Converting from Traditional Pension Plans to Cash Balance Plans Can Create Fertile Ground for Age Discrimination Claims
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In recent years, hundreds of employers across the U.S., including Boeing, IBM, AT&T Corp., Bell Atlantic Corp., Eastman Kodak Co., Aetna Inc., and CBS Corp., have sought to reduce expenses and attract today’s highly mobile workforce by converting their retirement plans from traditional defined benefit pension plans to cash balance plans. A maelstrom of controversy has erupted as a result, spawned by concern that employers’ conversion to cash balance plans unlawfully discriminates against older workers. Politicians and lawmakers across the country have begun weighing in on the issue, and in November 1999, the Department of Labor posted on its internet site answers to plan participants’ most common questions regarding these plans. It is likely that the debate over conversion to cash balance pension plans will continue for the next several years, either until a legal challenge to pension plan conversions reaches the U.S. Supreme Court, or until Congress passes legislation regulating the practice.

What’s the difference between traditional pension plans and cash balance plans?

Traditional pension plans pay pension benefits in the form of annuity; these plans guarantee a set monthly benefit payable for life, determined in accordance with the plan’s benefit formula. For example, a fairly standard pension formula would peg benefits at approximately 1.2% of a participant’s annual salary during their final five years of employment (the years in which their salary is likely to be highest), multiplied by the total number of years the participant has been employed by the plan sponsor.

By contrast, cash balance pension plans pay out benefits as a lump sum, calculated based on a set percentage of the participant’s pay each year, plus interest (typically calculated based on the consumer price index or the 30-year Treasury bill rate). The benefit payable is whatever is in the account when the participant retires. Like 401(k) plans, cash balance plans are portable; that is, employees who change jobs may roll the money in their cash balance account into an Individual Retirement Account (“IRA”), or into a cash balance account provided by a subsequent employer. This feature provides flexibility not offered by traditional pension plans, and is generally favored by younger employees who expect to hold numerous jobs before they retire.

Why might it be a problem to convert from a traditional pension plan to a cash balance plan?

Participants in traditional pension plans earn most of their benefit in their final years of service, whereas benefits under cash balance plans are calculated based on a fixed percentage of pay, so that participants accrue their pension benefit evenly from year to year. Therefore, conversions to cash balance accounts may have the effect of providing lower than
expected pension benefits to older workers who anticipated benefiting from a "spike" in earnings (and, accordingly, in their accrued pension benefit) as they approach retirement. The problem may be exacerbated if employers establish employees' opening balances in cash balance accounts at less than the present value of the employees' accrued benefit in the traditional pension plan. Finally, plan participants whose accrued benefits under the prior plan exceed their benefit in their newly-converted cash balance account might not accrue further benefits until the cash balance account "catches up" to the benefits they accrued under the prior plan.

Who cares if an employer converts to a cash balance plan from a traditional plan?

For starters, older workers care, and complaints about employers who have forced older workers out of their prior pension plans into cash balance plans has resulted in heavy criticism of those employers in the media. The issue has also captured the attention of a number of federal agencies, including the Department of Labor ("DOL"), the Internal Revenue Service ("IRS"), and the Equal Employment Opportunity Commission ("EEOC"), all of which are currently investigating whether conversions from traditional pension plans to cash balance plans violate the federal Age Discrimination in Employment Act ("ADEA"). The DOL has empanelled a working group to review the issue and make recommendations to the Secretary of the DOL, the EEOC is investigating age discrimination charges filed by employees who had participated in traditional pension plans that have been converted to cash balance plans, and the IRS has recently solicited public comment on the ADEA implications of pension plan conversions. Legislation recently introduced in both houses of Congress would, if passed, prohibit employers from forcing employees who participate in a traditional pension plan to switch to a cash balance plan. President Clinton has expressed preliminary support for alternative proposed legislation which would strengthen disclosure requirements when employers intend to convert to cash balance plans, by requiring employers to provide employees with at least 45 days' advance notice of plan conversion.

Does this mean employers shouldn't convert to cash balance plans, even though lots of employees would prefer a cash balance plan?

No, it doesn't. However, in view of the yet-unresolved debate regarding the potential discriminatory effect on older workers of cash balance conversions, it is advisable for employers to permit employees age 40 and over (that is, those employees who fall within the statutory protections of the ADEA) to choose whether to remain in the defined benefit plan, or transferring to a cash balance plan. Alternatively, employers may elect to enroll all newly-hired employees in a
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cash balance plan, but to allow employees already participating in a traditional pension plan to choose between remaining in that plan, or switching to a cash balance plan, or to "grandfather" participants in the old defined benefit plan for some period of years after the conversion to a cash balance pension plan so that employees planning to retire shortly after the conversion do not suffer as a result of the conversion.