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WHOSE MONEY IS IT ANYWAY? THE CASE FOR A MORTALITY DISCOUNT FOR CASH BALANCE PLAN EARLY TERMINATION LUMP SUM DISTRIBUTIONS

William Handley Woolston*

I. INTRODUCTION

Over the last twenty years, the traditional career-focused employment model has changed, with employees becoming more transient than ever before. The likelihood that a particular employee will spend his entire career with one company and receive a traditional retirement benefit has steadily decreased. Over this same time period, many employers have created ERISA defined benefit plans known as cash balance plans. The plans resemble 401(k) plans in that the employee's benefit is expressed as an individual, albeit hypothetical, account. These plans have become popular, for both employees and employers, because of perceived cost savings; a perception which has resulted in millions of American employee participants in cash balance plans.

Since employees are likely to leave employment before retirement, ERISA provides for lump sum distributions of the employee's accrued benefit to be made when an employee terminates his employment with his employer. Cash-balance plan lump sum distributions are subject to ERISA defined benefit rules, which have resulted in litigation affecting millions of participants. This is because, while cash balance plans state the accrued

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benefit in terms of a hypothetical account balance, ERISA mandates that the lump sum payment be actuarially equal to an age 65 annuity. How a hypothetical account balance is translated into a present value amount equal to an age 65 annuity has been litigated in the courts and regulated by the Internal Revenue Service without complete satisfaction.

In August 2003, the 7th Circuit decided *Berger v. Xerox*,¹ a controversial case,² upholding a controversial and confusing rule concerning qualified cash balance plans; the Internal Revenue Service's (IRS) "whipsaw" rule. The Court also made another controversial and confusing ruling, by prohibiting the taking of a mortality discount in the calculation of early termination lump sum distributions.³

The holding in *Berger* has raised questions about benefit accrual and payout that have not been fully answered. It has been more than four years since *Berger* was decided, and neither Congress nor the IRS has spoken to clarify, affirm, or reject the controversial holding in *Berger* concerning mortality discount. The conceptual issue of "whipsaw" has been thoroughly litigated and is now well-settled. Mortality discount has not been litigated as often; *Berger* is the only appellate level case that discusses it. Similarly, much has been said in the academic world concerning "whipsaw" but little has been said about the necessity of a mortality discount to more accurately represent an employee's early termination lump sum entitlement.

Since August 2006, "whipsaw" and cash balance plans may no longer raise legal questions as they did for the preceding twenty years. On August 17, 2006, President Bush signed the Pension Protection Act (PPA) of 2006 into law. PPA featured drastic changes to ERISA and, in particular, set out new requirements for cash balance plans. As a result, Congress believes the thorny problems of "whipsaw" and mortality discount will be effectively solved for future years. However, Congress's opinion on this matter could be viewed with skepticism because of the ambiguous language used in its solution. "Whipsaw" is the more likely of the two

1. *Berger v. Xerox Corp. Ret. Income Guarantee Plan*, 338 F.3d 755 (7th Cir. 2003).

2. The Court upheld a \$300 million judgment against Xerox. *Id.* Judge Posner's opinion in *Berger* has been criticized for its lack of explicit reasoning and clarification. See Rosina B. Barker & Kevin P. O'Brien, *Berger v. Xerox: Looking for Law in All the Wrong Places*, 16 BENEFITS L. J. 5 (2003) (focusing primarily on the "whipsaw" rules and its associated problems, and exploring, in-depth, the mortality discount question hinted at in *Berger*). The opinion has contributed to rising costs to employers in the administration of their cash balance plans and has allowed employees to receive more money from their retirement plans than they truly deserve.

3. *Berger*, 338 F.3d at 764. This decision will be discussed at length later in this Article, but for now, note that this ruling is confusing because *Berger* required plans to calculate lump sum distributions for cash balance plans differently than other defined benefit pension plans by not permitting the mortality discount.

issues to have been solved legislatively, as Congress clearly explained its intent in this matter despite its ambiguous language. Additionally, PPA's solution to the cash balance lump sum distribution problem operates only prospectively; any claims made for conduct arising prior to PPA's effective date will still be litigated. Regardless, mortality discount will still be a litigated issue after PPA goes into effect because Congress did not discuss it explicitly. This Article will be helpful in crafting a judicial solution to the mortality discount problem; at the very least for those payments made prior to the PPA's effective date and perhaps those made after.

Part II of this Article will analyze the current state of the retirement plan industry, the historical background of ERISA and qualified retirement plans, and will conclude with the competing policy choices concerning risk allocation that have defined the main distinctions between defined benefit and defined contribution plans. Part II will also introduce and discuss ERISA-defined accrued benefits, the understanding of which is essential to comprehending the issues discussed in *Berger*. Part II also contains an introduction to traditional defined benefit plans, ERISA-mandated qualified death benefits for surviving spouses, a discussion of cash balance plans in general, and the motivation employers have cited in their decisions to adopt cash balance plans instead of traditional defined benefit pension plans.

The final sections of Part II will analyze one of the most interesting behavioral aspects of retirement plans: specifically, the rising tendency of individuals to terminate employment prior to reaching retirement age and their resulting decisions to elect lump sum distributions. Part II then analyzes the consequences of electing lump sum distributions and how they are valued under traditional defined benefit plans. Part II concludes by discussing lump sum valuation when the employer sponsors a cash balance plan.

Part III begins the discussion on the topics truly at issue in this Article with an analysis of *Berger*. Section A recalls the framework of accrued benefit analysis, and Sections B and C analyze "whipsaw" and the mortality discount to determine their status under the accrued benefit analysis. Discussion of PPA will be limited in Part III, as the main discussion of PPA will take place in Part V.

After completing an accrued benefit analysis, this Article in Part IV recommends the affirmation of the IRS "whipsaw" rules, but recommends the rejection of the 7th Circuit's prohibition against using a mortality discount in the determination of the amount of lump sum distributions made to employees who depart before the age of 65. Following these recommendations would result in more accurate payments to employees and lower costs for employers. Part V discusses PPA's effect on cash balance plans, outlines how lump sum distributions will be managed in

future years, and describes how this Article's conclusions will assist courts in deciding cases arising from pre-PPA conduct.

II. AN INTRODUCTION TO THE DEFINED BENEFIT WORLD

A. *The Current State of the Retirement Industry*

Defined benefit plans⁴ are a major element of the United States retirement industry, covering roughly 20% of all American workers.⁵ There are around \$1.6 trillion of assets in defined benefit plans, and almost 75% of the Fortune 500 companies have a defined benefit plan.⁶ Although defined benefit plans are a force to be reckoned with, the outlook for defined benefit plans is dire.⁷ The number of defined benefit plans is declining at an ever increasing rate,⁸ and the recent failure of pension plans from bankrupt companies, like United Airlines, have put a harsh spotlight on pension funding issues and whether defined benefit plans still have a place in the scheme of qualified retirement plans.⁹ Since the late 1980s, cash balance plans have been touted as a cheaper alternative to the traditional defined benefit pension plan, and many of these traditional

4. A defined benefit plan is a type of retirement plan that guarantees a participant an annual benefit, which is calculated under the terms of the plan and under the requirements of ERISA. For an in-depth discussion of defined benefit plans, see *infra* Part II.D.

5. STAFF OF JOINT COMM. ON TAXATION, 108TH CONG., PRESENT LAW AND BACKGROUND RELATING TO THE FUNDING RULES FOR EMPLOYER-SPONSORED DEFINED BENEFIT PLANS AND THE FINANCIAL POSITION OF THE PENSION BENEFIT GUARANTY CORPORATION ("PBGC") 44-48, (Comm. Print 2003) [hereinafter PRESENT LAW] (stating that "[t]he National Compensation Survey also found that, in 2000, among full-time employees in the private sector, 42[%] participated in an employer-sponsored defined contribution plan and 22[%] participated in an employer-sponsored defined benefit plan. Some employees participated in both."). The Bureau of Labor Statistics also states that 20% of workers participate in defined benefit plans as of March 2006. Bureau of Labor Statistics, National Compensation Survey: Employee Benefits in Private Industry in the United States, 7 T.2 (2006), <http://www.bls.gov/ncs/ebs/sp/ebsm0004.pdf>.

6. Edward A. Zelinsky, *The Defined Contribution Paradigm*, 114 YALE L.J. 451, 469-70 (2004).

7. *Funding Challenge: Keeping Defined Benefit Pension Plans Afloat: Hearing Before the S. Comm. On Finance*, 108th Cong. 37-38 (2003) (statement of Henry Eickelberg, Staff Vice President for Benefit Programs, General Dynamics Corporation, representative of the American Benefits Council) (stating that "[t]he total number of defined benefit plans has decreased from a high of 170,000 in 1985 to 56,405 in 1998 . . . and most analysts believe there are fewer than 50,000 plans in the U.S. today.").

8. *Id.* at 38.

9. *Promises, Ahem; Company Pensions in America*, ECONOMIST, May 14, 2005, at 78 (discussing the effects of United Airlines' plan termination on the PBGC and pensions in general).

defined benefit plans have converted to cash balance plans.¹⁰ Still, there are many issues surrounding cash balance and traditional defined benefit plans that must be resolved in the near future.¹¹

B. *Historical Background of Qualified Plans and ERISA*

The Employee Retirement Income Security Act (ERISA)¹² was passed in 1974 to provide security for “the continued well-being and security of millions of employees and their dependents [who] are directly affected by [retirement] plans.”¹³ There are two general categories of retirement plans that are “qualified” under ERISA: defined benefit plans¹⁴ and defined contribution plans.¹⁵ Defined benefit plans are traditionally identified as pension plans, while most Americans may recognize defined contribution plans in the form of 401(k) plans. The main distinctions between the two involve: 1) investment risk allocation, 2) funding, 3) benefit calculation and payout, and 4) longevity risk.¹⁶

Under defined benefit plans, investment risk is entirely upon the employer, whereas under defined contribution plans, the investment risk is squarely upon the shoulders of the employee.¹⁷ Defined benefit plans use

10. Dana M. Muir, *Counting the Cash: Disclosure and Cash Balance Plans*, 37 J. MARSHALL L. REV. 849, 857-64 (2004).

11. For a discussion of age discrimination, employer asset recovery and cash balance plans, see Regina T. Jefferson, *Striking a Balance in the Cash Balance Plan Debate*, 49 BUFF. L. REV. 513 (2001). For another discussion of “whipsaw” and cash balance plans, see Edward A. Zelinsky, *The Cash Balance Controversy*, 19 VA. TAX REV. 683 (2000). The Pension Protection Act (PPA) of 2006, which this Article discusses briefly in Part V, made many changes to the pension laws, and attempted to fix many of the age discrimination issues that have plagued cash balance plans since their inception. It remains to be seen whether Congress’s efforts were effective. A full discussion of PPA’s cash balance age discrimination legislation is beyond the scope of this Article, but the relevant PPA section is § 701.

12. Employee Retirement Income Security Act of 1974 (ERISA), Pub. L. No. 93-406, 88 Stat. 829 (1974) (codified as amended in scattered sections of the United States Code, including 29 U.S.C., and the Internal Revenue Code).

13. *Id.* at § 2(a).

14. ERISA § 3(35), 29 U.S.C. § 1002(35) (2000).

15. ERISA § 3(34).

16. See Zelinsky, *supra* note 6, at 458-65. See also 1 JEFFREY D. MAMORSKY, EMPLOYEE BENEFITS HANDBOOK 11:3 (2007) (discussing the pros and cons of defined benefit and defined contribution plans).

17. See Zelinsky, *supra* note 6, at 458-59 (explaining that investment risk is “the risk that retirement resources will earn an inadequate rate of return. Defined benefit arrangements impose investment risk upon the sponsoring employer”); see also PRESENT LAW, *supra* note 5, at 7 (explaining that “[t]he person who bears the risk of investment loss with respect to qualified retirement plan assets depends on whether the plan is a defined benefit plan or a defined contribution plan. In a defined benefit plan . . . [i]nvestment risk is generally on the employer”); see generally Daniel Halperin, *Employer-Based Retirement Income—the Ideal, the Possible, and the Reality*, 11 ELDER L.J.

complex actuarial methods to determine benefits and payouts, but defined contribution plans usually disburse in a method determined by the plan and the employee. The timing of the defined contribution plan disbursement is often at the discretion of the employee.¹⁸

ERISA subjects defined benefit plans to intense employer-based minimum funding requirements, while employees principally fund defined contribution plans using their own pre-tax dollars, with the employer periodically contributing additional funds.¹⁹ In defined benefit plans, an employer contributes an actuarially determined amount to a fund each year, from which plan administrators make payments to employees.²⁰ Participants are protected from an employer's bad behavior via a complex set of fiduciary rules that, in the case of a breach,²¹ require the breaching fiduciary to "make good to such plan any losses to the plan resulting from each such breach, and to restore to such plan any profits of such fiduciary which have been made through the use of assets of the plan by the fiduciary"²² Defined benefit plan participants are also protected generally from an employer's inadequate funding contributions and fund investment losses by the Pension Benefit Guaranty Corporation (PBGC), a quasi-governmental agency that acts as an insurer of pension plans that are terminated for various reasons.²³ Taken together, the fiduciary rules, the funding rules, and the PBGC generally make retirement income "safer" for participants because the plan takes on the investment risk, the participant is

37, 61 (2003) (explaining that "[e]mployers have much greater capacity than employees to absorb the risks associated with investment performance. Besides benefiting from economies of scale, the employer can average out investment results among cohorts of retirees, so it need not worry about a temporary market downturn.").

18. Patrick J. Purcell, *Cash Balance Plans: Background and Policy Issues*, 29 J. PENSION PLAN. & COMPLIANCE 67, 68-69 (2004) (stating that "[t]he worker typically has the option to receive these funds in the form of a life-long annuity, as a series of fixed payments over a period of years, or as a lump-sum.").

19. Zelinsky, *supra* note 6, at 461-62. *See also* MAMORSKY, *supra* note 16, at 12:56-66 (discussing the minimum funding standards of ERISA).

20. *See* MAMORSKY, *supra* note 16, at 12:56, 12:67.

21. These fiduciary rules include the so-called "Exclusive Benefit" duty, the duty of prudence, the duty of diversification, the noninurement rule and the prohibited transaction rules. These rules are found in ERISA § 404(a) and (b), and § 406. An exact explanation of these fiduciary duties is unnecessary for the purposes of this Article. Let it suffice that, in general, employers who sponsor defined benefit plans are subject to greater fiduciary duties than employers who sponsor only defined contribution plans. *See infra* note 25 and accompanying text.

22. *See* ERISA § 409(a), 29 U.S.C. § 1109(a) (2000).

23. *See* JOHN H. LANGBEIN, SUSAN J. STABILE & BRUCE A. WOLK, PENSION AND EMPLOYEE BENEFIT LAW 223 (4th ed. 2006) [hereinafter LANGBEIN] (explaining that "some plans would continue to terminate with insufficient assets to pay promised benefits, Congress created a government program designed to insure against such defaults."). *See also* ERISA § 4002, 29 U.S.C. § 1302 (2000 & Supp. IV 2004) (setting forth the rights and responsibilities of the Pension Benefit Guaranty Corporation).

not responsible for the income, and the PBGC insures the plan in case things go wrong.

