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2007 Employee Benefits Seminar

Current Trends in Litigation and Enforcement

Presenters: **Tom Gigot (Moderator)**
Lars Golumbic
Mark Nielsen
Mike Prame
Chris Rillo

Topics: **Defined Contribution Plan Fee Litigation**
DOL Consultant/Advisor Enforcement Initiatives
ERISA Remedies in Flux
Company Stock Developments

Materials: **Presentations**
LaRue v. DeWolff **and the Possible Barriers to Recovery Under ERISA**
Emerging IRA "Rollover Desk" Issues
Recent Developments in Cash Balance Plan Litigation

Follow the Money:
Revenue Sharing Litigation

Chris Rillo

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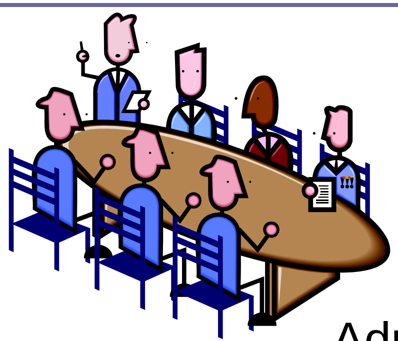
Common Fiduciary Structure

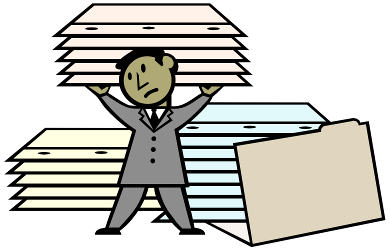


Administrative Fiduciary

Investment Fiduciary

- Administrative Fiduciary typically selects recordkeeper, negotiates and monitors recordkeeping contract.
- Investment Fiduciary typically selects and monitors plan investment options.
- Selection of recordkeeper or trustee often involves both aspects since choice will often limit available investment options to those provided on the recordkeeper/trustee system

Common 401(k) Plan Traits - Recordkeeping Arrangement



Typical arrangement might include:

- Third party offers recordkeeping services and platform of investment options
- Mutual funds are typical options
- Sponsor/fiduciary chooses plan's options
- Small or no direct fee to recordkeeper for its services
- Recordkeeper receives payments (revenue sharing) from investment options based on plan investments

Legal Landscape: Fiduciary Duty of Prudence

- Procedural Prudence
  - identify what information is required
  - obtain it from a competent, independent source
  - give it due consideration
  - make a decision consistent with the information
  - document the decision
  - use experts as appropriate

- Standard is “prudent expert” and not “prudent layman”
- Good intentions not enough: "A pure heart and an empty head are not an acceptable substitute for proper analysis.”

Legal Landscape: Other Fiduciary Duties

- Comply with plan documents
- Use plan assets only to pay benefits and reasonable expenses of administering the plan
- Avoid conflicts of interest (self-dealing and kickbacks)
- Avoid party-in-interest transactions

Legal Landscape: Selecting Service Providers

- A fiduciary must *"engage in an objective process designed to elicit information necessary to assess the qualifications of the provider, the quality of services offered, and the reasonableness of the fees charged in light of the services provided. . . such process should be designed to avoid self-dealing, conflicts of interest or other improper influence."* - Field Assistance Bulletin 2002-3 (Nov. 5, 2002).

Legal Landscape:
Service Provider Exemption

- Payment of service provider is prohibited transaction unless transaction meets conditions of statutory exemption - ERISA § 408(b)(2)
  - Necessary services
  - Reasonable compensation
  - Reasonable contract
- DOL regulations provide that exemption doesn’t cover fiduciary self-dealing
- A Provider can not exercise fiduciary authority or provide advice “causing” a plan’s investment that results in the payment of compensation to such Provider.

Legal Landscape: Is Recordkeeper a Fiduciary?

- A Provider may accept payments from third parties, If the payment is not caused by a fiduciary act.
  - e.g., plan recordkeeper/investment provider who merely offers a "platform" of investments from which plan sponsor choose, are not plan fiduciaries and may retain fees from mutual funds.
    - See DOL Adv. Ops. 2003-09A (Aug. 25, 2005) and 1997-16A (May 22, 1997)
  - The opinions recognize that offering a typical 401(k) investment platform doesn’t make a recordkeeper a fiduciary.

Legal Landscape: Service Provider Disclosure Duties

- Currently, a non-fiduciary Provider has no affirmative ERISA duty to disclose its compensation from third parties.
  - DOL has "encouraged" disclosure in guidance on mutual fund fees and "float.“
  - A key consideration is what will need to be disclosed to plan sponsors compared to what will need to be disclosed to participants.

