

CENTER OF GRAVITY SHIFTS TO 3rd CIRCUIT

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Two remarkable cash balance decisions were announced at the end of January within four days of each other, both in the 3d circuit, the first in the New Jersey district court, the second in the 3rd circuit appeals court. Neither was apparently written with the benefit of having seen the other's opinion, but the cases arrived at remarkably similar conclusions, both dismissing age discrimination (and other) claims against cash balance plans launched by plan participants, both relying on the 7th circuit's *IBM* opinion, but each pursuing its own distinctive approach, based on its own choice of case support and reasoning, and informed by its own insights and judicial sensibilities.

The opinions in these cases, together with the *IBM* opinion of the 7th circuit last August, are now the three most important documents in the field, the *IBM* decision for its pointed repudiation of the district decision in its circuit that had had such unbelievable repercussions and, just as importantly, for its seminal position as the first decision at the circuit court level. But the two decisions in the 3rd circuit are, in a sense, more useful to a proper understanding of the critical factors at play in this troubling area; for, where the 7th circuit's opinion relied heavily – not solely, obviously --on the solid and sound instincts of Judge Easterbrook, who wrote a remarkably terse (one might almost say simplistic) opinion for the unanimous court, the two opinions in the 3rd circuit are more deeply analytical and meticulously founded on the usual badges of scholarship.

I therefore suspect the proper study of the cash balance plan henceforth will concentrate on what the judges in the 3rd circuit have written, District Judge Chesler in the first of the cases to be decided, *Dun & Bradstreet.Corp.*, 2007 U.S. Dist. LEXIS 6078 (D.N..J.1/26/07), and Circuit Judge Greenberg in the second, writing for the unanimous 3rd circuit court panel in *Register v. PNC Financial Services Group, Inc.*, ___ F.3d ___ (2007), 2007 U.S. App. LEXIS.1967 (1///30/07). The center of gravity has suddenly and decisively shifted to the 3rd circuit.

Where the judges in *J.P. Morgan* and *Citigroup*, decided in the Southern District of New York in almost the immediate wake of *IBM* (In re J.P. Morgan Chase Cash Balance Litigation, 460 F. Supp. 2d 479 (10/30/06), and In re Citigroup Pension Plan ERISA Litigation, 2006 U.S. Dist .LEXIS 89565 (12/12/06)), could almost cavalierly brush aside the *IBM* decision that most observers had thought would make the world safe again for cash balance plan sponsors, specifically rejecting its authority and reasoning, future judges, confronted with the *D & B* and *PNC* cases in deciding the fate of cash balance plans, will not so lightly face their tasks.

Each of these two new cases in the 3rd circuit, *PNC* and *D&B*, decided on the heels of the New York cases, do a complete 180 degree turn away from the New York opinions. Indeed, Judge Chesler does more, specifically attacking portions of the reasoning in *Morgan*. This quartet of post-*IBM* decisions provides a most unusual pair of bookends around the *IBM* decision, that are sure to command intensive study from scholars and practitioners (not to imply

there are no scholars among benefits practitioners).. What follows is not offered as a critical study of *PNC* and *D&B*, rather only some first impressions of these two robust decisions.

A Good Credit Report For D&B

What first strikes one about the *Dun & Bradstreet* opinion, right after the *Morgan* and *Citigroup* decisions, is how completely the court acknowledged its debt to the *IBM* appellate decision, although, as a district court within the jurisdiction of the 3rd circuit court of appeals, it was not obliged accept that as binding authority any more than the New York district judges.

Describing the *IBM* decision as supported by “an opinion that provides a strikingly clear, concise, and persuasive treatment of the issue,” the New Jersey court enumerated among its “several important points” that the plaintiffs in *IBM* had confused “payments into the account with payments out”, by failing to recognize that the operative term was “benefit accrual”, which describes “what the employer puts into the account”, not “accrued benefit”, which “refers to what the employer takes out of it.” That same distinction “undermines Plaintiff’s claim” in the *Dun & Bradstreet* suit, says the court, and so plaintiff has failed to state a claim, as to which the “Court perceives no way for Plaintiff to amend (his complaint) so that it could withstand a future motion to dismiss.”