Some employees, however, prefer to have the option to make decisions regarding their own retirement. For these participants, defined contribution plans are a better fit, but the right to exercise control does not come without a price. Defined contribution plans receive fewer statutory protections and no PBGC insurance because the investment decisions and cash distributions are nominally under the employee's control.²⁴ Employers who sponsor defined contribution plans often can escape much of their fiduciary responsibility via ERISA § 404(c), which states that if a plan allows its participants to direct their own investing and exercise control over their own account, then "no person who is otherwise a fiduciary shall be liable . . . for any loss, or by reason of any breach, which results from such participant's . . . exercise of control."²⁵ Defined contribution plans are attractive to employers because they can avoid much of the fiduciary responsibility to which they would otherwise be subject.²⁶ Defined benefit plans are superior in the eyes of the participant because there is little risk of loss for which the participant will be held responsible.

Finally, longevity risk is the risk that one will outlive his retirement assets, resulting in a marked decrease in quality of life. Most traditional defined benefit plans are specifically designed to ameliorate this risk through the payment of annuities, while defined contribution plans must be

24. See Regina T. Jefferson, *supra* note 11, at 516 (explaining that "[a]lthough 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 . . . [b]ecause, unlike in defined benefit plans, there is neither a minimum guaranteed benefit nor Pension Benefit Guaranty Corporation (PBGC) protection"). See also ERISA § 404(c), 29 U.S.C. § 1104(c)(1) (2000) (stating that plans allowing employees to control investments in defined contribution arrangements will have reduced fiduciary duties to participants).

25. ERISA § 404(c)(2). See also LANGBEIN, *supra* note 23, at 633 (explaining that "§ 404(c) is primarily concerned to redraw the lines of fiduciary responsibility under ERISA § 404(a) to clarify that when the participant conducts his or her own investing, the plan fiduciaries are not responsible for decisions that the participant or beneficiary 'controls.'").

26. There are several other requirements that must be met before the employer is absolved of fiduciary responsibilities under § 404(c). First, the plan must allow the employee to exercise sufficient control. This requirement is only met if the participant is "provided or has the opportunity to obtain sufficient information to make informed decisions with regard to investment alternatives available under the plan . . ." 29 C.F.R. § 2550.404c-1(b)(2)(i)(B) (2006). Second, the plan must provide the participant "an opportunity to choose, from a broad range of investment alternatives, the manner in which some or all of the assets in his account are invested." 29 C.F.R. § 2550.404c-1(b)(1)(ii) (2006). See also LANGBEIN, *supra* note 23, at 634-35 (illustrating in-depth the control and "broad range" requirements).

designed on an individual basis to meet the threat of outliving one's assets.²⁷

The traditional defined benefit plan will pay an annuity in monthly installments for the lifetime of the participant or beneficiary.²⁸ Because these payments are stretched out over the retiree's remaining life, there is no need to worry about running out of money. Some defined benefit plans have an inflation element or cost of living adjustment (COLA) to make sure the participant's dollars will continue to finance a similar quality of life, but many do not. Regardless, there is very little longevity risk inherent to defined benefit plans, at least as far as the participant is concerned.

The exact opposite is true for defined contribution plans. Because defined contribution plans are generally lump sums kept in employee-controlled accounts, to which the employee is only entitled to the account balance, the employee is the true determinant of how the benefits are paid and how long the assets will last.²⁹ Arguably, the employee is far less equipped to make investment decisions than an experienced plan investment advisor. The focus of this Article is specifically on traditional defined benefit and cash balance plans, but much has been written on the rise of defined contribution plans.³⁰

C. *Accrued Benefits under ERISA*

For the purposes of this Article, one of the key elements of ERISA is the notion of the accrued benefit. At its most basic level, an accrued benefit is the amount to which the employee-participant is entitled, based on his compensation and his years of service. The accrued benefit is cryptically defined as the "amount that the plan participant would receive

27. See Jefferson, *supra* note 11, at 532 ("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.").

28. *Id.* ("In traditional defined benefit plans, the normal retirement benefit is expressed as an amount certain, payable at retirement in the form of an annuity.").

29. See PRESENT LAW, *supra* note 5, at 7 (stating that "[i]n a defined contribution plan, the benefit the participant is entitled to is the account balance. Thus, the plan participant bears the risk of investment losses . . ."). See also Zelinsky, *supra* note 6, at 456-57 ("Typically the distribution from a defined contribution plan today takes the form of a single lump sum payout of the employee's account balance rather than an annuity or other periodic distribution spread over time").

30. See Colleen E. Medill, *The Individual Responsibility Model of Retirement Plans Today: Conforming ERISA Policy to Reality*, 49 EMORY L.J. 1, 3-14 (2000) (discussing defined contribution plans and the emergence of individual responsibility for retirement planning as an integral part of ERISA policy); Bradley P. Rothman, *401(k) Plans in the Wake of the Enron Debacle*, 54 FLA. L. REV. 921, 929-32 (2002) (outlining the evolution of defined contribution and 401(k) plans and the role of ERISA).

annually as a life annuity beginning at the plan's normal retirement age."³¹ The normal retirement age for the purpose of private pension plans is 65.³² Most importantly, however, a benefit, once accrued, cannot be taken away from the participant by his employer.³³ Concurrently, a participant cannot alienate his benefit once it has accrued.³⁴ The issue of what an accrued benefit is and how it accrues is key to the later discussion of "whipsaw" and the mortality discount.

Accrued benefits complete the accrual process by becoming "fully vested," meaning that they cannot be taken away from an employee once they are earned. Generally, ERISA requires that an employee's accrued benefit "vest" in the employee after he has completed five years of service.³⁵ In plain language, the employee's benefits that have accumulated over his service and have vested become nonforfeitable, meaning that the employer cannot take the benefits away or replace them arbitrarily.³⁶ No death benefits are required for accrued benefits, and unless otherwise stated, accrued benefits are forfeited when the participant dies.³⁷

31. UNITED STATES GENERAL ACCOUNTING OFFICE, ANSWERS TO KEY QUESTIONS ABOUT PRIVATE PENSIONS 13 (2002) [hereinafter ACCOUNTING OFFICE, ANSWERS]. See also ERISA § 3(23), 29 U.S.C. § 1002(23) (2000) (defining an accrued benefit as the benefit determined under the plan).

32. See ERISA § 3(24) (defining the "normal retirement age" as the later of age 65 or the 5th anniversary of the participant beginning their participation in the plan).

33. An accrued benefit that has vested and cannot be taken away is known as "nonforfeitable." ERISA § 3(19). Nonforfeitable benefits must be unconditional, meaning that receiving the nonforfeitable benefit in the future cannot be conditioned on a contingency, e.g., a non-compete agreement or further service requirements.

34. This requirement is also known as the "Antialienation Rule" of ERISA § 206(d)(1), which states that "[e]ach pension plan shall provide that benefits provided under the plan may not be assigned or alienated." ERISA § 206(d)(1), 29 U.S.C. § 1056(d)(1) (2000).

35. See ERISA § 203(a)(2)(A), 29 U.S.C. § 1053(a)(2)(A) (2000). This five-year vesting period is known colloquially as "cliff vesting," because every dollar of the benefit is forfeitable until the participant completes five years and then fully vests in all of his benefits. Plans may elect a longer vesting period, known as graded vesting, in which the employee vests gradually over a seven year period. ERISA § 203(a)(2)(B). ERISA requires 20% vesting after three years, with an additional 20% accruing every year until the seventh, at which the employee is fully vested. *Id.* Graded vesting is uncommon in defined benefit plans. See LANGBEIN, *supra* note 23, at 140 (noting that "[c]liff vesting schedules predominate in defined benefit plans"). Defined contribution plans are now subject to a shorter vesting period, but this is irrelevant for the purposes of this Article. *Id.*

36. See ERISA § 203(a)(1). For a discussion of vesting and how it works in general, see ACCOUNTING OFFICE, ANSWERS, *supra* note 31, at 39-40.

37. See ERISA § 203(3)(A). See also 26 C.F.R. § 1.411(a)-4(b)(1)(i) (2005) (stating that a right is not treated as forfeitable and thus noncompliant with ERISA "merely because such accrued benefit is forfeitable by the participant to the extent it has not been paid or distributed to him prior to his death.").

Accrued benefits must also satisfy the “backloading” provisions of ERISA.³⁸ As a matter of policy, ERISA requires that plans not skew retirement earnings too heavily toward the end of a worker’s career, and to that end, Congress has created different methods for guaranteeing that retirement earnings are spread more evenly across a working life.³⁹ When discussing and preventing “backloading”, cash balance plans follow a rule called the “133 1/3%” rule.⁴⁰ In essence, the “133 1/3%” rule requires that the benefit accrual in a future year of the plan up to the age of 65 cannot exceed the accrual in the current year—or any year in between the two—by more than 33 1/3%.⁴¹

D. The Traditional Defined Benefit Plan

In the strictest sense, the traditional defined benefit plan could be more accurately termed a single-employer “final-average-pay” plan (FAP).⁴² FAPs are not the only type of defined benefit pension plan, but they have been the most commonly used.⁴³ These plans are subject to ERISA’s minimum funding requirements,⁴⁴ and are thus under PBGC protection in case the company goes bankrupt or the plan is otherwise terminated.⁴⁵ These plans feature a defined annuity payment to the retired employee that will provide a constant source of income for the remainder of the employee’s life.⁴⁶

38. See I.R.C. § 411(b)(1) (2000). Backloading is a technique companies used regularly before ERISA to heavily skew retirement benefit accrual to the end of the employee’s career. The practical result of backloading was that employees who did not complete a career with the backloading plan sponsor would receive very little if they left employment before approaching retirement age. ERISA tempered these backloading rules considerably.

39. See Barker & O’Brien, *supra* note 2, at 10.

40. See *id.* See also DAN M. MCGILL, KYLE N. BROWN, JOHN J. HALEY & SYLVESTER J. SCHIEBER, *FUNDAMENTALS OF PRIVATE PENSIONS* 312 (8th ed. 2005) (“[A] cash balance plan most commonly uses the 133 1/3[%] accrual rule, so the increase in pay credits . . . cannot exceed any prior year’s accrual by more than a third.”).

41. See I.R.C. § 411(b)(1)(B) (2000). See also Barker & O’Brien, *supra* note 2, at 10 (stating that the “133 1/3%” rule, “requires that the rate of benefit accrual in any future year, measured as the age 65 benefit stated as a percentage of pay, not exceed the rate in the current year (or any year in between) by more than 33[%]”).

42. See MAMORSKY, *supra* note 16, at 11:20.

43. See *id.* at 11:21 (indicating that “[b]y the late 1970s, final-average-pay plans became the most common plan for salaried employees.”).

44. See Employee Retirement Income Security Act of 1974 (ERISA), Pub. L. No. 93-406, § 302(b), 88 Stat. 829, 869 (1974). These plans are also subject to the same fiduciary rules discussed earlier in Part II.

45. See *id.* at §§ 4021-22 (containing sections that outline the basics of PBGC coverage and the single-employer plan benefit guarantee).

46. See MAMORSKY, *supra* note 16, at 11:20.

There are two categories of benefit formulae: unit benefit formulas and flat benefit formulas.⁴⁷ A unit benefit formula specifies a unit of benefit to be awarded to the employee based on years of service.⁴⁸ A flat benefit formula often specifies a flat percentage of compensation or a flat yearly benefit accrual.⁴⁹ Regardless, the benefit payment is typically calculated using an equation dependent on the employee's years of service and compensation.⁵⁰ While there are other options, the three most common methods used by defined plans to calculate benefits are:

1. X dollars for each year of benefit service;
2. Y percent of career average compensation for each year of benefit service; or
3. Z percent of highest consecutive average compensation for each year of benefit service.⁵¹

The first option is the simplest calculation, because a participant receives a specific dollar amount for each year of service.⁵² It is also the clearest example of a flat benefit formula. For example, Employee X is a soon-to-retire line worker who earns \$50,000 per year. For retirement, Employee X receives \$200 per year for each year of service and she has 30 years of service. Upon retirement her annual benefit will be \$6,000, or \$500 per month. The benefits of this type of plan are clear: the plan sponsor and the participant know at all times what the participant's benefit will be and the costs are easy to calculate and plan for. The main drawback to this type of benefit accrual is also clear: it ignores the participant's compensation and—indirectly—the participant's contribution to the enterprise.⁵³ Under this plan type, it does not matter whether the employee is the company's president, earning \$125,000 per year, or the near-retirement line worker earning \$50,000 per year. Both will receive an identical benefit, despite the drastic difference in their responsibilities and remuneration. This incongruence has probably contributed to making this

47. See ALICIA H. MUNNELL, *THE ECONOMICS OF PRIVATE PENSIONS* 214 (1982) (indicating that unit benefit formulas are sometimes referred to as "conventional plans", and flat benefit formulas are sometimes called "pattern plans").

48. *Id.*

49. See *id.* (noting that a common rate is between 20% and 40%, regardless of the period of employment).

50. See MAMORSKY, *supra* note 16, at 3:6.

51. *Id.*

52. See MUNNELL, *supra* note 47, at 214.

53. Many workers near the end of their careers are earning the most they have ever earned. They have contributed to the enterprise for many years and are thus rewarded with higher compensation. This sort of plan design is interesting in that it offers equality to all participants, but the accompanying cost is that an employee's career-long contributions cannot be individually rewarded.

type of benefit accrual most popular in plans “where the range of hourly wage rates among participants is relatively narrow.”⁵⁴

The second option is an example of a unit benefit formula, in that the participant is awarded a specified percentage of his career average compensation for each year of service.⁵⁵ For example, Employee Y has 30 years of service credit and retires with a career average annual compensation of \$50,000. The plan states that Employee Y will receive 1% for each year of service. Because Employee Y is awarded a unit percentage for each year of service, the longer he works the more money he will receive. In this example, Employee Y would receive 30% of \$50,000 as his annual benefit, or \$15,000 per year. This is a startlingly different result than that of Employee X in the prior example, at least from the employer’s perspective.⁵⁶ In the first example, the employer can make fairly quick and accurate projections regarding how much the benefits will cost. The second example is affected heavily by other factors that are specific to the employee (e.g., the employee’s promotions and pay raises) to come up with the accrued benefit. These additional factors create significant actuarial costs for employers beyond those they would incur in the first example.⁵⁷ Despite these cost considerations, this method has become fairly common.⁵⁸

Finally, an FAP typically uses the third option in calculating benefits.⁵⁹ In some ways, the name “final-average-pay” plan is a misnomer, because the “final average” salary is not always the salary at retirement. FAP plans are similar to the second example in that both are unit benefit formulas. Many FAP plans take the average of salary over the last ten years of service, while others consider the average salary over the highest three or five consecutive years in the last ten years, or some other combination.⁶⁰ For example, suppose Plan Z’s accrued benefit at retirement is 1.5% of the average of the employee’s final five years of service up to forty years. Assume further that Employee Z’s final average salary for the purposes of the plan is \$75,000 and his years of service are

54. See MUNNELL, *supra* note 47, at 214.

55. *Id.*

56. The difference is perhaps not quite so alarming in practice, however, because Employee Y, with a career average salary of \$50,000, clearly has made more money in his lifetime than Employee X. If Employee X were subject to the second option, her amount would be different than Employee Y because she undoubtedly has some lower-paid years earlier in her career that would reduce her career average below \$50,000.

57. Actuarial costs are important to plans because they use actuarial assumptions to determine their obligations under the ERISA minimum funding rules of ERISA § 302. ERISA’s funding rules are outside the scope of this Article, but the costs involved in complying with all of ERISA’s standards are clearly a consideration for plan sponsors.