Litigation

- Class Actions against Plan Sponsors
- Class Actions against Service Providers
- DOL Enforcement Initiative
- Spitzer Settlement

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Class Actions vs. Plan Sponsors

- Schlichter, Bogard & Denton has filed lawsuits against major corporations alleging that the corporations' 401(k) plans have been charged excessive and improper fees and have failed to disclose these fees and "revenue sharing" payments to participants
  - Advertising continues…and more lawsuits threatened
- The corporations include: Boeing; Lockheed Martin; Exelon; Caterpillar; General Dynamics; United Technologies; Bechtel; International Paper; Kraft; Northrop Grumman; Deere & Co.; and ABB

Class Actions vs. Plan Sponsors

- All the cases hinge on application of Section 404(a) of ERISA. The three issues arising out of that ERISA subsection are —
  - *Procedural Prudence* - Did the plan fiduciaries exercise due diligence in their consideration of the plan's compensation arrangement with service providers, including any revenue sharing component?
  - *Substantive Prudence* – Did the plan fiduciaries cause the plan to pay excessive compensation to service providers because of revenue sharing or other circumstances?
  - *Disclosure* – Did the plan fiduciaries violate ERISA in how and what they disclosed to plan participants about revenue sharing and other fees charged to the plan?

Class Actions - Plan Sponsors

- Procedural Prudence –
  - Test focuses on the fiduciary's decision making process, not the result of that process.
  - Considerations include (1) thoroughness of the investigation, (2) expertise of those undertaking it, (3) if appropriate issues were considered, and (4) fiduciary's reliance on expert advice.
  - Argument can be made that satisfaction of test is all that is necessary to avoid imposition of liability under ERISA.
- Substantive Prudence –
  - Test focuses objectively on whether a plan fiduciary caused a plan to pay excessive fees.
  - Reasonableness of fees is determined based on industry standards.
- Disclosure –
  - ERISA imposes reporting and disclosure requirements on plan administrator.
  - After *Varity v. Howe Corp.*, 516 S. Ct. 489 (1996), courts have begun to fashion a "duty to disclose" requirement that exceeds obligations imposed under ERISA.
  - Duty to disclose is not open-ended: generally speaking, litigant must show that failure to disclose was (1) intentional, (2) material, and (3) caused a loss to the plan.

Hecker v. Deere & Co. (W.D.Wis.)

- Plaintiffs alleged that Deere & Company hired Fidelity Investments to provide "bundled" 401(k) plan services under a traditional arrangement centered on the use of Fidelity mutual funds.
  - Deere selected the plan's primary investment options from a menu of Fidelity's retail mutual funds.
  - The plan offered a brokerage window through which participants could invest in more than 2500 different publicly-available investments.
  - The Fidelity mutual funds charged asset-based fees ranging from .07% to 1.01%. The funds' investment advisor shared some of that asset-based fee revenue with the two Fidelity defendants (recordkeeper and trustee).

- Tracking allegations in other revenue sharing complaints, Plaintiffs claimed that Deere and Fidelity breached fiduciary duties under ERISA by (i) failing to disclose the revenue sharing arrangement to plan participants, and (ii) allegedly causing the plan to overpay for the bundled services.

Hecker v. Deere & Co. (W.D.Wis.)

- On June 20, 2007, the district court dismissed all claims by Plaintiffs

- Disclosure Claims
  - “Nothing in the statute or regulation directly requires such a disclosure."
  - The mutual fund prospectuses provided to the plan participants "accurately reflect the expenses paid to the fund manager."
  - The court expressed skepticism that participants would gain any practical benefit by knowing the precise details about how the manager subdivided divided that total fee among profits, revenue sharing and other expenses.
  - Labor Department's proposal to amend existing regulations to require further fee disclosures evidences that such disclosures are not required under current law.

Hecker v. Deere & Co. (W.D.Wis.)

- The court ruled that ERISA § 404(c) shielded the defendants from any liability arising from the allegedly excessive fees.
  - Section operates to shield alleged fiduciaries from liability where the alleged loss or breach results from a participant's exercise of control over his or her plan account.
  - Citing the fee disclosures provided by the mutual fund prospectuses, and the plan's brokerage window, the court held that "[t]he only possible conclusion is that to the extent participants incurred excessive expenses, those losses were the result of the participants exercising control over their investments within the meaning of [ERISA § 404(c)'s] safe harbor provision.“

- As an alternative ground for its dismissal of the claims against Fidelity, the court ruled that the plaintiffs' allegations disproved any claim that the plan's trustee or recordkeeper functioned as an ERISA fiduciary with respect to the disclosure or fund-selection issues

Class Actions vs. Plan Sponsors Other Decisions

- *United Technologies,* (D.Conn. Aug. 9, 2007), dismissing claim that plan sponsor breached duties under ERISA by failing to disclose "revenue sharing" to plan participants
  - Court allowed lawsuit to proceed based on theory that company caused the plan to pay unreasonable expenses
- *Lockheed Martin, (S.D.Ill.* Aug. 13, 2007), allowing excessive fee claims to go forward.
- *Exelon* (N.D. Ill. Feb. 21, 2007), claim for investment losses dismissed
- *Kraft Foods* (S.D. Ill. March 16, 2007), motion to dismiss denied, but transferred case to N.D. Ill. (employer's headquarters, where plan administered)
- *Boeing* (S.D. Ill. April 18, 2007), motion to dismiss denied
- *Caterpillar* (C.D. Ill. May 15, 2007), granting motion to dismiss without prejudice to refiling
- *Northrop Grumman* - trial scheduled for January 2008

