entered into a partial settlement with plaintiffs pending appeal to the Seventh Circuit. Under the terms of the public settlement agreement, if the Seventh Circuit affirmed the district court’s age discrimination finding, IBM would provide plan participants with additional pension benefits that, along with attorneys’ fees, had an approximate value of \$1.7 billion—nearly \$1.4 billion more than IBM agreed to pay if the Seventh Circuit determined that the plan was not age discriminatory.²

A SPLIT WITHIN THE SECOND CIRCUIT

In 2006, Congress enacted the Pension Protection Act (the “PPA”) to specifically allow for cash balance defined benefit plans going forward. But the PPA did not resolve the question of whether, prior to June 29, 2005 (the effective date of the PPA), cash balance plans violated ERISA’s prohibition against age-based reductions in the rate of benefit accrual.

Before yesterday’s decision, three circuit courts of appeals had considered the question. The Third, Sixth, and Seventh Circuits each had determined that even prior to the PPA, ERISA did not prohibit cash balance defined benefit plans. See *Drutis v. Rand McNally & Co.*, 499 F.3d 608 (6th Cir. 2007);

¹ For example, a 45 year-old participant will have a larger benefit at age 65 than a 55 year-old participant with the same years of service and salary, because the 45 year-old will have 10 more years to earn interest credits before reaching age 65.

² The Seventh Circuit ultimately reversed the district court. *Cooper v. IBM v. Personal Pension Plan*, 457 F.3d 636 (7th Cir. 2006). Notwithstanding the positive decisions from the other circuit courts of appeals, the risk of substantial liability and uncertainty in the Second Circuit has led to significant settlements.

Register v. PNC Fin. Servs. Group, Inc., 477 F.3d 56 (3d Cir. 2007); *Cooper v. IBM v. Personal Pension Plan*, 457 F.3d 636 (7th Cir. 2006).³

District courts in the Second Circuit, however, have been split on the issue. Several district courts, including the courts that decided *Hirt* and *Verizon*, determined that pre-PPA cash balance plans were not age discriminatory. But at least four district courts determined that the Second Circuit's decision in *Esden v. Bank of Boston*, 229 F.3d 154 (2d Cir. 2000) – which addressed a different ERISA provision involving an “accrued benefit” and “normal retirement age” – required a finding that cash balance plans were age discriminatory. Compare, e.g., *In re Citigroup Pension Plan ERISA Litig.*, 470 F. Supp. 2d 323 (S.D.N.Y. 2006) (concluding cash balance plans violate ERISA § 204(b)(1)(H)), with *Amara v. Cigna Corp.*, 534 F. Supp. 2d 288 (D. Conn. 2008) (concluding cash balance plans do not inherently violate ERISA § 204(b)(1)(H)).

The Second Circuit heard oral argument on the *Hirt* and *Verizon* appeals in April 2008. These appeals gave the Second Circuit its first opportunity to weigh in on the issue and resolve the conflict among district courts.

SUMMARY OF THE OPINION

In its July 9 decision, the Second Circuit resolved the split in favor of cash balance plans: “We write today to clarify that we share the view of cash balance plans put forth by the Third, Sixth and Seventh Circuits: Even prior to the PPA, cash balance plans could survive scrutiny under ERISA § 204(b)(1)(H)(i).”

The Court specifically rejected the plaintiffs’ “output-oriented evaluation” and their interpretation of the term “benefit accrual.” The Court found that the plaintiffs’ interpretation of ERISA § 204(b)(1)(H)(i) improperly relied upon the statutorily defined term “accrued benefit,” used elsewhere in ERISA:

Because ERISA measures “accrued benefit” by reference to the ultimate retirement-age annuity, plaintiffs claim, we should apply the same test to our consideration of “benefit accrual”. . . . But Congress did not use the term “accrued benefit” when it drafted ERISA § 204(b)(1)(H)(i); rather, Congress used the term “rate of benefit accrual.”

Because “Congress knew how to reference accrued benefit,” but chose not to do so, the Second Circuit presumed Congress’s word choice was intentional and rejected plaintiffs’ argument. Moreover, the Court found, the key consideration in ERISA § 204(b)(1)(H)(i) was the *rate* of benefit accrual: “In this context, rate carries with it a temporal limitation: One cannot evaluate the rate of accrual without controlling for the passage of time. Thus, that the ultimate benefit might grow to be

³ Another case presenting this issue is currently pending before the Ninth Circuit. Oral argument was heard in that case in February 2008.

larger for younger employees—who have more time until normal retirement age than their older counterparts—would not be relevant to the comparison of accrual rates.”

Finally, although the Court found the statute to be unambiguous, the Second Circuit noted that ERISA’s legislative history is consistent with the plain meaning of the statute. Congress added ERISA § 204(b)(1)(H)(i) “to prohibit the creation of pension ‘cliffs’ from which 65-year old workers could fall [Thus,] it makes little sense to look at the accrued benefit—i.e., the annual benefit commencing *at* normal retirement age—as a reference point in evaluating whether there has been a reduction in the rate of benefit accrual.”

IMPLICATIONS

Yesterday’s decision resolves the question within the Second Circuit of whether cash balance pension plans violate the age discrimination prohibition of ERISA. In holding that cash balance pension plans do not run afoul of the age discrimination prohibition, the Second Circuit added to the increasingly overwhelming weight of authority resolving this question in favor of defendants/plans. In addition, through a summary order in *Hirt*, the Second Circuit held that the six-year statute of limitations for ERISA claims stemming from allegedly illegal plan provisions and allegedly insufficient notice of plan amendments can begin to accrue upon the distribution of a summary plan description (or potentially some other communication) alerting a participant to the fact that he “had received insufficient notice of a plan amendment or otherwise considered himself entitled to benefits other than those disclosed.” This additional ruling, while not binding authority, rejects the argument often advanced by plaintiffs that the statute of limitations in such cases can only begin to run when the plaintiff requests benefits from the plan.

For further information about this ruling, please feel free to contact members of the Firm’s Litigation Department, including:

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