58. See MUNNELL, *supra* note 47, at 214.

59. See MAMORSKY, *supra* note 16, at 11:20.

60. *Id.*

30. Plan Z would use the following equation to discover Employee X's benefit: $(1.5\% \times 30) \times \$75,000$. Thus, Employee Z's benefit at retirement would be \$33,750 annually.

FAPs are also subject to ERISA mandates that require minimum vesting standards for an employee's retirement benefit.⁶¹ Typically, after five years an employee's accrued benefits become nonforfeitable, and the employee retains a right to the funds, even if the employee quits or is terminated by the company.⁶²

Another element of the FAP is an ERISA-mandated death benefit in the form of a qualified joint-and-survivor annuity (QJSA).⁶³ Essentially, if a fully vested retired employee dies, "[j]oint and survivor annuities guarantee that the plan participant's surviving spouse will continue to receive payments after the plan participant dies."⁶⁴ A QJSA must pay the surviving spouse an annuity for the rest of her life that is not less than 50% and not greater than 100% of the benefit payable to the participant while the participant is alive.⁶⁵ Spouses can waive the QJSA in favor of another type of benefit offered by the plan, but there are many requirements surrounding such a waiver.⁶⁶ Because the benefit can be waived, it does not meet the non-forfeiture provisions of ERISA § 203. Importantly, a QJSA is only implicated where the participant has already begun receiving payments as a retiree.

Defined benefit plans must also provide annuity payments to surviving spouses even when the plan participant has died before retirement.⁶⁷ These plans are called qualified preretirement survivor annuities (QPSA).⁶⁸ The amount to which a survivor is entitled under a QPSA depends on whether the participant reached the earliest possible retirement age under the plan, but suffice it to say that survivors are guaranteed an amount similar to those with QJSAs: no less than 50% and no greater than 100% of the participant's accrued benefit.⁶⁹ The key difference between QJSAs and QPSAs is simple: QJSAs apply after a participant has retired and begun

61. See ERISA § 203(a), 29 U.S.C. § 1053(a) (2000 & Supp. IV 2004). All ERISA-compliant plans are subject to the requirements discussed in this paragraph, but for the purposes of this illustration only FAP plans will be discussed. See *id.* There are also ERISA-mandated age discrimination requirements, participation requirements, and benefit limits, but these are not relevant for the purposes of this Article.

62. See *supra* note 35 and accompanying text (discussing vesting standards).

63. See ERISA § 205(a), 29 U.S.C. § 1055(a) (2000).

64. See ACCOUNTING OFFICE, ANSWERS, *supra* note 31, at 15.

65. See ERISA § 205(d)(1). See also 2 JEFFREY D. MAMORSKY, EMPLOYEE BENEFITS HANDBOOK 41:54 (2007) (discussing ERISA's requirements for death benefits).

66. See ERISA § 205(c). See also MAMORSKY, *supra* note 65, at 41:55 (discussing the waiver of the joint-and-survivor annuity requirement).

67. See ERISA § 205(a)(2).

68. See *id.*

69. See ERISA § 205(e).

receiving payments; QPSAs apply before a participant has retired and received any payments. Regardless, because QJSAs and QPSAs are inherent to the defined benefit form, they will become important during the later discussion of “whipsaw” and the mortality discount.⁷⁰

While FAPs are no longer the most popular form of retirement plan, they still cover millions of current and retired employees⁷¹ and will be essential in the discussion of cash balance plans and early termination lump sums. The FAP will be used in subsequent Parts to illustrate the key differences between lump sums distributed from traditional defined benefit plans and the hybrid, but still technically defined benefit, cash balance plans.

E. Cash Balance Plans in General

Cash balance plans are one of the newest and most popular forms of defined benefit plans, covering millions of employees nationwide.⁷² Many employers have taken their FAPs and other defined benefit plans and converted them into cash balance plans.⁷³ The first cash balance plan surfaced in 1985 when one of the predecessors to Bank of America converted their traditional plan into a cash balance plan.⁷⁴ Cash balance plans are somewhat a creation of the financial services market, in that they were not specifically authorized by any act of Congress. Cash balance

70. QJSAs and QPSAs do not exist in the defined contribution world because there are no annuities being paid from one general fund like there are in the defined benefit world. If a participant in a defined contribution plan dies before receiving payments, his surviving spouse will receive the amount in the participant's account, subject to other ERISA rules. See ERISA § 205(b)(1)(C)(i).

71. See *supra* notes 5-7 and accompanying text.

72. UNITED STATES GENERAL ACCOUNTING OFFICE, CASH BALANCE PLANS: IMPLICATIONS FOR RETIREMENT INCOME 13 (2000) [hereinafter ACCOUNTING OFFICE, CASH BALANCE] (noting that about 19% of Fortune 1000 firms sponsor cash balance plans, covering an estimated 2.1 million active participants.). In 2003, one study showed that “nearly one third of Fortune 100 companies [had] adopted some form of cash balance plan.” Kevin E. Cahill & Mauricio Soto, *How Do Cash Balance Plans Affect the Pension Landscape?*, 14 CENTER FOR RETIREMENT RES. AT BOSTON C. 2 (2003).

73. ACCOUNTING OFFICE, CASH BALANCE, *supra* note 72, at 15. Over 60% of the firms surveyed in 2000 had created their cash balance plans in the past five years, many of whom did so by converting old defined benefit plans into cash balance plans. *Id.* at 14-15.

74. See MAMORSKY, *supra* note 65, at 53:4 (noting that Bank of America believed, “the ideal pension vehicle to address its needs would be neither a traditional defined benefit plan nor a traditional defined contribution plan, but instead a new vehicle that combined the best features of both—and thus the cash balance pension plan was born”). See also LANGBEIN, *supra* note 23, at 62 (“The recent trend toward cash balance plans began in 1985, when the Bank of America replaced its traditional defined benefit plan with a cash balance plan”).

plans, however, are classified as defined benefit plans for the purposes of ERISA and the Internal Revenue Code.⁷⁵

Many commentators and plan designers have described cash balance plans as a defined benefit plan that looks and acts like a defined contribution plan.⁷⁶ Plan participants are given hypothetical “accounts,” in which a certain percentage of their earnings are placed every year.⁷⁷ In addition to having a percentage of compensation set aside, participants also receive interest credits every year for the money in the account.⁷⁸ The plan determines these interest credits with some help from the IRS. The employee has no access to the account or control over the funds because the account does not really exist.⁷⁹ All of the funds used to pay out benefits are kept in a trust identical to the trusts set up for other defined benefit plans, subject to the same ERISA minimum funding rules and PBGC requirements. The hypothetical account is merely a creation of accounting, and the employee has no control over the funds in the account until either: he terminates employment (if the plan permits lump sum distributions)⁸⁰ or

75. ACCOUNTING OFFICE, CASH BALANCE, *supra* note 72, at 10 (citing Treas. Reg. § 1.401(a)(4)-8(c)(3)(i) (1999) that “[c]ash balance plans are not specifically identified in the law, but IRS guidance describes a cash balance plan as ‘a defined benefit plan that defines benefits for each employee by reference to the amount of the employee’s hypothetical account balance.’”).

76. See Muir, *supra* note 10, at 855-56 (2004) (“As a technical matter, [cash balance] plans are a subset of [defined benefit] plans because they promise participants a benefit based on a formula and do not provide actual individual accounts for plan participants.”). See also Patrick J. Purcell, *Cash Balance Plans: Background and Policy Issues*, 29 J. PENSION PLAN. & COMPLIANCE 67, 71 (2004) (describing the cash benefit plan as a hybrid of both the defined benefit and defined contribution plan); Zelinsky, *supra* note 11, at 687 (“The common characterization of the cash balance plan is that it is a defined benefit pension designed to look like a defined contribution arrangement.”); LANGBEIN, *supra* note 23, at 62 (“A cash balance plan is a defined benefit plan that provides a benefit that largely mimics the account balance of a defined contribution plan.”).

77. See Muir, *supra* note 10, at 856.

78. See MAMORSKY, *supra* note 65, at 53:10 (“Employees’ accounts are also credited with interest-related credits at a rate specified in the plan. However, this rate is not tied to the actual investment performance of the plan’s assets.”); see also I.R.S. Notice 96-8, 1996-1 C.B. 359 (“An employee’s hypothetical account balance is credited with hypothetical allocations and hypothetical earnings determined under a formula selected by the employer and set forth in the plan.”).

79. See Purcell, *supra* note 76, at 71 (“[I]n a cash balance plan, these account balances are merely bookkeeping devices that show the amount that each employee has earned under the plan. They are not true individual accounts because they are not owned by the plan’s participants.”).

80. See ACCOUNTING OFFICE, CASH BALANCE, *supra* note 72, at 31 (“Cash balance plans are more likely than traditional defined benefit plans to offer participants the option of receiving their benefits in a lump sum either at retirement or at termination of employment.”).

reaches the "normal retirement age," which is defined as the age of 65.⁸¹ When an employee terminates employment before the age of 65, in most cases he is given two options: either leave his accrued benefits in the plan until the age of 65 and receive annuity payments thereafter, or elect to take the money out of the plan in the form of a lump sum distribution.⁸² Most employees elect the lump sum distribution, which triggers a calculation required by the Internal Revenue Code.⁸³

Companies cite a variety of reasons for the popularity of cash balance plans. Some of the most important include: 1) investment risk, 2) lower costs, 3) portability of benefits and 4) employee understanding. These will be discussed individually below.

First, investment risk in the context of retirement planning is the risk that invested resources will be inadequate to cover retirement expenses.⁸⁴ Under a cash balance plan the investment risk is entirely upon the employer because the employer must follow ERISA's funding guidelines and can invest the money in the fund accordingly.⁸⁵ The employee is guaranteed interest credits at a certain interest rate for every year of service, so the employee is indifferent to investment risk.⁸⁶ But, with risk comes reward; if the money in the fund performs better than the guaranteed interest rate, the employee receives nothing extra and the increased earnings accrue to the fund.⁸⁷ However, the reverse is also true; if the fund does poorly, the

81. See ERISA § 3(24), 29 U.S.C. § 1002(24) (2000) (defining the "normal retirement age" as the later of the age 65 or the 5th anniversary of the participant beginning their participation in the plan).

82. Jefferson, *supra* note 11, at 535 (explaining that "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"). See also I.R.C. § 402(e)(4)(D)(i) (2000).

The term "lump-sum distribution" means the distribution or payment within one taxable year of the recipient of the balance to the credit of an employee which becomes payable to the recipient (I) on account of the employee's death, (II) after the employee attains age 59½, (III) on account of the employee's separation from service, or (IV) after the employee has become disabled.

Id.

83. See *infra* notes 99-103 and accompanying text for a discussion of the tendency of employees to elect lump sum distributions.

84. See Zelinsky, *supra* note 6, at 458-61.

85. See MAMORSKY, *supra* note 65, at 53:7.

86. See *supra* note 78; see also Muir, *supra* note 10, at 856 ("[A]s with a [defined benefit] plan, the first tier of investment risk remains on employers because they must fund the plan sufficiently to pay promised benefits, and make up any difference if the promised investment returns exceed the actual investment returns.").

87. See Muir, *supra* note 10, at 856 ("[T]he plan captures any positive difference between the promised investment return and the actual return.").

employee does not share in the losses.⁸⁸ For many risk-averse employees, this is an important feature of cash balance plans and defined benefit plans in general.

Second, many companies also believe that, over time, cash balance plans are cheaper than traditional FAPs.⁸⁹ Some employers have achieved cost savings by eliminating subsidized early retirement benefits and through other benefit manipulation.⁹⁰ One study found that most employers who convert traditional defined benefit plans to cash balance plans do achieve some level of cost savings, but the study also concluded that the cost savings sometimes became moot because many employers sweeten their defined contribution plans when the conversion takes place, thus keeping aggregate retirement costs at almost the same level.⁹¹ Perhaps the most important concept is that employers believe they will save money via a hybrid cash balance plan, which is why they adopt them.

Third, because of the lump sum distribution factor that is built into cash balance plans, these plans are viewed as having more portable benefits. This means that mobile employees in today's world of transient employment are not required to leave their retirement funds in the plan, but can take them and reinvest them as they see fit once they have separated from the company.⁹² The benefits also accrue faster under a cash balance plan than they do under a traditional plan, thus adding another incentive to

88. See Muir, *supra* note 10, at 856.

89. ACCOUNTING OFFICE, CASH BALANCE, *supra* note 72, at 18 ("A survey of 100 cash balance plan sponsors by PricewaterhouseCoopers found that 56[%] of firms expected the long-term cost of their defined benefit plans to decrease after conversion [to cash balance plans]").

90. See Muir, *supra* note 10, at 862-63.

91. KYLE N. BROWN ET AL., THE UNFOLDING OF A PREDICTABLE SURPRISE: A COMPREHENSIVE ANALYSIS OF THE SHIFT FROM TRADITIONAL PENSIONS TO HYBRID PLANS 18-20 (2000), <http://www.watsonwyatt.com/us/research/resrender.asp?id=W-326&page=1> (follow "download PDF" hyperlink). There are also ERISA compliance costs associated with converting from a traditional defined benefit plan to a cash balance plan (as a brief example, note the notice requirements associated with ERISA § 204(h)). When these are taken into account in concert with heightened defined contribution benefits, it is quite possible that plans save much less in the conversion than they anticipated.

92. See ACCOUNTING OFFICE, CASH BALANCE, *supra* note 72, at 18 ("Firms that adopted cash balance plans reported that the opportunity for the increased portability of benefits influenced their decision to adopt such plans. The lump sum benefit distribution feature common to many cash balance plans allows eligible workers, upon separation, to gain access to their pension benefit"); see also Jefferson, *supra* note 11, at 543 ("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.").

young workers looking for portable benefits that they can take with them when they leave.⁹³

Fourth, many employers also believe that because cash balance plans present benefits to employees in a way that resembles a 401(k) plan, namely in a lump sum in an individual account, it is easier for employees to understand the benefits to which they are entitled. Furthermore, it is easier for employees to see how the benefits grow over time.⁹⁴ According to the United States Government Accounting Office report on cash balance conversions: "Human resource and benefits officials at several firms we visited said that [traditional] defined benefit plans have been one of the least understood and least appreciated benefits in a worker's compensation package."⁹⁵ Cash balance plans arguably increase a worker's appreciation of the plan because it is easier to understand than an archaic formula that relies so heavily upon averaging late-career compensation. Employees are arguably most familiar with something that resembles a savings account, which is one reason 401(k) and defined contribution plans have become so popular. A cash balance plan adds increased benefit comprehension among participants without creating more risk for them. The participants are not subject to the same risks they face when investing defined contribution dollars, which is attractive for plan managers and those who have a more paternalistic view of retirement preparation.

In closing this section, understand that employers have cited all of these reasons when converting old traditional plans to cash balance plans or creating cash balance plans from scratch. Cash balance plans have become an important part of the retirement landscape, and they will not be disappearing from the scene any time soon. The next section will explore how the election of early-terminating employees to receive lump sum distributions instead of annuities under cash balance plans has also become its own controversial topic.

F. The Early Termination Phenomena

Employees view cash balance plans as an excellent way to increase portability of benefits because of the availability of lump sum distributions to those who separate from service to the company before reaching age

93. See Muir, *supra* note 10, at 861 ("[cash balance] plans tend to be more attractive than [traditional defined benefit] plans to younger workers with relatively short job tenures because of the difference in accrual patterns and payment options.").

