Applying ERISA’s Fiduciary Standards to Cash Balance Plan Conversions

The conversion of traditional defined benefit plans into cash balance plans has prompted quite a debate. Several large, well-known employers have been vilified in the press, Congress is considering remedial legislation and the Equal Employment Opportunity Commission, the United States Department of Labor and the Internal Revenue Service have announced that they are studying the situation. Plan conversions also have resulted in scattered lawsuits across the country.\(^1\)

The litigation and the public debate have focused on three principal issues. The issue that seems to generate the most heated argument is whether cash balance plans inherently discriminate on the basis of age in violation of the Age Discrimination in Employment Act.\(^2\) Substantial questions also have been raised regarding whether some plan formulas comply with the very technical requirements of sections 411(a)(11) and 417 of the Internal Revenue Code of 1986 (the “Code”) as interpreted by the Internal Revenue Service in Notice 96-8\(^3\) and sections 203(e)(2) and 205(g)(3) of the Employee Retirement Income Security Act of 1974 ("ERISA").\(^4\) Many also are concerned that some of the more aggressive approaches to conversion may be unfair to certain older workers and, in some cases, may not comply with the anti-cutback protections of section 411(d)(6) of the Code and section 204(g) of ERISA.\(^5\)

Thus far, scant attention has been paid to the possible impact of ERISA’s fiduciary responsibility provisions on cash balance plan conversions. Because of the lack

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2 For an excellent explanation of the ADEA implications of cash balance plan conversions, see D. Ward Kallstrom, Age Discrimination Issues in Cash Balance Plans. Mr. Kallstrom’s paper was published by the American Bar Association in January of 2000 in connection with its mid-winter meeting. The paper can be obtained by visiting the ABA Tax Section’s web page (www.abanet.org/tax). Simply select Comm-Online, a joint project with Lexis Publishing.\(^\text{TM}\) Follow the instructions provided. The ABA Tax Section Employee Benefits Committee also is submitting a document titled “Comments Concerning Age Discrimination Issues In Cash Balance Pension Plans” to the government. When this Comment is finalized, it will be available on the Employee Benefits Committee’s web page, which can be accessed through the Tax Section’s web page.

3 1996-1 C.B. 359.

4 ERISA is codified at 29 U.S.C.A. § 1001 et seq. All references in this paper are to the ERISA section numbers. For an excellent explanation of these issues and the techniques used in cash balance plan conversations, see Bruce D. Pingree, Traditional Defined Benefit To Cash Balance Conversion Techniques. Mr. Pingree’s paper was published by the ABA in January of 2000. It may be accessed in the same fashion as the Kallstrom paper referred to in footnote 2.

5 Id.
of case law or agency guidance, definitive answers to the fiduciary issues that inevitably arise in the cash balance conversion context are unavailable. The purpose of this paper is to identify the more important fiduciary responsibility issues and suggest a few possible answers.

I. The Decision to Convert.

Is an employer’s decision to convert a traditional defined benefit plan into a cash balance plan subject to ERISA’s fiduciary standards? Based on several Supreme Court decisions, the answer appears to be a resounding “no”.

As the Supreme Court has recognized, an employer is subject to ERISA’s fiduciary standards only when it is acting as a plan fiduciary. When an employer amends one of its benefit plans, it is acting as the “settlor” of the plan, not a fiduciary, and ERISA’s fiduciary standards are inapplicable. As a result, the employer need not act for the exclusive benefit of plan participants or measure up to ERISA’s “prudent man rule”.

The only published cash balance decision to squarely address this precise issue is Corcoran v. Bell Atlantic Corp. In Corcoran, the court disposed of the plaintiff’s contention that the employer’s conversion of its defined benefit plan into a cash balance plan violated section 404(a) of ERISA in the following passage of its opinion:

In light of the Supreme Court’s clear holding on this issue, we have little trouble in finding that plaintiff’s fiduciary claims must fail as a matter of law. Plaintiffs here are alleging that amendment of Bell Atlantic’s pension plan violated fiduciary duties. [Lockheed Corp. v. Spink] to the contrary squarely holds that amendment of a pension plan is not subject to fiduciary scrutiny under ERISA.

II. Implementing the Decision.

Although the employer’s decision to convert a traditional defined benefit plan into a cash balance plan is not subject to ERISA’s fiduciary standards, some commentators suggest that cash balance plan fiduciaries may be under an obligation to ignore various provisions of a cash balance plan due to section 404(a)(1)(D) of ERISA. Section 404(a)(1)(D) provides, in essence, that plan fiduciaries may not follow or enforce plan provisions that violate ERISA.

An amendment converting a traditional defined benefit plan into a cash balance plan might implicate any number of substantive ERISA provisions. For example, the amendment could result in an impermissible cutback of benefits in violation of

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8 Id.
section 204(g) of ERISA. The cash balance plan’s formula also might violate the interest rate provisions of section 203(e) of ERISA or the amendment notice and timing provisions of section 204(h).

