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Ninth Circuit Rules Cash Balance Plans Do Not Discriminate Against Older Workers

Following four other Circuits, the U.S. Court of Appeals for the Ninth Circuit has ruled that cash balance plans are not inherently age discriminatory.

Background

Over the past two decades, many traditional pension plans have been converted to cash balance plans. Under a cash balance formula, hypothetical account balances are established for each participant and are periodically credited with contributions and interest. While contributions are credited by the employer during employment, interest credits continue until normal retirement age, regardless of continued employment. As a result, the dollar value at retirement age of the benefits earned by younger workers with comparable service is greater than the value of the same benefits earned by older workers. For that reason, cash balance plans have been challenged as being age discriminatory in numerous lawsuits over the last decade.

In 1998, Southern California Gas Company (SCGC) converted its traditional defined benefit plan to a cash balance plan. Under the amended plan, each participant's accrued benefit under the traditional formula was converted to an opening hypothetical account balance, to which monthly retirement credits and interest credits were added. The plan's grandfather provision allowed eligible participants to continue accruing benefits under the pre-conversion formula for another five years, at which time their accrued benefits under the pre-conversion formula were frozen. At retirement, plan participants were to receive the greater of the actuarial equivalent of either their cash balance account or their frozen accrued balance under the pre-conversion formula.

Plan participants' lawsuit in federal district court alleging that SCGC's amended plan violated the age discrimination provisions of ERISA and the California Fair Employment and Housing Act (FEHA), as well as ERISA's anti-backloading rules and notice requirement, was dismissed. On appeal, the U.S. Court of Appeals for the Ninth Circuit, in *Hurlic v. Southern California Gas Co.*, joined the Second, Third, Sixth and Seventh Circuits in ruling that cash balance plans do not discriminate on the basis of age. The court also ruled that the plan did not violate ERISA's anti-backloading rules.

The Ruling

ERISA expressly prohibits age discrimination in defined benefit plans. In *Hurlic*, the court held that cash balance plans are not inherently discriminatory and do not violate ERISA's anti-backloading rules since cash balance formulas do not reduce older workers' accrued benefits because they attain a certain age. Rather, the benefits earned by younger employees are worth more than the same benefits earned by older employees due to the time value of money.

The Age Discrimination Claim. The court rejected the participants' interpretation of ERISA's age discrimination provisions, finding that the "rate of an employee's benefit accrual" and "accrued benefit" are two very distinct – and fundamentally different – concepts. The rate of benefit accrual refers to the employer's contribution to the plan, while the accrued benefit is measured by the age-65 annuity that can be purchased with the participant's account balance. The court recognized that younger workers have a longer period of time over which to earn interest. Therefore, the court concluded that although younger workers may end up with higher accrued benefits, it is a function of the time value of money and not age discrimination. Because the benefits of older and younger plan participants accrued at the same rate under SCGC's cash balance plan (i.e., employer contributions were made on a nondiscriminatory basis), the court held that the plan did not violate ERISA's age discrimination provisions.

> ***BUCK COMMENT.*** *Because the Pension Protection Act of 2006 (PPA) has insulated cash balance plans from such challenges going forward, the discrimination issue only applies retroactively. This ruling by the Ninth Circuit, not usually considered a pro-business court, should largely end the litigation over whether cash balance plans are age discriminatory.*

Anti-Backloading. Participants also claimed that the SCGC cash balance plan violated ERISA's anti-backloading provisions. In essence, they argued that they would accrue no additional pension benefits during the "wearaway" period (i.e., until their cash balance benefits exceeded their benefits under the old plan) and, thus, the benefits they would accrue in the first year in which their cash balance accounts exceed their frozen plan benefits would violate the 133-1/3% rule. The Ninth Circuit rejected this argument, concluding that only the new cash balance formula should be taken into account to determine whether the 133-1/3% rule is satisfied. In so doing, the court disagreed with the IRS' interpretation in Revenue Ruling 2008-7 (see our February 8, 2008 *For Your Information*), which said that use of "greater of" provisions in cash balance conversions could violate ERISA's anti-backloading provisions. The Ninth Circuit also held that wearaway in cash balance conversions is not age discriminatory.

> ***BUCK COMMENT.*** *Since Revenue Ruling 2008-7, the IRS has issued proposed regulations on the anti-backloading requirement which clarify that aggregation would not be required where a cash balance plan has a grandfather provision. (See our July 7, 2008* For Your Information*.) Treasury/IRS held a hearing on these regulations on October 15, 2008.*

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The FEHA Claim. The participants also argued that SCGC's cash balance plan violated state laws prohibiting age discrimination in benefits. However, the Ninth Circuit found that the claim brought under the California Fair Employment and Housing Act was preempted by ERISA.

Conclusion

The Ninth Circuit's decision should be particularly welcome to plan sponsors of existing cash balance plans, given that PPA provides clarity on the age discrimination issue only prospectively. This decision, coupled with PPA's generally helpful hybrid plan provisions and the Supreme Court's refusal to review other cases finding that cash balance plans are not inherently age biased, makes the adoption of new cash balance plans more viable than ever before. Buck's consultants are ready to assist you in reviewing how this decision may affect your existing or prospective plan design.

This FYI is intended to provide general information. It does not offer legal advice or purport to treat all the issues surrounding any one topic.