94. See ACCOUNTING OFFICE, CASH BALANCE, *supra* note 72, at 19 ("Because benefits under cash balance plans are expressed as lump sum values rather than retirement age annuities, employees may better understand and value such plans."); see also BROWN ET AL., *supra* note 91, at 44 (reporting that 96% of employers surveyed believe that cash balance plans improve employees' appreciation of their retirement plans).

95. See ACCOUNTING OFFICE, CASH BALANCE, *supra* note 72, at 19.

65.⁹⁶ As stated previously, separated employees are generally given two options: either (1) leave the money in the plan and receive an annuity payment beginning at the normal retirement age, or (2) receive a single lump sum payment when leaving the company.⁹⁷ It has become an accepted fact that most choose the lump sum distribution.⁹⁸ Once the participant has received the payment, he or she is under no obligation to reinvest the money for their retirement. The money is the participant's to spend or to save, depending on his or her individual circumstances.

A majority of employees electing a lump sum is not, on its face, a disconcerting fact, but in practice, this phenomenon is having a negative effect on retirement planning.⁹⁹ According to a Health and Retirement Study conducted between 1992 and 1998, 77.48% of workers who take lump sum defined benefit distributions request their money in the form of cash, and do not roll the money over into another investment vehicle.¹⁰⁰ Only 16.8% roll over their lump sum into another investment.¹⁰¹ One alarming statistic is that 42.1% of the money taken in cash is spent on current consumption of goods.¹⁰²

Factors influencing whether a worker elects lump sum distributions include the worker's age, education, income level, mortality risk, and marital status.¹⁰³ Each individual's situation is different, but the fact remains that many lump sum retirement distributions are used to pay for current bills, obligations, or merely squandered on luxury items. This phenomenon is alarming for its implications on our society, especially considering the impending retirement of the baby boomer generation and their imperfect retirement planning. For the purposes of this Article, the important thing to note is that a large number of individuals elect lump sum

96. See BROWN ET AL., *supra* note 91, at 44.

97. See *supra* note 82, and accompanying text.

98. See Gary V. Engelhardt, *Pre-Retirement Lump-Sum Pension Distributions and Retirement Income Security: Evidence from the Health and Retirement Study*, 55 NAT'L. TAX J. 665, 667-68 (2002).

99. The reasons why separated employees elect lump sum distributions rather than lifetime annuity payments is a topic beyond the scope of this Article, but much has already been written on the subject. For such writings, see *id.*; Michael Hurd et al., *An Analysis of the Choice to Cash Out Pension Rights at Job Change or Retirement* (RAND Inst. for Civil Justice 1998), available at <http://www.rand.org/health/centers/archive/dol/papers/DRU-1979-DOL.pdf> (discussing in-depth the factors involved in the choice to take a lump sum distribution); Leonard E. Burman, Norma B. Coe & William G. Gale, *Lump Sum Distributions from Pension Plans: Recent Evidence and Issues for Policy and Research*, 52 NAT'L TAX J. 553, 553-60 (1999).

100. See Englehardt, *supra* note 98, at 667-68.

101. *Id.*

102. *Id.*

103. See generally Hurd et al., *supra* note 99.

distributions and this choice has a controversial impact on the amount in actual dollars that a participant receives when he or she separates.

G. The Consequences of Electing a Lump Sum Distribution under a Final-Average-Pay Plan

Depending upon whether an employee participates in a traditional FAP or a cash balance plan, the election to receive a lump sum distribution can have drastically different results. This is most effectively demonstrated by illustrating how lump sum distributions are calculated under current law for FAPs as oppose to how they are calculated for cash balance plans. As a result of this analysis, it will become clear that cash balance plans lack an important variable in the calculation of lump sum distributions—an omission that results in employees being paid more money from their employers than they are entitled to receive.

Many traditional FAP plans have a benefit feature built into the plan that allows workers to elect a lump sum distribution on retirement or even on separation from the company.¹⁰⁴ An employee who elects a lump sum distribution under a traditional defined benefit plan is entitled to the present value in lump sum form of the life annuity to which he or she is entitled at the age of 65.¹⁰⁵ Section 417(e) of the Internal Revenue Code (the Code) governs lump sum distributions for defined benefit plans.¹⁰⁶ Plans cannot force a lump sum distribution on a worker unless they are only entitled to a present value lump sum of \$5,000 or less.¹⁰⁷ The participant's consent is required before a company can pay a lump sum for retirement benefits greater than \$5,000.¹⁰⁸

When participants elect to receive a lump sum, they are entitled to the present value of their accrued benefit. Recall from the previous sections that an accrued benefit is the benefit expressed in terms of an annuity beginning at age 65. The plan must calculate the participant's entitlement using § 417(e). Section 417(e) requires, "the present value [of the annuity] shall not be less than the present value calculated by using the applicable mortality table and the applicable interest rate."¹⁰⁹

While the term "present value" is common language for all financial professionals, the term is not intuitive for those who do not have any experience with finance. The concept behind the time value of money, and

104. See I.R.C. § 402(e)(4)(D)(i) (2000) (defining lump sum distributions for the purposes of the Internal Revenue Code in general).

105. See I.R.S. Notice 96-8; I.R.C. § 417(e) (2000 & Supp. IV 2004).

106. See I.R.C. § 417(e) (2000 & Supp. IV 2004).

107. I.R.C. § 411(a)(11) (2000 & Supp. IV 2004).

108. *Id.*

109. I.R.C. § 417(e)(3)(A)(i) (2000).

its present value in particular, is that a dollar today is worth more than a dollar tomorrow because of a variety of factors such as inflation and interest rates.¹¹⁰ Thus, if someone is entitled to \$100 ten years from now, the \$100 is worth less than it is worth today. At its most basic level, calculating the present value of a sum involves selecting a certain interest discount rate to allow for the time between the present and the expected date of future payment and then using a simple mathematical equation to “discount” the future payment to what it would be worth in today’s dollars.¹¹¹ In the case of lump sum distributions from pension plans, the general expected date of future payment is the age of 65, and the discount rate is defined in the Code.

The applicable interest rate requirement through 2006 is defined in the Code as “the annual rate of interest on 30-year Treasury securities for the month before the date of distribution or such other time as the Secretary may by regulations prescribe.”¹¹² Thus, the discount rate used in the lump sum calculation is rather easy to discover—simply find the annual rate of interest on 30-year Treasury bonds and plug the number into your discount equation. For plan years beginning in 2007, however, the applicable interest rate will be a segmented rate based on a corporate bond yield curve prescribed by the Secretary of the Treasury.¹¹³ This interest rate will likely be higher, since it is generally accepted that corporate bonds yield greater returns than simple government Treasury bonds. Regardless of the new changes to the discounting rules, the applicable interest rate is not difficult to locate or apply.

110. See STEPHEN A. ROSS, RANDOLPH W. WESTERFIELD & BRADFORD D. JORDAN, FUNDAMENTALS OF CORPORATE FINANCE 129 (6th ed. 2003) (“[T]he phrase *time value of money* refers to the fact that a dollar in hand today is worth more than a dollar promised at some time in the future The trade-off between money now and money later thus depends on, among other things, the rate you can earn by investing.”).

111. *Id.* at 138-42 (illustrating how to create simple present value equations).

112. I.R.C. § 417(e)(3)(A)(ii)(II) (2000). After the Pension Protection Act of 2006, discussed *infra* note 113, the applicable interest rate is no longer the 30-year Treasury Bond rate.

113. Pension Protection Act of 2006, Pub. L. No. 109-280, § 102(a), 120 Stat. 789 (2006). The PPA, discussed *infra* Part V, made these changes to the applicable interest rate definition. These changes were scheduled to go into effect for plan years beginning after 2007. According to the PPA:

The term ‘corporate bond yield curve’ means, with respect to any month, a yield curve which is prescribed by the Secretary of the Treasury for such month and which reflects the average, for the 24-month period ending with the month preceding such month, of monthly yields on investment grade corporate bonds with varying maturities and that are in the top 3 quality levels available.

Pension Protection Act of 2006, Pub. L. No. 109-280, § 102(a), 120 Stat. 798 (2006) (creating new ERISA § 303(h)(2)(D)).

The “applicable mortality table” is referenced in § 417(e)(3) of the Code, and is “based on the prevailing commissioners’ standard table . . . used to determine reserves for group annuity contracts issued on the date as of which present value is being determined”¹¹⁴ The prevailing commissioners’ standard table is further defined later in the Code as, “the most recent commissioners’ standard tables prescribed by the National Association of Insurance Commissioners, which are permitted to be used in computing reserves for that type of contract under the insurance laws of at least 26 States when the contract was issued.”¹¹⁵ The applicable mortality table for § 417(e) valuations can be found specifically in Revenue Ruling 2001-62.¹¹⁶

The use of the applicable mortality table allows the company to take a mortality discount to obtain an accurate present value lump sum. Mortality directly affects the probability that a payment will be made and when it will be made. Since the probability is no longer in question, it is logical that the company should be allowed to discount mortality from the present value of the lump sum. The plan is also making the payment in today’s dollars, while it had been planning all along to pay the amount expected when the participant turns 65. Mortality also is a factor in how actuaries determine the amount of payments under a life annuity, and since mortality is no longer a risk, it should be taken into account when valuing the lump sum.

Additionally, once the payment is made, there is no longer a qualified joint and survivor annuity or qualified pre-retirement survivor annuity involved, which is another reason mortality is a significant factor in valuing lump sums. The plan has experienced a cost for providing the QPSA and QJSA to the participant, and should be able to recover some of that cost since the participant’s beneficiaries will never need to use the QPSA or QJSA benefit. It is unclear to anyone but the actuaries what exactly the costs are for providing QPSA and QJSA benefits. However, across any large population of employee-participants, the cost is undoubtedly significant.¹¹⁷

H. Cash Balance Plan Lump Sum Valuations

Even though cash balance plans are defined benefit plans for the purposes of the Code and thus under the purview of § 417(e), in practice lump sums are valued differently under cash balance plans than they are

114. I.R.C. § 417(e)(3)(A)(ii)(I) (2000).

115. I.R.C. § 807(d)(5)(A) (2000).

116. See Rev. Rul. 2001-62, 2001-2 C.B. 632.

117. Ready information on QPSA and QJSA claim occurrences is not available because each plan’s experience will be different. However, it is clear that plans have to account for the possibility of these claims in determining their funding obligations for each year.

under traditional pension plans. This disparity has arisen because of questions over when and how benefits accrue. This controversy has resulted in the IRS “whipsaw” rules discussed in *Berger v. Xerox*, and recently in certain sections of the Pension Protection Act of 2006.¹¹⁸ This will be discussed further in the Article, but for the purposes of general understanding, it is necessary to see how, under pre-PPA 2006 law, cash balance lump sum distributions were—and perhaps will be—calculated.

The IRS issued Notice 96-8 in 1996 to eliminate some of the confusion surrounding cash balance plans.¹¹⁹ This is the only official IRS discussion specifically of cash balance lump sum distributions, and no regulations have been issued. Courts have upheld Notice 96-8, so even though it has not been codified, it was the state of the law through 2006 and all cash balance plans have attempted to follow Notice 96-8 to avoid litigation.¹²⁰

Under the pre-PPA rules, when an employee elects a lump sum distribution from a cash balance plan, a complicated computation must take place before the employee actually receives a check. The computation comes directly from Notice 96-8. The calculation requires the plan to credit the employee’s account for interest at the plan’s stated interest rate for every year to the age of 65 regardless of the employee’s current age.¹²¹ As previously discussed, these credits are called “future interest credits” and for the purposes of lump sum calculations they have been upheld as accrued benefits even when an employee has not remained with the company to the age of 65.¹²² Once the future interest credits have been credited to the employee’s account, theoretically the account then holds the

118. See *infra* Part V.A-B.

119. I.R.S. Notice 96-8, 1996-1 C.B. 359.

120. See *Berger v. Xerox Corp. Ret. Income Guarantee Plan*, 338 F.3d 755 (7th Cir. 2003); *Lyons v. Georgia-Pacific Corp. Salaried Employees Ret. Plan*, 221 F.3d 1235, 1249-50 (11th Cir. 2000) (acknowledging that if Notice 96-8 had been issued prior to plaintiff’s lump sum distribution it would have probably forced defendants to comply). The Pension Protection Act of 2006 purports to have changed how cash balance lump sum distributions are calculated, so under post-PPA law the value of Notice 96-8 is limited. For this Article, however, it is essential to understand how the “whipsaw” rules applied pre-PPA. Notice 96-8 still applies to all lump sum payments made prior to PPA’s enactment, and are sure to be litigated over in the next few years.

121. I.R.S. Notice 96-8, 1996-6 I.R.B. 23 (“[T]he balance of the employee’s hypothetical account must be projected to normal retirement age and then the employee must be paid at least the present value . . . of that projected hypothetical account balance.”).

122. See *Berger*, 338 F.3d at 758. The IRS’s argument makes logical sense based on the ERISA definition of an accrued benefit. If an accrued benefit under a defined benefit plan is defined as the benefit payable in terms of an age 65 annuity, then the employee is at least entitled to the future interest credits for the monies which he already has in his account. This definition has been hotly contended, as will be discussed *infra*, because it is arguable when the future interest credits actually accrue, and whether they accrue based on the prior service or whether they should be contingent on future service.

amount of money that it would have held had the employee left his money in the account to the age of 65 and began to receive annuity payments. The lump sum then must be represented as the value of an annuity at age 65 because ERISA requires that the normal retirement benefit for a defined benefit plan must be “expressed in the form of an annual benefit commencing at normal retirement age.”¹²³ The new lump sum must then be discounted back to the current year, using the applicable interest rate, to discover the present value of what could be called the employee’s “future lump sum entitlement.” Because the IRS requires plans to discount the future lump sum at the 30-year Treasury Bond Rate, which is usually lower than the plan’s stated interest rate, a startling effect occurs.¹²⁴ The practical result of this calculation, and a source of great controversy, is that in many cases employees receive a cash amount greater than what is actually stated in their account balance. The controversy involves determining whether the future interest credits are an accrued benefit, and if so, when they accrue.¹²⁵

For a simple example, suppose Employee X is 45, and has \$36,788.95 in his hypothetical account. Employee X takes a job with another firm, and elects to take his money in a lump sum. Then suppose that the stated interest rate of the plan is 5% and that the 30-year Treasury Bond Rate is 4%. The future value of the lump sum would be \$100,000 (\$37,688.95 at 5% per year for 20 years). The employee’s actual entitlement would be \$45,638.70 (\$100,000 discounted at 4% for 20 years). This represents a difference of \$7,949.75 between the employee’s lump sum and the amount actually in the account. This \$7,949.75 is the result of the “whipsaw” and is the source of great controversy between employers, employees, and the government. If the 5% future interest credits are not accrued benefits, then the employee is only entitled to the amount in his hypothetical account. The true question then is whether the right to a future interest credit accrues when service has been provided, and monies deposited, into the hypothetical account. The answer to this question is by no means clear, even after Congress’s attempted solution in PPA 2006. ERISA specifically prohibits plans from conditioning the receipt of vested future benefits—in this case the future interest credits—on continued service, but arguably the

123. See I.R.C. § 411(a)(7)(A)(i) (2000 & Supp. IV 2004); see also *Esden v. Bank of Boston*, 229 F.3d 154, 163 (2d Cir. 2000) (stating that “the accrued benefit under a defined benefit plan must be valued in terms of the annuity that it will yield at normal retirement age.”).