At the same time, as the decisions to date amply demonstrate, cash balance plans do not necessarily violate any provision of ERISA. Stated another way, cash balance plans certainly can be designed and drafted in full compliance with all of ERISA’s substantive requirements. As a result, section 404(a)(1)(D) should not pose an inordinate burden on cash balance plan fiduciaries or have a negative impact on the formation and adoption of cash balance plans.11

III. Communicating the Decision.

The conversion of a traditional defined benefit plan into a cash balance plan typically is accompanied by considerable publicity. At a minimum, participants must receive the requisite notice called for by section 204(h) of ERISA and either a summary of material modifications or a new summary plan description. Employers or other fiduciaries often supplement these required communications with additional material explaining a variety of matters that may be of interest to plan participants.

For example, supplementary materials might well provide projections of the amount available at various ages with the cash balance plan and, perhaps, compare them with the benefits previously provided by the defined benefit formula. If the employer has taken measures to protect the interests of older workers (for example, by providing them with additional benefits or providing them with the greater of the cash balance benefit or the old defined benefit plan benefit), these features also may be highlighted.

When they provide these plan communication materials, employers and plan fiduciaries must take care to avoid inaccurate statements. In some circuits, they also must consider whether the materials are adequate to provide the plan participants with the information they may need to make informed retirement decisions.

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9 This is the allegation advanced by the plaintiff in Corcoran v. Bell Atlantic Corp. In Corcoran, the plaintiff’s allegation was rejected in part and reserved for further review in part. The case is fact specific and certain cash balance conversion amendments might well violate the anti-cutback rules.

10 This argument was advanced, unsuccessfully, in Lyons v. Georgia-Pacific Corp. Salaried Employees Retirement Plan. A similar argument was advanced, again unsuccessfully, in Esden v. Retirement Plan of First National Bank of Boston.

11 If a violation of section 404(a)(1)(D) occurs, participants seemingly would bring an action under section 502(a)(3)(A) of ERISA to enforce the provisions of ERISA. Arguably, participants would not be able to bring an action against the breaching fiduciaries for appropriate equitable relief under section 502(a)(3)(B) of ERISA. No relief would be appropriate since the participants have another avenue for redressing the violations. See, e.g., Forsyth v. Humana, 114 F.3d 1467, 1475, 1997 U.S. App. LEXIS 12264, *12 (9th Cir. 1997).
A. **The Duty to Inform.**

As the Supreme Court found in *Varity Corp. v. Howe*, “‘lying is inconsistent with the duty of loyalty owed by all fiduciaries and codified in section 404(a)(1) of ERISA.’” 12 Based on the facts in *Varity*, the Court did not need to consider whether an employer or other fiduciary had an affirmative duty to disclose information on a voluntary basis or in response to inquiries by plan participants. A number of circuits, however, have had little difficulty in doing so.

For example, in *Bixler v. Central Pennsylvania Teamster’s Health & Welfare Fund*, the Third Circuit held that a plan fiduciary has an affirmative duty to speak “when the trustee knows that silence might be harmful”. 13 The Third Circuit also recently held that a plan fiduciary has an obligation to inform a plan participant of its reading of a potentially ambiguous plan provision pursuant to which the participant may be charged with a break in service. 14

Similarly, the Sixth Circuit has held that plan fiduciaries have an obligation to disclose “complete and accurate information material to the beneficiary’s circumstance, even if that requires conveying information about which the beneficiary did not specifically inquire.” 15 The Sixth Circuit went on to hold as follows:

As set out in the Restatement (Second) of Trusts, a trustee ‘is under a duty to communicate to the beneficiary material facts affecting the interest of the beneficiary which he knows the beneficiary does not know and which the beneficiary needs to know for his protection in dealing with a third person.’ Restatement (Second) of Trusts, § 173, Comment d 1959. Moreover, we have been admonished by the Supreme Court to interpret the trust-like fiduciary standards ERISA imposes ‘bearing in mind the special nature and purpose of employee benefit plans.’ (Citations omitted). Accordingly, we agree with the conclusion of our sister circuits that the ‘duty to inform is a constant thread in the relationship between beneficiary and trustee; it entails not only a negative duty not to misinform but also an affirmative duty to inform when the trustee know that silence might be harmful.’ (Citing *Bixler, supra.*) 16

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13 12 F.3d 1292, 1300 (3rd Cir. 1993).


16 Id.
The court also held that the fiduciary’s duty was not satisfied by the dissemination of the statutorily required summary plan descriptions.17

In the Ninth Circuit, a plan fiduciary “has an obligation to convey complete and accurate information material to the beneficiary’s circumstance, even when a beneficiary has not specifically asked for the information.”18 More recently, the Ninth Circuit found that plan fiduciaries had an obligation to provide plan participants with enough information regarding the tax consequences of various elections to alert them to potential tax problems.19 The Ninth Circuit also has held that once an employer has given “serious consideration” to a benefit change, it has an affirmative duty to communicate the change to plan participants; it may not simply wait for participant inquiries.20

The Eighth Circuit also has acknowledged that “ERISA fiduciaries are prohibited from materially misleading plan participants, and fiduciaries sometimes have a duty to disclose information.”21

B. **The Duty to Inform in the Cash Balance Plan Conversion Context.**

To guard against potential claims, all plan communication materials regarding the conversion should be carefully checked for accuracy. The much more difficult issue facing fiduciaries in the context of a cash balance plan conversion is to identify and provide the information that the participants will need in order to make an informed decision regarding retirement.