The court further goes along with the 7th circuit’s conclusion that the plaintiffs there, as in the case before him, were complaining of a consequence of “the time value of money, rather than age discrimination”, an argument that he dismisses with a quote from the 7th circuit that treating that “as a form of discrimination is not sensible”. Note that word “sensible” that is such a breath of fresh air in the Easterbrook opinion of the 7th circuit. Further directly quoting from the *IBM* opinion, that “it is essential to separate age *discrimination* (italicized in the text) from other characteristics that may be correlated with age”, Judge Chesler adds, “Again, this is right on point in the instant case.”

Having thus placed himself firmly in the *IBM* camp, he then points out specific mistakes in district opinions of courts that went the other way, not least the *Morgan* opinion, where, proving himself no less grounded in philology than law, he says in no uncertain terms, “the court took the wrong word from the dictionary”, mistaking the verb “to accrue” with the noun “accrual” and so applied to the noun the dictionary definition for the verb, leading the court in *Morgan* to reach the erroneous interpretation of the statutory test for determining an improper “rate of benefit accrual” as requiring one to look to “the end result of accumulation”, not “the action or process of accumulating”.

This is not pettifoggery. It goes to the heart of the error of those courts that have found age discrimination in the fact that younger participants are advantaged over older ones because the interest factor will provide them with a greater retirement benefit from a given year’s combined pay and interest credits. As Judge Chesler says, at another point: “Finding ‘benefit accrual’ to be the same as ‘accrued benefit’ is tantamount to equating a past process with the present result of it. It violates both language and logic.” Again, citing the *IBM* opinion, he says, “it is a mistake to confuse the two; they are different.”

Well said, thou good and noble judge. That I should so completely concur can come as

no surprise to the reader who recalls (if there be one) my words in the 2005 volume of the NYU Review of Employee Benefits and Executive Compensation, writing of the then recently issued decision of the trial court in *IBM*, where this confusion first made its way into the law books, that "this conflation of the merely projected accrued benefit and the aggregation of annual benefit accumulations that make up the participant's actual benefit at any particular time was the source of his confusion and the basis of his decision." "Blue Notes: A Modern Andersen Fable", 2005 NYU Rev. of Employee Benefits and Exec. Comp, Ch.2 § 2.01[4], pg 2-6

In the paragraph just before the preceding quote I had stated my reason for this unforgiving conclusion:

"...the trial court decision is not just wrong, but flagrantly so for resting on a completely erroneous interpretation of the age discrimination statutes as related to cash balance plans. It focuses on the progressive shrinkage of the annual interest credit projection to retirement age that is a purely *hypothetical* facet of the accrued benefit calculation, devised by the IRS for a purpose having nothing to do with the *actual* annual interest-crediting element of the benefit accumulation that is distinctive to cash balance formulas. The annual interest credit, not the interest component of the accrued benefit, is the only relevant interest number in determining a participant's actual benefit. In confusing the two, the court was able to mislead itself ... into concluding that the age statute's prohibition against a reduction in the 'rate of an employee's benefit accrual' because of age was offended by the entirely proper time-value operation of interest hypothetically projected to retirement age, for purposes of the 'accrued benefit' concept as applied to cash balance plans..."

I then noted the obvious, that an interest projection to retirement age self-evidently shrinks continuously for every participant with the advance of age, "even for participants 22 years old relative to their 21-year-old colleagues!."