124. I.R.S. Notice 96-8, 1996-6 I.R.B. 23 (“[T]he present value of the employee’s accrued benefit, determined using the § 417(e) applicable interest rate, will generally exceed the hypothetical account balance.”).

125. See *Barker & O’Brien*, *supra* note 2, at 6 (“[T]he [*Berger*] court in effect rewrote the accrued benefit to include, as an unconditional right, those additional interest earnings that under the plan’s terms were conditional . . .”).

employee has only earned an interest credit for the years in which he has already served, and has not vested in the future interest credits at all. This conundrum is discussed further below.

Additionally, under current judicial precedent no mortality discount is allowed in circuits that elect to follow *Berger*, even though cash balance plans are defined benefit plans and governed by § 417(e) of the Code. Even after the PPA was made, it is not clear whether a mortality discount is permitted, even though § 417(e) seems to demand it. The case for a mortality discount will be made later in the Article, but for the purposes of Employee X's entitlement, no mortality discount can be taken under *Berger*.¹²⁶ Employee X would thus be entitled to \$45,638.70. The following Part will discuss *Berger*'s specific failings without substantial reference to the new changes rendered by the PPA. The PPA and its handling of "whipsaw" will be discussed in Part V.

III. *BERGER V. XEROX* DROPS THE BALL ON CASH BALANCE LUMP SUM DISTRIBUTIONS

A. *The Court's Treatment of Cash Balance Plans in Berger*

The Seventh Circuit has been the only court to discuss both the Notice 96-8 "whipsaw" rules and the mortality discount. In deciding *Berger*, Judge Posner followed other circuits and upheld the "whipsaw" rules in Notice 96-8.¹²⁷ He did not, however, come to the correct conclusion regarding the mortality discount. Judge Posner's flip dismissal of the mortality discount stands out as the most glaring error in the *Berger* opinion. Opposite of some commentators, this Article argues that under the then-state of the law, Judge Posner was correct in his analysis of and his decision to uphold the "whipsaw" rules of Notice 96-8. However, this Article argues that the Seventh Circuit dropped the ball on the mortality discount, and that the court's holding concerning the mortality discount should be overturned, or at the very least not followed in other circuits.

The cash balance plan at issue in *Berger* had an interesting aspect that was the main cause of contention between the parties. The defendant Xerox Corporation had set up a cash balance plan in which terminated employees who did not elect to take a lump sum distribution were rewarded with a higher interest rate for future interest credits.¹²⁸ Conversely, those who elected to take a lump sum distribution received future interest credits but at a lower rate than promised to the other employees.¹²⁹ This incentive

126. See *Berger*, 338 F.3d at 764.

127. See *id.* at 762.

128. See *Barker & O'Brien*, *supra* note 2, at 6.

129. *Id.*

ostensibly allowed Xerox to keep as much money in its trust account as possible, which helped to keep the company's yearly required contributions to a minimum, although this motive was not discussed in the opinion. The dispute arose because employees who elected the lump sum distribution believed they were entitled to the higher interest rate regardless of whether they received a lump sum or an annuity.¹³⁰ The Seventh Circuit agreed.

Xerox argued that certain future interest credits were not accrued benefits, and because the credits were not accrued benefits their receipt could be made conditional upon leaving the hypothetical account balance in the plan until the age of 65.¹³¹ The plaintiff argued the opposite, specifically that future interest credits accrue to the employee when the original service credits are deposited into the hypothetical account; and that by not including future interest credits in lump sum distributions, the Xerox cash balance plan was in violation of ERISA.¹³²

In reference to "whipsaw" and future interest credits, Judge Posner was correct in his isolation of the issue, namely, that "the key question . . . is whether future interest credits are part of [the employee's] accrued benefit. If they are, then in determining his pension entitlement . . . the plan must add the credits to the employee's cash balance account."¹³³ Ultimately, the Seventh Circuit decided that future interest credits are accrued benefits and upheld IRS Notice 96-8 as ". . . an authoritative interpretation of the applicable statutes and regulations"¹³⁴ Judge Posner cited the Second Circuit's discussion of IRS Notice 96-8 in *Esden v. Bank of Boston* as a primary source for an explanation of Notice 96-8, so it is helpful to explore some of the reasoning in *Esden*.¹³⁵

In upholding Notice 96-8, Judge Leval of the *Esden* court relied on the well-settled doctrine that "an agency's reasonable, consistently held interpretation of its own regulation is entitled to deference."¹³⁶ Judge Leval stated that even though the IRS's guidance is in the form of a Notice, rather than new regulations, the Notice, as a "consistent and reasonable interpretation by the responsible agency is entitled to deference, regardless of its form of publication."¹³⁷ One might have argued that the IRS was not

130. *Id.*

131. *See Berger*, 338 F.3d at 761. Remember that it is illegal under ERISA to condition the receipt of fully vested accrued benefits on anything post-accrual.

132. *See id.* at 759.

133. *Id.* at 760. Throughout the opinion Posner interchanged the terms "accrued benefit" and "entitlement," perhaps as an easier way of thinking of accrued benefits: a true entitlement for participants because of the nonforfeiture and anti-alienation rules in ERISA.

134. *Id.* at 762.

135. *Id.* at 762.

136. *Esden v. Bank of Boston*, 229 F.3d 154, 168 (2d Cir. 2000) (quoting *I.N.S. v. Nat'l Ctr. for Immigrants' Rights, Inc.*, 502 U.S. 183, 189-90 (1991)).

137. *See id.* at 169.

interpreting its own regulations, especially since cash balance plans were not specifically legislatively authorized, but Judge Leval was prepared for this type of argument. Judge Leval went one step beyond deference and found that the I.R.S. makes the case for future interest credits as accrued benefits in the regulations. So, Notice 96-8, while entitled to deference, did nothing more than explain that future interest credits were accrued benefits under current law.¹³⁸

All of this discussion of course begs the question, when do benefits accrue? While Judge Posner and Judge Leval did not directly answer this question in their respective opinions, their reasoning seems to argue that future interest credits become accrued benefits when the original service credits are deposited into the employee's hypothetical account. This is the only way calling future interest credits an accrued benefit would make sense. Put a slightly different way, the courts held that the right to receive future interest on the amount in the account vests when the "principal" is deposited into the hypothetical account. Every year when a new amount is added, the right to receive yearly interest through age 65 is attached to the amount.

To continue the analogy, future interest credits and the hypothetical account could be likened to a loan that the employee has made to the employer.¹³⁹ For example, suppose that Employee X has \$1,000 deposited into her account this year, with the promise of a 5% interest credit on the money. Employee X could then be said to have agreed to forgo receiving money today in exchange for receiving \$1,000 plus 5% annual interest in the future, specifically at age 65. If this is thought of as a loan, with the interest credits accruing to age 65 acting as the terms, it seems clear that Employee X's right to the future interest credits vests on the loan date, regardless of when the plan decides to pay off their debt to Employee X. In this case, the plan does not have the option to pay off its debt to Employee X at any time without implicating ERISA provisions, but Employee X can demand payment in full upon her separation from employment. Although the arrangement seems to overly favor Employee X, remember that she can only demand "repayment" of her "loan" when she has left her employment. As a condition precedent, she must lose or quit her job.

Returning to *Berger*; in holding that future interest credits are an accrued benefit, Judge Posner also found that to allow Xerox to make receipt of interest credits conditional upon leaving the money in the fund

138. *Id.* at 169-71. Judge Leval looked to Treasury Regulation 1.401(a)(4)-8(c)(3)(ii) for guidance. The regulation states: "The plan must provide that an employee's accrued benefit under the plan as of any date is an annuity that is the actuarial equivalent of the employee's projected hypothetical account as of normal retirement age . . ." *Id.* at 169.

139. As far as the author is aware, he is the only person to liken cash balance accounts to loans.

would be inviting participants to “sell their pension entitlement back to the company cheap, and that is a sale that ERISA prohibits.”¹⁴⁰ In effect, Posner reasoned that Xerox was attempting to require participants to “sell back” their accrued benefits in order to receive the accrued benefits—even though the participants already had accrued benefits which could not be forfeited under ERISA.¹⁴¹

Although it appears Judge Posner correctly upheld the “whipsaw” rules, he did not fare as well with mortality discount. The truly troubling part of his discussion of mortality is his brevity. In dismissing Xerox’s contention that a mortality discount should be allowed, Judge Posner held that, because the plan provides for a qualified joint and survivor annuity, if the participant dies before retirement age “his spouse or other designated beneficiary steps into his shoes and is entitled to his entire pension benefit,” so a mortality discount would be improper.¹⁴² He writes nothing else concerning a mortality discount, and it seems that from his quick dismissal of the argument he may not have considered fully the requirements of I.R.C. § 417(e) that apply to all defined benefit plans, not just the traditional model. Posner also seemed to have an incorrect grasp of the QJSA and QPSA. The spouse does *not* step into the shoes of the participant and receive her entire benefit. A QJSA or QPSA entitles the spouse only to a minimum 50% of the benefit the participant would have received, a fact Posner seems to have overlooked. Posner also did not consider whether the QPSA or QJSA annuity death benefit is an accrued benefit and, if it is, to whom it accrues.¹⁴³

Those who have disagreed with *Berger* or *Esden* concerning “whipsaw” or mortality have been vocal in their disagreement. Rosina Barker and Kevin O’Brien, two prominent ERISA attorneys who were involved in *Berger*, published a dissenting commentary in 2003, a few months after *Berger* was decided.¹⁴⁴ They characterized the *Berger* problem as a question of “how ‘accrued benefit’ may be defined by the plan—and in the *Berger* case, redefined by the court.”¹⁴⁵ Barker and O’Brien do not contest that generally future interest credits are unconditional and thus accrued benefits, but they do argue that it did not violate ERISA to have an unconditional element—the guaranteed future interest credits in the Xerox plan—or a conditional element—the extra one percent awarded to those who left their money in the plan.¹⁴⁶

140. See *Berger*, 338 F.3d at 762.

141. *Id.* (quoting I.R.S. Notice 96-8, “benefits attributable to interest credits are in the nature of accrued benefits . . . and thus, once accrued, must become nonforfeitable”).

142. See *id.* at 764.

143. See *infra* Part III.B.

144. See Barker & O’Brien, *supra* note 2.

145. *Id.* at 9.

146. See *id.* at 13.

Barker and O'Brien interpret Notice 96-8 differently than the courts have, and consequently argue that there are two forms of interest credits rather than one: unconditional, known as frontloaded, and conditional, known as backloaded.¹⁴⁷ They further argue that assuming all unconditional interest credits violate ERISA is a dangerous assumption and that, if designed correctly, unconditional interest credits can satisfy ERISA's backloading provisions.¹⁴⁸

The simple version of their argument is that conditional interest credits do not accrue until the actual interest credits are deposited and, thus, cannot accrue if the money is taken out in an early distribution.¹⁴⁹ They are, in effect, a bonus to employees based on a choice. The authors rely on analogies to another section of the Code, § 417(e), which permits adding additional service credits post-employment when certain requirements are met.¹⁵⁰ They find no difference between these accruals and conditional interest credits, and argue that, essentially, "they are additional accruals contingent on post-employment events."¹⁵¹

The counterargument is that the public policy of ERISA's defined benefit regime is violated if some employees, by making a choice, could end up with a greater accrued benefit in the terms of an age 65 annuity than employees making a different selection.¹⁵² Subscribing to this counterargument clearly implicates the policy that two identical employees—one who elects to take a lump sum distribution and one who elects to leave the money in the plan—should be entitled to the same amount in the terms of an age 65 annuity irrespective of their choices. The holdings in *Berger* and *Esden* give credence to this claim. Barker and O'Brien admit that such a protective policy could have been part of the court's reasoning, but dismiss that possibility because they find no basis in ERISA for denying a reward to those who defer their distributions to age 65.¹⁵³

As an aside, it is useful to remember that this would not be a problem if the plan in question were a defined contribution plan. Employees would

147. *Id.* at 9-11.

148. *Id.* For a discussion of backloading standards, see *supra* notes 31-33; see also I.R.C. § 411(b)(1) (2000).

149. This ignores the fact that the whole account is a fictional way of representing a traditionally defined benefit plan, one that would require an annuity payment at age 65.

150. See Barker & O'Brien, *supra* note 2, at 16.

151. See *id.*

152. If this were a defined contribution situation, the employee would exercise vast control both over his benefit and its eventual payout. Because employees have no control over the defined benefit situation, their interests must have greater protections from ERISA, which is why allowing employees to make these kinds of choices is unattractive.

153. See *id.* at 16. The reward in this case would be the future interest credits awarded to the former employee in exchange for the employee's agreement to leave the money in the plan until age 65.

retain control over the funds in defined contribution plans and their accrued benefit would be a direct result of their choices in regard to investments, tax issues, and length of investment.¹⁵⁴ Defined benefit plans do not have this characteristic. In many cases, the only choice given to employees related to a defined benefit plan is whether to take a lump sum distribution or an annuity. It seems clear that protecting employees by guaranteeing that they will all receive the same benefit promised in the plan regardless of their distribution election is sound policy.¹⁵⁵

B. Accrued Benefit Analysis

The final analysis in this section centers upon whether future interest credits and the mortality discount are accrued benefits. Because much ink has already been spent in this Article and elsewhere discussing future interest credits and their status as accrued benefits, discussion here will be brief. The mortality discount, however, has not been discussed in great detail. Analysis will show, I believe, that based on the Code and provisions surrounding defined benefit plans, a mortality discount is not an accrued benefit to anyone. Because a mortality discount lacks the special status given to accrued benefits, it is an essential element of any lump sum distribution calculation for employees electing such a distribution under cash balance plans. Consequently, either the holding in *Berger* should be overturned or other circuits should disregard it on this issue.

1. Future Interest Credits are Accrued Benefits

Even though future interest credits have been discussed at length in the preceding parts, it is helpful to reiterate that future interest credits are accrued benefits under ERISA and the Internal Revenue Code. Courts have unanimously upheld IRS Notice 96-8,¹⁵⁶ which states, “benefits attributable to interest credits are in the nature of accrued benefits . . . rather than ancillary benefits, and thus, once accrued, must become nonforfeitable”¹⁵⁷ Because these benefits are accrued benefits, “the retirement benefits payable at normal retirement age are determined by reference to

154. For a discussion of defined contribution plans and their characteristics, see *supra* notes 24-26.

155. *Cf. Costantino v. TRW, Inc.*, 773 F. Supp. 34, 40 (N.D. Ohio 1991) (stating that it is Congress’ aim to ensure that “to the fullest extent possible that participants who elected lump sum distributions and participants who elected monthly benefits will be treated equally”).

156. *See Berger v. Xerox Corp. Ret. Income Guarantee Plan*, 338 F.3d 755, 758 (7th Cir. 2003); *see also Esden v. Bank of Boston*, 229 F.3d 154, 168 (2d Cir. 2000).

