SEYFARTH SHAW

MANAGEMENT ALERT

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First Circuit: Wear-Away To Cash Balance Plan Is Okay

Understanding the "Wear-Away" Concept

Serious issues can arise when an employer chooses to convert its traditional defined benefit (DB) plan to a cash balance plan. While the facts of each conversion to a cash balance plan vary significantly, a conversion typically entails establishing a hypothetical opening account balance based on a participant's accrued benefit under the traditional DB plan (*i.e.*, his or her protected benefit, usually expressed as a single life annuity payable at age 65) at the time of conversion.

BankBoston structured its pension plan conversion in 1989 to provide long-term participants with the greater of continuing the traditional DB benefit or a new cash balance benefit. In 1997, the bank determined that the "greater of" formula was too expensive and decided to freeze the continuing traditional DB accruals. For the plaintiff in *Campbell v. BankBoston*, and presumably for other similarly situated employees, this had the effect of cutting off new pension accruals indefinitely. This halt in accruals occurs when the value of the frozen traditional DB benefit would exceed the value of the cash balance benefit, even with additional benefit and interest accruals.

The First Circuit Court of Appeals, in *Campbell v. BankBoston, N.A.*, 2003 U.S. App. LEXIS 4027 (1st Cir. Mar. 7, 2003), held that the wear-away scheme in connection with the bank's cash balance conversion does not violate ERISA's anti-cutback provision. The Court did not decide the issue of whether a cash balance conversion gives rise to an ERISA age discrimination claim under the Older Workers Benefits Protection Act because the plaintiff did not raise it in the district court, but the Court of Appeals made a point of expressing its reservations about the merits of such a claim.

Alleged Violation of ERISA's Anti-Cutback Provision

In analyzing the impact of this wear-away scheme, the Court held that BankBoston's switch to a cash balance-only plan benefit did not result in any forfeiture of an accrued benefit in violation of ERISA's anti-cutback provision because "no accrued benefit benefits were reduced; only expected benefits were reduced, which BankBoston could, under the law, modify or eliminate." In other words, ERISA's anti-cutback provision protects only those pre-conversion benefits earned under the former traditional DB formula, not expected future unearned benefits under such formula after a conversion to a cash balance formula. As the Court noted, "for many workers, including [the plaintiff], their pension benefits stop accruing completely in their final years of service, when their expectation was that during these years, the benefits would build up the most."

We note that the IRS recently issued proposed anti-age discrimination regulations on December 11, 2002. These proposed IRS regulations, the subject of much debate, recognize that the possibility of a wear-away period for some or all participants affected by a cash balance conversion does not necessarily constitute a violation of ERISA's anti-cutback and anti-age discrimination provisions, provided each participant's hypothetical opening account balance under an eligible cash balance plan is not less than the actuarial present value of his or her pre-conversion accrued benefit at normal retirement age, using reasonable actuarial assumptions. Thus, in converting a traditional DB formula with a subsidized early retirement benefit to a cash balance

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formula, the proposed IRS regulations would permit the converted cash balance account to exclude the value of the early retirement subsidy, potentially resulting in a period where participants at early retirement ages experience wear-away in their annuity benefits.

Alleged Violation of ERISA's Anti-Age Discrimination Provision

The Court held that the plaintiff failed to properly raise his claim that BankBoston's cash balance conversion violated ERISA's anti-age discrimination provision. Nevertheless, stressing the likelihood of such a "sophisticated charge" being raised in the future, the Court seized the opportunity to briefly summarize the controversy. *In dicta*, the Court framed both sides' potential arguments.

Based on the "annuity method" for determining benefit accrual rates, the plaintiff attempted to claim that the bank's cash balance conversion violated ERISA's anti-age discrimination provision since older participants accrued less pension benefits following the conversion solely due to age. Under the annuity method approach, a participant's rate of benefit accrual is computed by converting his or her hypothetical account balance into an annuity beginning at normal retirement age. Taking into account the time value of money, a cash balance pay credit to a younger worker's hypothetical account will have a longer time to accrue interest, which will invariably result in a larger annuity upon retirement when compared to that same pay credit being applied towards the hypothetical account of a participant who is nearing retirement age. After outlining the potential ERISA age discrimination argument, the Court listed the following two possible counterarguments. First, based on statutory interpretation and legislative history, ERISA's anti-age discrimination provision may not even apply to workers younger than normal retirement age. Second, because different methods for calculating benefit accrual rates under ERISA exist, it is unclear whether the annuity method is the only method that can be used for such purpose. For example, the Court cited to the proposed IRS regulations, which permits the rate of benefit accrual under an eligible cash balance plan to be calculated as the annual additions to a participant's hypothetical account - akin to a defined contribution plan.

Conclusion

In light of the ongoing controversy surrounding cash balance conversions, *Campbell v. BankBoston, N.A*. buttresses a plan sponsor's argument in support of being able to convert its traditional DB plan to a cash balance plan. However, plan sponsors should continue to closely monitor any new developments in this area, especially claims asserting that a cash balance conversion violates ERISA's anti-age discrimination provision.

If you have any questions about cash balance plans and wear-aways, please contact the Seyfarth Shaw employee benefits group attorney with whom you regularly work, or any employee benefits attorney listed on the web site at www.seyfarth.com.

ATLANTA
One Peachtree Pointe
1545 Peachtree Street , N.E., Suite 700
Atlanta, Georgia 30309-2401
404-885-1500
404-892-7056 fax

BOSTON
Two Seaport Lane, Suite 300
Boston, Massachusetts 02210-2028
617-946-4800
617-946-4801 fax

CHICAGO
55 East Monroe Street, Suite 4200
Chicago, Illinois 60603-5803
312-346-8000
312-269-8869 fax

HOUSTON
700 Louisiana Street, Suite 3850
Houston, Texas 77002-2731
713-225-2300
713-225-2340 fax

LOS ANGELES
One Century Plaza
2029 Century Park East, Suite 3300
Los Angeles, California 90067-3063
310-277-7200
310-201-5219 fax

NEW YORK
1270 Avenue of the Americas, Suite 2500
New York, New York 10020-1801
212-218-5500
212-218-5526 fax

SACRAMENTO
400 Capitol Mall, Suite 2350
Sacramento, California 95814-4428
916-448-0159
916-558-4839 fax

SAN FRANCISCO
101 California Street, Suite 2900
San Francisco, California 94111-5858
415-397-2823
415-397-8549 fax

WASHINGTON, D.C.
815 Connecticut Avenue, N.W, Suite 500
Washington, D.C. 20006-4004
202-463-2400
202-828-5393 fax

BRUSSELS
Avenue Louise 500, Box 8
1050 Brussels, Belgium
(32)(2)647.60.25
(32)(2)640.70.71 fax