On reading the New Jersey district court opinion, with such gratification, one could only hope that the good feelings would survive the decision in the 3rd circuit when the D&B case reached that level. That the answer would come only four days later – not, of course, in *D&B* -- was more than one could have been anticipated, at least not one such as I who was then not aware that another district court decision in the 3rd circuit, in *Register v. PNC Financial Services Group*, 2005 U.S. Dist. LEXIS 29678 (E.D. Pa. 11/21/05), was so ripe for determination by the 3rd circuit.

PNC Makes It A Clean Sweep For CBs In 3rd Circuit

The opinion of the 3rd circuit in *PNC* displays that court as possessing the firmest grasp of any court on the factors that matter in the resolution of this continually troubling issue of age discrimination for cash balance plans. Consequently the court has not fallen into the trap of picking the wrong principles on which to posit its decision. The same cannot be said of the courts that have reached a contrary conclusion.

It is not for no reason that this issue has produced such a tangled web of conflicting

decisions, and even contradictory commentary in the journals. The cash balance plan is a curiosity. It has been called a hybrid of the defined benefit and defined contribution designs. That is wrong. It is no more a hybrid than man is a hybrid of the monkey and chimpanzee species. It is quite simply a new form, which, while taking on some of the trappings of DB and DC plans, puts them together in quite different ways. The problem is that the regulation of pensions recognizes only those two forms, dividing the pension universe into DBs and DCs, each with its own distinct rules, forcing cash balance plans to be governed by one or the other, when it really should have its own separate governing regime.

In an extremely perceptive passage of the *PNC* opinion Judge Greenberg, noting that “cash balance plans are a type of defined benefit plan” (as, by most observers’ view, not least the IRS, they clearly are), correctly comments that this “triggers a host of regulatory provisions applicable to defined benefit plans, but not to defined contribution plans.” He then puts his finger on a key problem for cash balance plans: “Application of the provisions, however, may be difficult because Congress enacted ERISA and the administrative agencies adopted the defined benefit regulations before the creation of cash balance plans...”. The court has here stated a fact that regrettably is not recognized in most of the judicial and other writings, which therefore unsupportably impute to Congress an “intent” that, even with clairvoyance, it could not possibly have possessed..

Continuing, the judge then writes:

“Thus, the original rules for defined benefit plans simply did not address the unique features and hybrid nature of cash balance plans. This circumstance has required courts, and no doubt persons designing and administering cash balance plans, to face the unenviable task of trying to fit cash balance plans, pension plans with fundamental differences from traditional defined benefit plans and with many attributes of defined contribution plans, within the defined benefit framework, a process somewhat similar to placing a round peg into a square hole. As might be suspected this task has proven not to be easy, and...has led courts throughout the country to reach diametrically opposed conclusions with respect to applying ERISA provisions to cash balance plans.”

In the *IBM* opinion the 7th circuit pretty much adopted the statutory defined contribution metric for testing age discrimination, “the rate at which amounts are allocated to the employee’s account”-- that is, the amounts put into the plan for participants by the employer -- which it calls the “inputs”, as opposed to the “accrued benefit” that has been accumulated -- the outputs -- for each participant, which ERISA and the Code define as “the annual benefit commencing at normal retirement age”. The 7th circuit justified its choice of the defined contribution test chiefly by the close resemblance of the benefits delivered by both DC and cash balance plans.

The 3rd circuit acknowledged that it reaches the same conclusion as the 7th, with the same terminology and even much the same analysis. But its opinion is more subtle, more finely tuned, probably to some extent so as to avoid an admonition in plaintiff-appellants’ brief that the court is not permitted to rewrite the statute or to fail to adhere to its text as applicable to defined benefit plans.