157. I.R.S. Notice 96-8, 1996-6 I.R.B. 24.

the hypothetical account balance as of normal retirement age, including benefits attributable to interest credits to that age.”¹⁵⁸

There have been a variety of arguments against recognizing future interest credits as accrued benefits, with much venom directed toward the IRS for not being more forthcoming with guidance for “hybrid” cash balance plans. As an example of the typical sentiment critics express, one author writes:

The § 417(e) interest rate requirements were designed to protect participants in traditional pension plans The application of the § 417(e) requirements to hybrid plans was never considered when the mandatory interest and mortality assumptions were enacted, and the basic rationale for the creation of the requirements do not apply to cash balance plans. Participants in traditional defined benefit plans needed legal protection to ensure lump-sum distributions represented an appropriate value . . . but a cash balance plan defines the benefit in terms of a lump-sum amount The scarcity of IRS guidance on how the § 417(e) requirements apply to cash balance plans has resulted in confusion and conflict, with significant development of the law by litigation.¹⁵⁹

Such critics make a good point in regard to laws being designed for traditional pension plans, and perhaps changes should be made through congressional or administrative action. Courts have uniformly affirmed, however, that future interest credits are accrued benefits and that the “whipsaw” calculation is necessary to comply with ERISA.

2. The Pre-retirement Mortality Benefit is not an Accrued Benefit

While interest credits are considered accrued benefits under pre-PPA law, pre-retirement mortality benefits are not an accrued benefit under ERISA. The reasoning for this disparity rests upon ERISA’s nonforfeiture requirements, waiver requirements, and the Internal Revenue Code. Because pre-retirement mortality benefits are not an accrued benefit, a mortality discount should be taken during the calculation of early termination lump sum distributions.

ERISA requires two mortality benefits: the qualified pre-retirement survivor annuity (QPSA) and the qualified joint-and-survivor annuity (QJSA).¹⁶⁰ The main difference between the two is when they are paid out. The QPSA is paid out if the participant dies before reaching the normal retirement age and before receiving payments, while the QJSA is paid out

158. *Id.*

159. See MCGILL ET AL., *supra* note 40, at 316.

160. See *supra* notes 63-69 and accompanying text.

if the participant dies after he has already retired and begun to receive annuity payments. Although the minimum mandated benefits for each are identical, QPSAs will generally be smaller because the deceased participant has not had as many years to accrue benefits.

Since a mortality benefit would be paid to a survivor, the real question can be phrased: If mortality benefits are accrued benefits, then when and to whom do they accrue? The answer to this question is that mortality benefits are not accrued benefits and so they do not accrue to anyone. Nonetheless, it is helpful to explore this question because it demonstrates the problems with characterizing the mortality benefit as an accrued benefit, or simply dismissing it the way the 7th Circuit did in *Berger*.

Before discussing the compelling reasons for a mortality discount, it is important to understand how the calculation works and how the numbers actually come out. While not actuarially correct, the following hypothetical illustrates the general concept.¹⁶¹ Assume that Brent is a 35 year-old man who has worked for BIGCO for fifteen years. BIGCO has a cash balance plan that takes a certain percentage of salary each year and deposits it into Brent's fictional account. The money in the account is credited with 5% interest. Brent has \$24,000 in his account today. The question then is: What would his lump sum distribution be if he cashed out tomorrow?

If Brent decided to cash out the day before PPA 2006 went into effect, I.R.S. Notice 96-8 obligations would mandate that the money in his account be extended out thirty periods to the value it would have when Brent would be 65. The future value of his current account, credited with annual interest at 5%, would be \$103,726.62.¹⁶² IRS Notice 96-8 requires that plans use the "applicable interest rate" from I.R.C. 417(e) to calculate the present value of the \$103,726.62 lump sum in Brent's account.¹⁶³ The plan would clearly prefer to use the same interest rate to discount the sum that they used to credit it, because this would result in an identical number. Because of Notice 96-8, however, the plan must use the "applicable interest rate," which is the rate on 30-year Treasury securities.¹⁶⁴ If Brent were to take his lump sum distribution in December 2005, the plan would be required to use the applicable interest rate for November 2005.¹⁶⁵ Thus,

161. An actuarially correct example is beyond the scope of this Article and is necessarily much more complex than the example given. The assumptions made for this example are the minimum in order to make the point as clear as possible.

162. $\$24,000 \times (1 + .05)^{30}$.

163. I.R.S. Notice 96-8, 1996-6 I.R.B. 24.

164. I.R.C. 417(e)(3)(C) (2000) ("The term "applicable interest rate" means the annual rate of interest on 30-year Treasury securities for the month before the date of distribution or such other time as the Secretary may by regulations prescribe.").

165. *See id.*

Brent's applicable interest rate would be 4.73%.¹⁶⁶ Discounting backwards, Brent's future value lump sum of \$103,726.62 becomes \$25,927.29.¹⁶⁷ When compared to Brent's actual account balance of \$24,000, it is evident that Brent receives an additional \$1,927.29 to his account balance due to this "whipsaw" calculation. A mortality discount would be taken *after* this calculation has been completed.

A mortality calculation relies on carefully compiled tables of statistics to determine the likelihood that an individual will not die before a certain age.¹⁶⁸ The "applicable mortality table" for purposes of I.R.C. 417(e) is the Commissioner's Standard Ordinary table.¹⁶⁹ The mortality table uses a "cohort" of one million people born during the same year as the participant to calculate the probability that he or she will live to a certain age.¹⁷⁰ To calculate the likelihood that Brent will live to age 65 using the prevailing table,¹⁷¹ take the number of people actuarially alive today in Brent's cohort—987,679.81—and divide that by the expected number of people in the cohort that will be alive at age 65, which is 903,771.11. This results in a 91.5% probability that Brent will be alive at age 65.¹⁷² The remaining calculation is simple: multiply Brent's \$25,927.29 present value entitlement by the probability of his survival. This reveals a post-mortality discount lump sum distribution of \$23,724.63. This is the amount to which Brent is truly entitled. It is important to note that this amount is actually \$275.37 less than the \$24,000 in Brent's hypothetical account.

Although the amount may seem trivial, it could be argued that this \$275.37 is a premium returned to the plan for the risk it has taken in providing a QPSA. More importantly, it should be noted that Brent's true entitlement is \$2,202.66 less than it is under the current methodology the Seventh Circuit required in *Berger*.¹⁷³ This \$2,202.66 is tantamount to a

166. I.R.S. Notice 2005-96, 2005-52 I.R.B 1210.

167. $\$103,726.62 / (1 + 0.0473)^{30}$.

168. See 1 WARREN FREEDMAN, RICHARDS ON THE LAW OF INSURANCE § 1.10 (6th ed. 1990) (stating that premiums to be charged are determined using mortality tables, "which are tabulated exhibits of the number of survivors and the number of those dying each subsequent year among a given number of persons taken at various given ages respectively"). For an interesting historical discussion of how mortality has been turned into a statistical factor and subsequently used to adjust premiums for mortality risk, see Edward A. Lew, *Mortality Statistics for Life Insurance Underwriting*, 43 J. AM. STAT. ASS'N 274 (1948).

169. See Rev. Rul. 2001-62, 2001-2 C.B. 632-34. See also I.R.C. 807(d)(5)(A) (2001) ("The term 'prevailing commissioners' standard tables' means, with respect to any contract, the most recent commissioners' standard tables prescribed by the National Association of Insurance Commissioners . . .").

170. *Id.*

171. See *id.* at 634.

172. $903771.11 / 987679.81 = 0.915044634$.

173. $\$25,927.29 - \$23,724.63 = \$2,202.66$.

judicially imposed windfall to the employee. Conversely, it can also be considered a judicially imposed taking from the employer *and* other workers, since the money is paid from the funds the employer has deposited into the plan. This taking means the plan will have less money with which to pay its retiring workers, and less money in the fund to increase in value through investment and interest.¹⁷⁴ It is easy to imagine how much these windfalls add up across the thousands of employees who elect lump sum distributions. Now that the numbers behind the calculation have been demonstrated, the legal and statutory case for the mortality discount must be made.

Simple logic debunks the notion that an accrued mortality benefit vests and accrues in the plan participant. If this were the case, then the participant would not be able to elect a lump sum distribution, since doing so would forfeit an accrued benefit that *cannot* be forfeited because of ERISA's anti-alienation and non-forfeiture rules. If mortality were an accrued benefit, I.R.C. § 417(e) would not require the use of the "applicable mortality table" in determining a discount when valuing a lump sum under a defined benefit plan. It also seems clear that a mortality benefit does not accrue in the plan participant because the participant must seek the consent of a surviving spouse in order to elect a lump sum. If the benefit accrued solely to the participant, no consent would be necessary. Participants cannot have it both ways. If they want the protections and positive aspects of a defined benefit plan, they have to be subject to the attendant negative aspects, including a mortality discount. Mortality discounts are not taken from defined contribution plans because there are no mortality benefits built in to the formula.

Additionally, when a participant receives a lump sum distribution, it should be obvious that once the money has been disbursed, the "survivor" who would receive the money in the event of the participant's death no longer has any claim to an annuity or a death benefit. The money is the property of the participant to do with as he desires, devising to his heirs in whatever ways he sees fit. The spousal beneficiary has no legal claim over the funds other than via state community property laws. Remember, however, that a participant electing a lump sum must seek the consent of a surviving spouse before receiving the lump sum. This makes a better case for arguing that if the mortality benefit accrues to anyone, it accrues in the

174. Though defined benefit plan funding and the vast problems associated with it—including premature employee payouts—are beyond the scope of this Article, it is an important issue that has received a variety of commentaries from economists and legal scholars. For in-depth treatments of the perils of defined benefit plan funding, see Daniel Keating, *Pension Insurance, Bankruptcy and Moral Hazard*, 1991 WIS. L. REV. 65 (1991); Nicholas J. Brannick, Note, *At the Crossroads of Three Codes: How Employers Are Using ERISA, the Tax Code, and Bankruptcy to Evade Their Pension Obligations*, 65 OHIO ST. L.J. 1577 (2004).

survivor. The very act of consenting, however, shows that the benefit is not accrued. Once a benefit accrues it becomes non-forfeitable for the plan and inalienable for the participant/beneficiary. If the QPSA benefits accrued to the survivor then he would not be able to waive his right to the annuities the way he can under current law. In fact, whenever a participant elects a lump sum, any surviving spouse must also consent to the lump sum and waive any right to the QPSA. If the benefit was of the accrued variety, this waiver would be illegal and the participant would not be allowed to elect a lump sum.

An even simpler logical argument is that the QPSA, by its very nature, is not accrued because it is designed to expire upon reaching a contingency, namely the annuity start date, presumably at age 65, or perhaps earlier depending upon the plan.¹⁷⁵ Once the participant reaches the annuity start date and begins receiving payments, the QPSA disappears and is replaced with the QJSA, which a survivor *can* waive in the event of a lump sum distribution.¹⁷⁶ The QPSA is designed to provide a simple mechanism for a survivor to receive the accrued benefit of the participant in the event of a preretirement death, and the QPSA itself is not an accrued benefit.

There is also one other important place to search for an answer to the accrued benefit question: the Code itself. Treasury Regulation 1.411(a)-7(a)(1)(ii) states, "In general, the term 'accrued benefits' refers only to pension or retirement benefits. Consequently, accrued benefits do not include ancillary benefits not directly related to retirement benefits such as . . . incidental death benefits"¹⁷⁷ If incidental death benefits include QPSAs, then it should be clear that the QPSA is not an accrued benefit. QPSAs, by their nature, are designed to provide death benefits, and are incidental in that they merely provide for the payout of benefits upon a certain contingency's occurrence, i.e., the death of the participant, and have nothing to do with benefit accrual or normal payout options.

Mortality benefits like QPSAs and QJSAs are also distinguishable from other "forms of benefit" that are protected much like accrued benefits. For example, the ability to choose a lump sum distribution is a protected form of benefit that, once given, cannot be taken away.¹⁷⁸ QPSAs and QJSAs are legislatively mandated and cannot be removed by plan

175. See 26 C.F.R. § 1.401(a)-20 Q&A 10 (2006).

176. See *supra* text accompanying note 66.

177. See Treas. Reg. § 1.411(a)-7(a)(1)(ii) (2005). See also Barker & O'Brien, *supra* note 2, at 22 ("The Treasury regulations, however, say that the 'accrued benefit' does not include 'incidental' death benefits.").

178. ERISA § 204(g)(2)(B), 29 U.S.C. § 1054(g)(2)(B) (2000 & Supp. IV 2004). However, a lump sum option can be discontinued for service arising after the plan amendment. This is the general rule for optional benefit forms; pre-amendment service still gets the optional benefit and post-amendment service does not. See LANGBEIN, *supra* note 23, at 175.

amendment. However, they are different in that mortality benefits can expire or be waived by the beneficiary. Mortality benefits are also distinguishable from benefit components like cost-of-living adjustments (COLAs).¹⁷⁹ In *Hickey v. Chicago Truck Drivers, Helpers and Warehouse Workers Union*, the Seventh Circuit held that a plan-mandated COLA is a protected accrued benefit.¹⁸⁰ The *Hickey* court relied heavily on the lower court's decision in *Shaw v. Int'l Ass'n of Machinists* for their reasoning.¹⁸¹ In *Shaw*, the plaintiff was a retiree of the International Association of Machinists Union.¹⁸² The plan had amended away a COLA it referred to as a "living pension." The plaintiff's argument rested on the idea that "an accrued benefit may be expressed in the form of a formula."¹⁸³ Accordingly, the formula in the plan included the "living pension" and therefore was an accrued benefit along with the main retirement benefit. The *Shaw* court agreed with the plaintiff, holding that "the living pension feature was an integral part of the formula through which the plaintiff's accrued benefits were expressed."¹⁸⁴

Mortality benefits, alternatively, are not an integral part of the benefit formula. The mortality benefits mandated by ERISA are simply alternative payout methods implicated only upon the death of the participant who earned the benefits. Once the participant has started receiving the payments, the QPSA disappears. A QJSA is only implicated if the participant dies before his beneficiary. If the participant elects a lump sum, all of the mortality benefits disappear. Although QPSAs and QJSAs are necessarily included in the plan documents for each defined benefit plan, they do not have the characteristics that protect benefit formulas and even ancillary items like optional benefit forms.

After the above discussion, it should be clear that the mortality benefits ERISA mandates, in defined benefit plans, are not accrued benefits. A participant has no accrued interest in a benefit that only pays out if he dies, and the survivor-beneficiary has no accrued interest in a benefit that can be waived or that will expire upon the occurrence of a contingency. Mortality benefits fail the accrued benefit tests of the Anti-alienation and Non-forfeiture Rule. They also fail because the Regulations

179. A cost-of-living adjustment is designed to help retirees maintain their standard of living by tying their yearly benefit to factors like salary increases or inflation. *Shaw v. Int'l Ass'n of Machinists and Aerospace Workers Pension Plan*, 563 F. Supp. 653 (C.D. Cal. 1983), *aff'd*, 750 F.2d 1458 (9th Cir. 1985).

180. *Hickey v. Chicago Truck Drivers, Helpers and Warehouse Workers Union*, 980 F.2d 465 (7th Cir. 1992).

181. *Id.* at 468.

182. *Shaw*, 563 F. Supp. at 654.

183. *Id.* at 655 (emphasis omitted).

184. *Id.* at 656.

are explicit in the statement that only direct pension or retirement benefits constitute an accrued benefit.

IV. THE FINAL CASE FOR THE MORTALITY DISCOUNT

Barker and O'Brien posited one of the best phrasings of the mortality discount question in their critique of *Berger*:

May a plan reduce the pre-age 65 benefit payout to reflect the value to the participant that, without the early payout, death before age 65 might possibly cause the participant to forego it, if the plan provides a death benefit to the survivors of a participant who dies before age 65?¹⁸⁵

A lay version of the question might be: when calculating a lump sum payment to terminated employees, may a plan reduce the payment based on the value of the ERISA-required qualified pre-retirement survivor annuity because a survivor's receipt of the annuity is conditional upon the participant actually leaving the money in the account until reaching age 65?