Consider the following questions that might confront a fiduciary depending on the approach followed in the conversion:

- May the fiduciary simply distribute a summary satisfying the Department of Labor’s summary plan description regulations?

- If the plan is using a “wear away” approach to preserving the accrued benefits from the replaced defined benefit plan, must the fiduciary specifically advise participants that they may not accrue any new benefits until the cash balance benefit “catches up to” the frozen defined benefit?22

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19 *Farr v. U.S. West Communications*, 176 F.3d 484, 1998 U.S. App. LEXIS 38509 (9th Cir. 1998). Although the Ninth Circuit found a fiduciary breach, it also concluded that no relief was available.


Should the fiduciary advise the participants that the risk and reward of future interest rate adjustments is now borne by the participants rather than the plan?

Should the fiduciary point out every instance in which the cash balance plan may be less favorable than the replaced traditional defined benefit program? For example, if the replaced defined benefit plan includes special forms of subsidized early retirement benefits (for example, a “30-and-out” benefit with no actuarial reduction for early commencement of benefits), must the fiduciary point out to the participants that they will no longer be accruing additional subsidized benefits?

Should the fiduciary provide plan participants with a comparison of the projected benefits under the cash balance formula and the projected benefits under the replaced traditional defined benefit formula? Must this comparison be done on a participant-by-participant basis or will general comparisons suffice?

The current case law does not provide definitive answers to these and other questions in the cash balance context. As a general matter, though, the careful fiduciary will consent to make an earnest effort to provide plan participants with all of the information they may need to make informed decisions.

Note: This paper is intended to provide general information concerning the application of ERISA’s fiduciary standards to cash balance plan conversions. This paper should not be relied on as legal advice or as a legal opinion on any specific facts or circumstances. You are urged to consult legal counsel concerning your situation and any specific legal questions you may have.

22 With the “wear away” approach, a participant in the replaced defined benefit plan has an initial benefit equal to the benefit under the defined benefit plan, frozen as of the date of the conversion. The participant’s benefit will remain at this level until the cash balance formula produces a greater benefit.
CASE STUDY

Big Old Co. (“BOC”) sponsors a defined benefit plan for its 50,000 U.S. employees. The defined benefit plan provides a generous benefit of 2% of pay for each year of service. The plan has a normal retirement date of age 65, but unreduced early retirement benefits are provided to employees who have completed 30 years of service, employees who have attained the age of 62 with 10 years of service and employees who have attained the age of 60 with 15 years of service. The plan also provides a reduced early retirement benefit for employees who have attained the age of 55 with 10 years of service. Although actuarial reductions are applied for each month by which the early retirement benefits begin prior to age 65, the actuarial reductions are not as great as a true actuarial reduction.

The benefits under the defined benefit plan are expressed in terms of a life annuity. The plan also provides a subsidized joint and survivor annuity. Benefits also may be paid in the form of joint and survivor annuities that provide various percentages of benefits to the survivor and life annuities with various guaranteed payment periods. The plan does not provide for a lump sum distribution except in the case of participants whose benefits have an actuarial value of $5,000 or less.

BOC has decided to amend the defined benefit plan to convert it into a cash balance plan, effective as of January 1, 2001. If as of January 1, 2001, an employee has attained the age of 55 and completed 10 years of service, the employee’s benefit will equal the greater of the benefit payable pursuant to the old defined benefit formula or the benefit provided by the cash balance formula. The benefits will be compared as of the employee’s last day of work. If the employee has not attained the age of 55 or completed 10 years of service as of January 1, 2001, the present value of the employee’s accrued benefit, determined as of December 31, 2000, will become the beginning balance in the employee’s cash balance account.

Each year, beginning with 2001, an employee’s account will be credited with an amount equal to 5% of the employee’s compensation. The account also will be credited with hypothetical interest in accordance with IRS Notice 96-8.

BOC’s cash balance plan preserves all of the early retirement options for employees who have attained the age of 55 and completed 10 years of service as of January 1, 2001. For other employees, the early retirement options are preserved, but only with respect to the benefits earned on or before December 31, 2000. Under the modified cash balance program, the only distribution options available are a lump sum (which is equal to the participant’s account balance as of the date of the distribution) and a 50% joint and survivor annuity, which is equal to the actuarial equivalent of the employee’s account balance.

Is BOC’s decision to convert the defined benefit plan into a cash balance plan subject to ERISA’s fiduciary standards?
May the fiduciaries of the plan implement the plan without violating their fiduciary duties under ERISA?

May BOC simply communicate the plan by distributing a summary plan description in compliance with the requirements of the Department of Labor regulations?

Must BOC and/or the plan fiduciaries provide the participants with any other information?