After first quoting some choice language in the cases on the proper approach to statutory construction generally (e.g., “a mistake to ‘suint[] myopically’ at the phrase in question and interpret it in isolation rather than in the context of the ‘text and structure’ of the statute as a whole”, and “ ‘[s]tatutes must be interpreted to receive a sensible construction, limiting application so as not to lead to injustice and oppression’ ”, the court observes that the statutory provisions for DB and DC plans “are nearly identical and prohibit the same behavior,” which, says the court, “is particularly relevant in that both cash balance and defined contribution plans are defined in terms of their stated account balances, albeit one is hypothetical and the other is cash.” Then the court comments:

“(W)hen dealing with a hybrid plan subject to defined benefit rules, a court should look to the parallel defined contribution plan anti-discrimination provision to clarify the meaning of ‘benefit accrual’ within the cash balance plan context.... ‘(A)ccrued benefit’...define(d).as ‘an annual benefit commencing at normal retirement age’ is simply not the same thing as ‘benefit accrual’.”

The “benefit” in the term “benefit accrual”, writes the judge is the –

“stated account balance as that is how the benefit is defined by cash balance plans. Once this proposition is grasped, it becomes clear that the ‘accrual’ of ‘benefit’...refers to the credits deposited into the participant’s cash balance accounts, *i.e.*, the inputs.”

Of course, the judge’s reference to a “deposit” of credits into a participant’s account is not technically correct, as it is clear from his opinion he well knows, since, as he says in the passage quoted two paragraphs up, the account is “hypothetical”. That does not detract from the force of his argument. Indeed, if the interest credits were actually so deposited at the time of their “accrual”, there might be at least a colorable argument that they should be considered in weighing the disparity of such “deposits” among participants, in ascertaining the presence of discrimination.

While the crucial issue in this case was termed by the judge as “com(ing) down to the meaning of ‘benefit accrual’ as applied to cash balance plans”, and admittedly that is the critical statutory language to be construed, the underlying issue in the case revolves around the significance of the interest credits, that are the distinctive feature of the cash balance design. That is what gives rise to the allegedly discriminatory reduced benefit “output” for an older participant than for every other younger participant. Regarding that very point, the court says:

“The effect of the cash balance design that appellants challenge (the accumulation of interest [the parentheses are so in the text]) is identical to the accumulation of interest on employer contributions under defined contribution plans...(I)t is no different than that when a bank deposit is drawing interest. The longer the deposit remains in the bank in an interest bearing account, the more it is worth.”

That is an important observation. It alludes to the time-value-of-money argument that Judge Easterbrook so effectively dismissed in his *IBM* opinion: “Treating the time value of

money as a form of discrimination is not sensible.” I agree with the point the judge is making by the analogy, and have made a similar one myself in earlier writings, except for the suggestion that the “accumulation of interest” in a cash balance plan is “identical” with the earnings potential for participants in a DC plan. As with the above-noted reference to “deposits” of credits into a participant’s account that the judge speaks of, that papers over too glibly the very distinct differences between the CB and DC designs – in this case, as regards their respective treatments of the interest element. But that does not gainsay the obvious fact that the relative durations of the projected “interest” element in the cash balance design as between one participant and another is no more discriminatory than the comparable, albeit not “identical”, earnings element in the DC design.

Nevertheless, that does not satisfactorily explain why the decreasing rate of growth of interest credits with increasing age, which is the main prop of the plaintiffs’ arguments in these cases, is not even posed by the statute. The easy but technically inexact answer favored by the courts is that CB plans are more like DC plans, in the way they rely upon an earnings factor (interest in the case of CBs, returns on contributions – i.e., interest, dividends, capital gains – in the case of DCs), so they should be tested under a like standard. I submit there is a better rationale, which I will attempt to lay out briefly in the following section.

The Interest Credit At The Core

The correct result can be reached under the DB age discrimination standard, without reference to the DC standard, because it is only by reason of improperly importing into the DB age discrimination standard the “accrued benefit” concept that the projection of interest to retirement even enters the calculus. Explaining why that is so can be a bit complicated, because of some interrelated elements that are involved, or, more literally, seemingly involved ; but I will attempt to reduce the matter to its most elemental expression.