As noted above, *Berger* is not helpful in determining whether the pre-retirement death benefit is an accrued benefit, and looking elsewhere for guidance also avails little. The court in *Esden* mentioned mortality but declined to discuss it as an issue because neither party raised it in their arguments.¹⁸⁶ The best place to look for further guidance on the mortality discount issue will be the language of the Internal Revenue Code concerning defined benefit plans and accrued benefits.

Cash balance plans are defined benefit plans for the purposes of ERISA and the Internal Revenue Code. As such, § 417(e) governs lump sum distributions from cash balance plans. To restate, § 417(e)(3) says: "the present value shall not be less than the present value calculated by using the applicable mortality table and the applicable interest rate."¹⁸⁷ The regulations further require the use of the mortality table: "A defined benefit plan must provide that the present value of any accrued benefit and the amount . . . of any distribution, including a single sum, must not be less than the amount calculated using the applicable interest rate . . . and the applicable mortality table."¹⁸⁸ In the context of defining benefit limitations under § 415(b), the mortality table must also be used to correctly value benefits for the purposes of the benefit limit under defined benefit plans.¹⁸⁹

185. See Barker & O'Brien, *supra* note 2, at 7.

186. See *Esden v. Bank of Boston*, 229 F.3d 154, 165 n.14 (2d Cir. 2000).

187. See I.R.C. § 417(e)(3)(A) (2000).

188. See Treas. Reg. 1.417(e)-1(d)(1) (2005).

189. I.R.C. § 415(b) (2000 & Supp. IV 2004). Defined benefit plans are subject to strict rules about how much a participant can receive in benefits per year, the violation of which

Revenue rulings are another source for validation of the mortality discount, even if that validation is by implication. Revenue Ruling 2001-62 reiterates the general statement that defined benefit plans must use the applicable mortality table in setting out the exact table that actuaries must use in determining the value of lump sum distributions from defined benefit plans. Mortality discounts are also mandated in the context of plans that have employee contributions. For example, Revenue Ruling 89-60 requires the use of a mortality assumption in valuing a single sum distribution upon termination of employment even if employee contributions are an element of the equation and governed by another section of the Code.¹⁹⁰ It is interesting that in most defined benefit plans employees have not contributed their own dollars, but if they have, those dollars are also subject to a mortality discount.

Beyond the direct statutory requirements concerning lump sum valuation, the requirement of a mortality discount makes perfect sense when one considers why mortality is a factor in valuing annuities. The whole question revolves around the concept of forfeiture, which could be stated better as the probability that: (a) a life annuitant outlives the age-65 value of his or her lump sum, thus resulting in the plan paying out a greater amount of money than it would if the participant had elected a lump sum; versus (b) a life annuitant dying before he or she outlives the value of his or her lump sum, thus resulting in a forfeiture of the annuitant's assets to the plan. This is a concern even though QPSAs and QJSAs allow another person to collect payments in lieu of the original annuitant, because it is still possible that a beneficiary collecting under a QPSA/QJSA will die before the assets are exhausted.

A mortality factor is a direct representation of the risk that a person will die before reaching some predetermined milestone, thus forfeiting assets to the plan. If a participant elects a lump sum, that risk of forfeiture has been effectively eliminated for the participant and his or her spouse because the participant will immediately realize the actuarial equivalent of the payments. For example, assume that a spouse predeceases a participant who has elected an annuity. The spouse will not receive payments under the QJSA once the participant dies because the spouse is already deceased. Now, the only life to which the annuity payments would be tied is the life of the participant, who would forfeit many assets to the plan if he died soon after his spouse. After electing a lump sum there is no longer a risk of forfeiture because the participant has the actuarial equivalent of all of those payments in hand.

will disqualify the plan for tax purposes. For 2008, that limit is \$185,000. I.R.S. Notice 2007-87, 2007-45 I.R.B. 966.

190. See Rev. Rul. 89-60, 1989-1 C.B. 700; see also Barker & O'Brien, *supra* note 2, at 23 (discussing Revenue Ruling 89-60 in the context of valuing lump sum distributions).

Because a plan must make many assumptions about how long people will live and thus how long they will be entitled to payments, the mortality factor heavily affects how a plan must fund its obligations. It seems only fair that plans should be able to take a discount from the lump sum because participants have been able to effectively escape the forfeiture and mortality risk, which as a matter of law, has already been factored into the annuity payments.

One can also look to the legislative history of ERISA for another argument to allow the mortality discount. As stated previously, Congress passed ERISA to provide for “the continued well-being and security of millions of employees and their dependents [who] are directly affected by [retirement] plans.”¹⁹¹ One way in which ERISA provides that security is by demanding equal treatment for employees regardless of when or whether they elect a lump sum distribution or whether that election is made under a traditional defined benefit or a cash balance plan.¹⁹² This argument is similar to the argument that Judge Posner found persuasive in *Berger*. In *Berger*, Xerox Corporation provided an “incentive” in the form of an extra 1% interest credit to those employees who elected not to receive a lump sum immediately, but to receive an annuity at age 65. In that case, Judge Posner found the plaintiff’s argument convincing, that this was an inequality based on a choice that should have had nothing to do with the actual amount received. The election to receive a lump sum, according to Posner, should have had no further consequence than the decision to allow the account to remain in the trust until age 65. In the mortality discount area, FAP and other traditional defined benefit plans are specifically permitted to take a mortality discount when a lump sum is chosen upon separation of service. To allow cash balance plans, which are defined benefit plans, to escape this cost merely because the benefits are displayed differently is an inequality that ERISA’s defined benefit statutes do not permit. To reach that aim of equality, plans must be allowed to apply the mortality discount. It should not matter whether the plan is FAP or cash balance, the effect of choosing a lump sum upon separation should be identical.

The most glaring argument against applying a mortality discount to the present value lump sum calculation is that the IRS did not apply a mortality discount in Notice 96-8, which is acknowledged as the only guidance the IRS has released on the subject of cash balance plan lump

191. Employee Retirement Income Security Act of 1974, Pub. L. No. 93-406, § 2(a), 88 Stat. 829, 832 (1974).

192. See *Costantino v. TRW, Inc.*, 773 F. Supp. 34, 40 (N.D. Ohio 1991) (stating that it is Congress’s aim to ensure “to the fullest extent possible that participants who elected lump sum distributions and participants who elected monthly benefits will be treated equally.”).

sum distributions.¹⁹³ Notice 96-8 is clear in its requirement of using the “applicable interest rate” but the mortality discount is a notable omission. Some critics have found that it is much more likely that this was merely an oversight by the IRS, and not an IRS statement that mortality discounts are not to be taken in this lump sum calculation.¹⁹⁴ One can argue however that the IRS did explicitly uphold the requirements of § 417(e) in the context of cash balance plans and thus, by implication, the mortality discount should be taken regardless of an omission elsewhere.

Judge Posner’s argument against applying a mortality discount is weaker than the above argument and hinges upon a possible misunderstanding of the Code. Judge Posner states that a mortality discount “is unfathomable, since the plan provides that if the employee dies before reaching retirement age his spouse or other designated beneficiary steps into his shoes”¹⁹⁵ This ignores the whole question of whether the QPSA is an accrued benefit, and in fact seems to assume it is an accrued benefit without any analysis. Judge Posner does not discuss such a situation, like the previous example, where a spouse predeceases the participant.

If the value of that QPSA or QJSA is an accrued benefit, where does it go? The answer to this question is clear: the QPSA and QJSA are not accrued benefits and a discount should be allowed for plans when they value lump sums. Additionally, the designated beneficiary does *not* fully step into the shoes of the participant. The beneficiary is entitled to a benefit, but not the full benefit to which the participant was entitled. This key distinction shows that it makes a difference whether the annuity is tied to the life of the participant or the beneficiary. If the annuity is still tied to the life of the participant, the benefits will be paid 100%. If the annuity is tied to the life of the beneficiary, those payments are generally 50% of the participant’s benefit. There is a different cost associated and a different cost for the lump sum distribution.

Part V will discuss “whipsaw” and mortality discount in light of the new pension legislation passed in 2006. The above discussion of “whipsaw” and mortality discount at the very least will be of assistance to those courts and lawyers who are litigating lump sum distributions paid prior to the passage of the PPA. However, it is also this Article’s argument

193. Even in light of the PPA, discussed *infra* Part V, there is no definitive answer from the judiciary or the legislature on whether a mortality discount applies to cash balance plans. Because Notice 96-8 is arguably overruled under the PPA, I.R.C. § 417(e) is now the only support one way or the other.

194. See Barker & O’Brien, *supra* note 2, at 23.

195. See *Berger v. Xerox Corp. Ret. Income Guarantee Plan*, 338 F.3d 755, 764 (7th Cir. 2003).

that the mortality discount question has still not been answered, and that the discount should still be taken even after the PPA is taken into account.

V. A PROBABLE SEA CHANGE IN CASH BALANCE PLAN LUMP SUM DISTRIBUTIONS: THE PENSION PROTECTION ACT OF 2006

On August 17, 2006, President George W. Bush signed the Pension Protection Act of 2006¹⁹⁶ into law.¹⁹⁷ In his remarks at that time, President Bush referred to the Act as “the most sweeping reform of America’s pension laws in over 30 years.”¹⁹⁸ The PPA made fundamental changes to defined benefit plans, defined contribution plans, hybrid cash balance plans, ERISA fiduciary law, and the PBGC.¹⁹⁹ In regard to cash balance plans, the PPA accomplished two objectives relevant to this Article: 1) cash balance plans are recognized as legitimate, defined benefit plans,²⁰⁰ and 2) employers are permitted to pay employees the amount of the hypothetical account balance without violating vesting rules.²⁰¹ These changes were made prospectively, so any payments made before August 17, 2006, were subject to the prior cloudy rules from I.R.S. Notice 96-8 and the Internal Revenue Code.²⁰²

Although it would seem that “whipsaw” and mortality discount problems have been effectively solved and, therefore, that this Article is no longer relevant, remember that, because relief from the PPA is prospective, any matter pending litigation or new litigation arising from payments made prior to the PPA enactment is subject to the judicial precedent of *Berger*, *Esden*, and *Lyons*. This Article will help other circuit courts decide whether a mortality discount should have been taken in lump sum distributions. The accrued benefit question is still highly relevant, and I argue in this Article that a mortality discount should be taken from lump sum distributions subject to a “whipsaw” calculation.

Additionally, there are several alarming implications arising from the manner in which Congress decided to solve the lump sum “whipsaw”

196. Pension Protection Act of 2006, Pub. L. No. 109-280, 120 Stat. 780 (2006) [hereinafter PPA].

197. See Press Release, Office of the Press Secretary, President Bush Signs H.R. 4, the Pension Protection Act of 2006 (Aug. 17, 2006), available at <http://www.whitehouse.gov/news/releases/2006/08/20060817-1.html>.

198. *Id.*

199. See generally STAFF OF JOINT COMM. ON TAXATION, 109TH CONG., TECHNICAL EXPLANATION OF H.R. 4, THE “PENSION PROTECTION ACT OF 2006,” AS PASSED BY THE HOUSE ON JULY 28, 2006, AND AS CONSIDERED BY THE SENATE ON AUGUST 3, 2006, (Comm. Print 2006).

200. PPA § 701(a). See also ERISA § 203(f)(3).

201. PPA § 701(a). See also ERISA § 203(f)(1).

202. PPA § 701(e)(2).

problem. First, Congress sidestepped the accrued benefit question in its resolution of “whipsaw.” Because a cash balance plan is a defined benefit plan, it is subject to the same rules, requirements, and logic as other defined benefit plans. While there is a plausible reading of the statute that will give the PPA’s language the desired effect, it is not entirely clear that this interpretation coheres with other ERISA requirements. Second, the changes to cash balance plans make them appear even more like defined contribution plans than before. One might question whether, as a public policy matter, cash balance plans *should* still be subject to the same requirements as defined benefit plans.

A. Pension Protection Act of 2006 Authorizes Cash Balance Plans

The most important aspect of PPA treatment of cash balance plans is that it specifically allows cash balance plans to qualify as valid defined benefit plans. Prior to the PPA, cash balance plans were not specifically authorized in any congressional action, but were merely tolerated by the IRS. Now it seems Congress has provided a definitive recognition of cash balance plans as permissible and not age discriminatory.²⁰³ Congress did not discuss “cash balance” plans per se, but did create rules designed to govern “applicable defined benefit” plans that utilize a “hypothetical account” for the purposes of benefit accrual.²⁰⁴ Therefore, it seems Congress did not create a third class of retirement plan, but merely allowed the cash balance plan to take its place in the pantheon of defined benefit plans. Although there are still some questions regarding how effective Congress’s measures will be, the Act does clear up some of the confusion that has surrounded cash balance plans since their inception in the 1980’s.

B. Pension Protection Act of 2006 Abolishes “Whipsaw”

Section 701(a)(2) of PPA modifies ERISA § 203, adding a new subsection that specifically discusses the accrued benefit under a cash balance plan.²⁰⁵ Under new ERISA § 203(f), an “applicable defined benefit

203. Cash balance plans have most often been attacked on the basis of age discrimination. This aspect of cash balance plans has not been discussed in this Article because it is unrelated to the question of lump sum distributions. Several PPA provisions would seem *prima facie* to affect accrued benefits and plan amendments, but upon further review these rules are applicable only for age discrimination and plan conversion purposes. For further discussion of cash balance plans and age discrimination, see generally Richard Shea, Michael Francese and Robert Newman, *Age Discrimination in Cash Balance Plans: Another View*, 19 VA. TAX. REV. 763 (2000).

204. See PPA § 701(a)(2) (creating new ERISA § 203(f)(3)(A), 29 U.S.C. § 1053(f)(3)(A)).

205. *Id.*

plan”²⁰⁶ is not treated as failing to meet certain benefit accrual or vesting requirements “solely because the present value of the accrued benefit (or any portion thereof) of any participant is, under the terms of the plan, equal to the amount expressed as the balance in the hypothetical account”²⁰⁷ The main point is that lump sums can be paid in an amount equal to the hypothetical account balance, eliminating the whipsaw calculation and the need for a mortality discount.²⁰⁸ Currently, this is the interpretation Congress and employee benefits lawyers have adopted²⁰⁹ and, consequently, it is likely to gain popular acceptance. Although it is not explicitly stated in the PPA, it seems Congress intends to simply allow plans to distribute the amount in the hypothetical account balances as lump sum distributions.

There is, however, another interpretation of Congress’s language that might concern plan managers.²¹⁰ Congress stated that a cash balance plan is not disqualified “solely because the *present value* of the accrued benefit is . . . equal to the amount” of the hypothetical account balance.²¹¹ Perhaps there are other reasons within the accrued benefit analysis that would disqualify a plan. According to ERISA’s definition, an employee’s accrued benefit is the individual’s accrued benefit “expressed in the form of an

206. An “applicable defined benefit plan” is defined in new ERISA § 203(f)(3)(A) as “a defined benefit plan under which the accrued benefit (or any portion thereof) is calculated as the balance of a hypothetical account maintained for the participant or as an accumulated percentage of the participant’s final average compensation.” PPA § 701(a)(2). Thus, an applicable defined benefit plan is essentially a cash balance plan.