To start with, the source of the problem is the interest credit, and that only enters the equation if the accrued benefit concept were relevant, and it would only be so if the age discrimination rule were to implicate the accrued benefit concept. Without that, there would be no projection of interest, and the problem disappears, since there would be no considering of the relative disadvantages of declining interest accumulations with advancing age. So the threshold question is whether the discrimination statute involves testing relative accrued benefits. It does not unless the critical term “rate of benefit accrual” means “accrued benefit”.

Let’s first see why the interest projection enters as part of the accrued benefit. ERISA and the IRC both identically define “accrued benefit”, under a defined benefit plan, as the participant’s benefit “expressed in the form of an annual benefit commencing at normal retirement age”. Treasury and the Service have translated that, as referable to CB plans, to require that interest credits be frontloaded, meaning that the participant is required to earn, on any year’s pay credit, all the interest that would accrue in respect of that pay credit for all subsequent years until retirement, without the need to perform any further services. Backloading would defer any entitlement to benefits, whether due to pay or interest credits, to service credits in later years of participation.

The problem of greater interest credits for younger participants only arises facially under

frontloading. But in fact that pre-credited interest accumulation will only be realized as long as the participant does not cash out his benefit before retirement age. Participants of different ages who work the same number of years after a pay credit and whose pensions are paid out at separation from service will be entitled to only the same number of years of interest credits, under the frontloading assumption. So, as a practical matter, the participant will only realize the *projected* later years' interest credits if he earns them by not previously withdrawing the principal funds to which such interest is geared – hence, much the same as withdrawals from a bank account, or early redemption of a bond, or the cashing out of any interest-accruing asset.

Theoretically plans could be designed to provide either frontloaded or backloaded interest credits. But, as noted just above, the government has essentially decreed the frontloaded method for cash balance plans, insofar as involves the accrued benefit concept. Thus, the Service stated its view, in a 1996 Notice, that, for CBs, only frontloaded interest would satisfy a separate statutory requirement applicable to all DB plans proscribing the backloading of benefits generally. In regulations proposed by Treasury subsequently, specifically as regards the age discrimination statute, it was made clear that a frontloaded interest accrual formula would permit use of a special testing method under which the counting of interest credits was avoided entirely for age discrimination purposes. The preamble to final regulations under the general plan qualification rules went farther, stating declaratively that the accrual of interest adjustments through normal retirement age in the year of hypothetical allocation of pay credits will *not* cause a CB plan to fail to satisfy the age discrimination requirements.

Thus, the government has never stated that the accrued benefit concept is subsumed in the age discrimination concept, and, on the contrary, has gone out of its way to point out that, in effectively imposing front-loaded interest projections on cash balance plans, it has not trapped them into violating the age discrimination requirements. Is it conceivable that they could have intended to spring such a trap? To my knowledge, no advocate of a reading of the age discrimination statute otherwise, and no court that has done so, defends that result on policy grounds (not even Judge Murphy, the district court judge in *IBM*, who acknowledged that his decision would mark the end of CBs). Moreover, Congress has in the recently enacted PPA made CBs immune to an age discrimination challenge prospectively (never having said otherwise in pre-PPA legislation or legislative history, it should be noted).

Dissonant Quartet

There have been other instances in the law where a spate of conflicting cases have come down on the identical issue; but there is something unique about this recent quartet, decided within a space of three months, following immediately upon a circuit court decision that had demolished the decision of the lower court in its circuit, which itself had been largely responsible for moving the Congress only months before to enact, as part of the Pension Protection Act, a legislative reversal (albeit only prospectively) of that initial lower court decision, to say nothing of a significant inaction during this same period when the Supreme Court declined to grant certiorari in the *IBM* litigation which had begun this whole frenzy

I strain to find the right term to describe this incredible journey through the courts, and can come up with nothing better than a ride on a roller coaster. Don't stand up yet. The ride isn't over. Such is the legacy of litigation left to us by the last Congress in failing to make the cash

balance provisions of the PPA retroactive.

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