207. *Id.* (citing new ERISA § 203(f)(1)(B)).

208. If a company can simply cut a check for the amount in the hypothetical account balance without engaging a “whipsaw” calculation, the company is effectively avoiding the requirements of ERISA § 206(g)(3), which states that the present value “shall not be less than the present value calculated by using the applicable mortality table and the applicable interest rate.” ERISA § 206(g)(3). Based on the PPA’s language, this is the most likely interpretation.

209. See STAFF OF JOINT COMM. ON TAXATION, *supra* note 199, at 154 (“In calculating the accrued benefit, the benefit may . . . be calculated as . . . the balance of a hypothetical account . . .”). See also DELOITTE, SECURING RETIREMENT: AN OVERVIEW OF THE PENSION PROTECTION ACT OF 2006 19-20 (2006) (“For distributions after the date of enactment, no distribution in excess of a participant’s hypothetical account balance is required.”); GROOM LAW GROUP, SUMMARY COMPARISON OF CURRENT LAW AND THE PRINCIPAL PROVISIONS OF THE PENSION PROTECTION ACT OF 2006: MULTIEMPLOYER PENSION FUNDING REFORMS 31 (2006).

210. The following discussion is hypothetical and, admittedly, unlikely to be accepted by any court. It is posited here merely for discussion and exploration of the terms of the PPA and its amendment of the ERISA accrued benefit rules.

211. PPA § 701(a)(2) (emphasis added). Several provisions of PPA § 701(a) discuss accrued benefits and interest credits, but only in the context of satisfying age discrimination benefit accrual rules in defined benefits plans that convert to cash balance plans.

annual benefit commencing at normal retirement age²¹² This requirement has been judicially interpreted to mean that the accrued benefit at any given time is equal to what the employee would receive if he got his accrued benefit as an annuity commencing at age 65.²¹³ This definition is what caused the “whipsaw” problem in the first place. Assuming this definition is still valid, which it likely is considering Congress has not altered it, then the amount in the hypothetical account would still be expressed as an age 65 annuity, and a present value calculated.²¹⁴ This interpretation does not seem to eliminate “whipsaw” entirely. Congress, however, would argue that PPA terms allow plans to ignore the age 65 annuity requirements under ERISA by allowing the plan to have the accrued benefit equal to the account balance.

It is also interesting that Congress uses the term “present value” in its language. Based on Congress’s usage of the phrase, Congress might merely allow for the present value of the amount in the hypothetical account, expressed in terms of an age 65 annuity, to equal the amount in the hypothetical account, not necessarily mandate that the amounts be equal. If Congress desired to eliminate “whipsaw” and say that the accrued benefit *is* the hypothetical account balance, then it is curious that they did not explicitly expand the ERISA definition of the accrued benefit to reflect this idea. Under this alternative interpretation, the “whipsaw” calculation could still be made, but the negative effects are stripped away.

To illustrate, recall the earlier example, in which Brent’s \$24,000 current hypothetical account balance was whipsawed to a current lump sum distribution of \$25,927.29 because the plan interest rate was 5% and the applicable interest rate for discounting purposes was 4.73%.²¹⁵ Under this interpretation of the PPA, a possible explanation for Congress’s language and the Joint Committee’s intent is that Congress intended to permit the plan to ignore the applicable interest rate and to use the plan’s normal rate.²¹⁶ This would result in Brent’s receiving a lump sum distribution of

212. Employment Retirement Income Security Act of 1974 (ERISA), Pub. L. 93-406, § 3(23)(A), 88 Stat. 829, 836 (1974).

213. *Berger v. Xerox Corp. Ret. Income Guarantee Plan*, 338 F.3d 755, 758 (7th Cir. 2003).

214. One might also assume that by using the term “present value” in the PPA, Congress meant something along the lines of “the amount in the account today.” This ignores both the financial definition of present value as the amount of future dollars expressed in terms of today’s dollar, and the ERISA definition of present value that requires a defined benefit plan to take interest and mortality into account when discounting an age 65 annuity. It would be irresponsible for Congress to use “present value” to mean “the amount in the account today” because this term has a solidified alternate meaning as a financial term of art.

215. *See supra*, notes 161-167 and accompanying text.

216. Because the PPA is so new, there are no judicial decisions that support any specific interpretation. To date, even Congress is silent on this issue.

\$24,000 because the two identical interest rates cancel each other out.²¹⁷ However, it is unlikely that this interpretation would carry the day in court, because Congress's intent seems clear, regardless of the indirect manner in which Congress went about avoiding the standard accrued benefit rules. It is much more likely that the PPA language allows plans to insert a clause into their cash balance plan that states something simple like, "the current balance of the hypothetical account will be the present value of the participant's age 65 retirement benefit for lump sum distribution purposes."

Congress's language was probably designed to permit cash balance plans to limit accrued benefits, via the benefit accrual terms in the plan documents, to only the amount in the account and the interest credited to the account at the date of separation. Although it is odd that Congress did not state this explicitly, it does seem that this interpretation achieves Congress's intent to allow plans to pay only the account balance. This interpretation would also serve as an effective overruling of *Berger* and its family of cases. Of additional importance, is that the interpretation would seem to allow *Berger* and Notice 96-8 to govern plans that were in existence at the time of PPA's passage. This would be because the future interest credits are part of the benefit formula and are an accrued benefit under *Berger*; plans can only be amended prospectively to deal with future plan years.²¹⁸ For these reasons, this seems to be the most likely interpretation.

Finally, because the term "present value" still implicates ERISA § 205(g)(3) and its inherent calculation,²¹⁹ which involves using the applicable interest rates and mortality tables, a mortality discount could arguably still be taken. A mortality discount clearly favors the plan, and the "solely" language in PPA might be enough to allow plans to take the mortality discount regardless of whether "whipsaw" still exists. Mortality benefits still represent a cost to the employer providing them, which adds support for allowing a mortality discount. If a mortality discount is authorized, the employee could receive less than the amount in his hypothetical account balance, thus adhering to the accrued benefit rules. PPA does not specifically allow for this, but it does not disallow it either. Furthermore, the same I.R.C. § 417(e) analysis used earlier could allow for mortality discounts.²²⁰

217. If the \$24,000 is projected to its age 65 value at 5%, and then discounted back at 5%, the employee would receive exactly \$24,000.

218. Pension Protection Act of 2006, Pub. L. No. 109-280, § 1107, 120 Stat. 780, 1063 (2006). The Act allows for plan amendments to be made to meet the requirements of the Act. Amendments must be made by December 31, 2009.

219. For this Article's discussion of ERISA § 205(g)(3) and I.R.C. § 417(e)(3), see *supra* notes 109, 208, and accompanying text.

220. See *id.*

PPA is silent on the use of the mortality tables with regard to cash balance plans, but the Act does require the use of mortality tables for lump sum distributions from defined benefit plans.²²¹ Because cash balance plans are by definition defined benefit plans, they are subject to the general defined benefit plan rules. Recall the earlier argument for why mortality discounts should be taken on lump sum distributions.²²² Preretirement benefits like QPSAs and QJSAs are still forfeitable and thus not accrued benefits. Lump sum distributions are still subject to I.R.C. § 417(e).²²³ In fact, because Congress's solution to the "whipsaw" problem negates Notice 96-8's whipsaw requirements prospectively, yet is silent regarding mortality discounts, it seems that I.R.C. § 417(e) is the only guidance to which courts may look for answers. Thus, the pre-PPA rationale would seem to apply to lump sum distributions post-PPA, which Congress may or may not have intended. When employees begin receiving the amounts in their hypothetical accounts as lump sum distributions and a mortality discount is not taken, the employee is arguably being unjustly enriched for the value of their pre- and post-retirement mortality benefits.

This reasoning is valid even if Congress's language is given the most expansive interpretation, which is that the normal accrued benefit rules do not apply to cash balance plan lump sum distributions. This idea also hinges on the costs that plans incur by offering ERISA-mandated mortality benefits. Congress's solution seems only to affect the "applicable interest rate" part of I.R.C. § 417(e). The mortality discount should still be taken, even if its calculation is made somewhat different because of more relaxed accrued benefit formulas. Regardless, this is an issue that savvy plan managers and lawyers should be aware of, and which judges should be prepared to address in the future. Although the mortality discount is, in pure dollar terms, not as dramatic as "whipsaw," when the discounts are spread over large populations they do add up. In today's declining but still expensive defined benefit world, the prospect of cost savings is music to a plan manager's ears.

C. Cash Balance Plans Should Retain the Features of a Defined Benefit Plan

As a matter of public policy, cash balance plans should not be altered any further and should retain as many features of defined benefit plans as possible. The "hybrid" nature of cash balance plans is more skewed toward a defined contribution model than ever before. Defined benefit

221. See PPA § 302 (discussing the interest rate assumption for determining lump sum distribution).

222. See *supra* Part IV.

223. See PPA § 302(b).

characteristics possibly at risk include mortality benefits and funding requirements. Because employers have great incentives to decrease the cost of cash balance plans, the government and employee interest groups should be wary of further changes to cash balance plan administration and benefit accruals.

After the enactment of PPA in 2006, cash balance plans changed to look even more like defined contribution plans than before, but with fewer benefits accruing to participants than would accrue under a traditional defined benefit plan.²²⁴ Because future interest credits are no longer part of the accrued benefit, employers will achieve legitimate cost savings, since the “whipsaw” effect will no longer exist. The “whipsaw” effect would not have existed in the first place if plans were allowed to use identical interest rates in the “whipsaw” calculation, so these cost savings seem fair. The elimination of other benefits, however, would be unfair to participants and would cause cash balance plans to drift even further from their official classification as defined benefit plans. Mortality benefits, like QPSAs, QJSAs, and the minimum funding requirements, are examples of protections afforded to participants under the defined benefit model that should not be relaxed or eliminated for cash balance plans.

Employer cost savings are the main force behind further revisions to cash balance plans. Because the “career-employment” model has declined, employers are clearly aware that fewer employees will remain with the company until age 65 to receive their cash balance benefits as annuities.²²⁵ Most employees will leave their jobs at some point before retirement, and research shows that employees are electing lump sum more than ever before.²²⁶ Employees receiving lump sum distributions may obtain them tax-free only if they roll them over into a “rollover IRA.”²²⁷ This rollover is the only incentive a separated employee has to reinvest his money into retirement. This incentive is effective for some, but many employees do not take advantage of it.²²⁸ Therefore, it may be advisable to grant

224. Remember that the traditional defined benefit plan still must express itself as an age 65 annuity, while cash balance plans do not. Also, traditional plans still must calculate a present value based on the age 65 annuity and the applicable interest rate and mortality table. Cash balance plans arguably are not required to do so.

225. See LANGBEIN, *supra* note 23, at 62.

226. See *supra* notes 96-103 and accompanying text.

227. I.R.C. § 402(c) (2000 & Supp. IV 2004).

228. See LANGBEIN, *supra* note 23, at 165 (noting that according to the 1998 Census Bureau Report, “almost two-thirds of those who took [a lump sum distribution] cashed out at least part of it rather than rolling it over.”). Professor Langbein also noted that those who spent rather than saved “tended to be the poorest and the least well-paid, that is, those whose retirement income needs are likely to be the most acute.” *Id.*

additional incentives, even though the current tax incentives are costly enough on their own.²²⁹

Defined benefit plans give employees greater protection for their retirement income, but that protection does not come without a price. Defined benefit plans are expensive, which is why new defined benefit plans are rare, and terminated defined benefit plans are common. It is also why companies funnel more retirement resources into inexpensive defined contribution plans. Defined contribution plans are an important element of retirement planning, but a 401(k) plan on its own is not enough to provide a healthy retirement.

Note that if Congress decides that public policy should shift even further towards the defined contribution model, then hybrid plans and defined benefit plans will also have to change. Congress should step carefully and be comprehensive when making these changes because the defined benefit plan regime is so complex that every change affects some other statute or bit of IRS guidance. The defined benefit regime has had over thirty years to entrench itself, and a few words in a new piece of legislation will likely be inadequate to completely alter the landscape. Regardless of what Congress does or does not decide to do, it is my belief that the defined benefit regime should have a place in the United States retirement landscape, and that these plans can coexist with defined contribution plans to help employees adequately provide for their retirement.

Protecting retirement income will become more important to United States citizens and to the government as the years pass. Making it easy for companies to cut costs and for employees to receive retirement benefits without any greater incentive to reinvest their money is an irresponsible stance given the country's building retirement crisis. Accordingly, cash balance plans should be encouraged, but not to the point where they lack the defined benefit features that protect employees from themselves and from the plan.

VI. CONCLUSIONS

The issues surrounding cash balance plans have been contentious, and, in most cases, the courts have not helped to change the situation. Because of the PPA, one issue that appears to finally have been decided is that of "whipsaw." The courts upheld "whipsaw" because they decided to show deference to IRS Notice 96-8 and the requirements of the Code. Congress

229. *Id.* Currently, Congress has acted to deter not rolling over rather than encourage individuals to roll over. I.R.C. § 72(t) requires a 10% excise tax on lump sum distributions that are not rolled over into either a tax qualified plan at the employee's new employer, or into a rollover IRA. I.R.C. § 72(t) (2000 & Supp. IV 2004).

appears to have decided to ignore the requirements of the Code and allow cash balance plan managers to do the same. Regardless, while it may be true that these laws were designed for traditional pension plans, and that the code drafters did not take cash balance plans into account when writing them, the fact remains that the pre-PPA state of the law is that “whipsaw” is an essential element of the cash balance lump sum valuation and will still be important for pre-PPA litigation.

Still, this Article is designed to illuminate the mortality discount mandated under I.R.C. § 417(e). The Seventh Circuit in *Berger* held that no mortality discount could be taken in the context of cash balance plans, a result that, based upon analysis of the Code, regulations, and the policy of mortality, seems incorrect. The PPA was also silent concerning the mortality discount, an oversight which may result either in employees legally receiving less in their lump sums than they had in their accounts, or perhaps continuing to receive their lump sums without a mortality discount, thus unjustly enriching them for the value of the mortality benefit. The PPA, however, stated that it was permissible for the amount in the account balance to be the accrued benefit; it did not say that the accrued benefit could not be less than the balance. The Code and regulations specifically mandate a mortality discount, and the policy behind mortality as a factor in the valuation of annuities clearly shows that plans must be allowed to take the mortality discount.

With cash balance plans covering millions of people and their numbers increasing daily, allowing participants to continue to receive lump sums without a mortality discount being taken is allowing them to abscond with extra money that is not theirs. Over time, the extra money paid out by cash balance plans will grow into millions of dollars. This is money that will no longer be available to the plan to invest, thus making it more difficult for plans to meet their obligations. This in turn will require greater influxes of cash from the corporations that sponsor the plans. Because more money must be infused into the plans, there is less money for the corporation to either reinvest in retained earnings or disburse to their investors as dividends.

The recommendation of this Article is simple: the *Berger* prohibition of a mortality discount must be overturned for pre-PPA litigation, or at the very least not followed by other circuits. The mortality discount is an important issue for the massive corporations that sponsor and fund cash balance plans, and who have early-terminating employees electing lump sum distribution at an ever-increasing rate. The nature of our economy has changed, with employees changing jobs more frequently than in any other generation. The laws should not penalize corporations or employees for making changes in employment prior to retirement; all employees must be treated the same. This was one of the primary motivations behind ERISA,

and allowing the mortality discount is an important way to bring about that equality for all defined benefit plan participants.