Class Actions vs. Plan Sponsors

- **Evolving Theories** - In more recent filings, Plaintiffs have claimed defendants breached their fiduciary duties in:
  - **Failing to capture additional compensation streams for the benefit of the plan**.
    - finders fees from investment managers
    - float on contributions pending investment
    - payments for lending securities to third parties
    - foreign currency exchange profits
  - **Selecting mutual funds as investment options -- Defendants should have moved to separate accounts.**
  - **Selecting active funds, instead of passive funds like lower cost index funds.**

Class Actions vs. Service Providers

- Shift in Tactics – Schlichter has joined service providers as defendants in some cases.
  - ABB Complaint; Deere Complaint

- Growing Number of Lawsuits Brought Only Against Service Providers

  - Plaintiffs are the plan fiduciaries, not plan participants

  - Basic theory is that Service Providers became ERISA Fiduciaries when they selected mutual funds for the recordkeeping platform and sought and received revenue sharing from the mutual fund companies

Class Actions vs. Service Providers

- *Haddock v. Nationwide Financial Services, Inc.* (D. Conn. Feb. 2006)
  - Lawsuit by 401(k) plan sponsors relating to Nationwide's receipt of fees from funds offered as investment options under variable annuity contracts
  - Under typical service arrangement, plan sponsor chose a group of funds for its plan from those Nationwide made available under its annuity contract
  - Allege that Nationwide selected available funds based in part on revenue sharing paid by funds.
  - Denying Nationwide's motion for summary judgment, court held –
    - Nationwide was a plan fiduciary because it retained discretion to add/delete fund options
    - Nationwide may have been a fiduciary in choosing funds for its platform
    - Revenue sharing payments from funds could constitute "plan assets"
    - Even if revenue sharing payments are not "plan assets," Nationwide's receipt of revenue sharing could have involved prohibited transactions

Class Actions vs. Service Providers

Ruppert v. Principal Life Ins. Co. (S.D. Ill.)

- Class action lawsuit against Principal attacking revenue sharing payments Principal allegedly received in connection with the plan's investments.
- Lawsuit alleges that Principal breached Section 404(a) of ERISA by:
  - Failing to disclose that Principal negotiates revenue sharing with, and accepts revenue sharing from, mutual funds that are included in the menu of investment choices Principal offers to sponsoring employers;
  - Failing to disclose the amount of revenue sharing fees that Principal accepts from mutual fund companies or their advisors; and by
  - Keeping revenue sharing "kickbacks" from mutual fund companies or their advisors.

Class Actions vs. Service Providers

- The *Ruppert* suit further alleges that Principal violated ERISA's prohibited transaction rule against "self-dealing" by:
  - Using the plans' assets to generate revenue sharing payments to Principal by mutual fund distributors and advisors; and
  - Retaining revenue sharing payments for its own account.
  - In alleging this, the lawsuit claims that revenue sharing received by Principal are "plan assets."

Class Actions vs. Service Providers

- *Phones Plus, Inc. v. Hartford Financial Services* (D. Conn.)
  - Lawsuit alleges that revenue sharing payments were for services that the Hartford was already obligated to provide to its plan clients.
- *Additional cases filed in the last few months:*
  - *Charters v. John Hancock Life Insurance Co., (D.Mass.)*
  - *Zang v. Paychex, Inc. (E.D.Mich.).*
  - *Stark v. American Skandia Life Assurance Corp., (D.Conn.)*
- *Beary v. Nationwide Life Ins. Co.* (S.D. Ohio)
  - Lawsuit not brought under ERISA, but state common law, and claims that Nationwide breached its fiduciary duties by keeping revenue sharing payments for services provided to Section 457(b) plans.

Class Actions vs. Service Providers

Status

- Nationwide -
  - Court denied motion to dismiss amended complaint; refused to reconsider prior decision
  - Class certification
- Ruppert –
  - Principal did not move to dismiss the complaint
  - Court granted motion to change venue to where Principal's headquarters are located
    - Standing to maintain action on behalf of other plans?
  - Class Certification
- Other Cases –
  - Motions to dismiss being filed
  - John Hancock moved to dismiss class allegations

DOL Enforcement Activity

DOL's CAP Enforcement Initiative

- DOL has added service provider enforcement initiative to its national enforcement priorities
- Consultant/Adviser Project (CAP)
  - Focus on the receipt of improper, undisclosed compensation by pension consultants and other investment advisers
  - Whether the receipt of compensation violates ERISA because the adviser/consultant used its position to generate additional fees for itself or its affiliates
  - Failure to adhere to investment guidelines and improper selection or monitoring of the consultant or adviser
  - Potential criminal violations, such as kickbacks or fraud.

Spitzer Settlement

Spitzer Settlement with 403(b) Provider

Retirement Product Disclosure – Settlement Agreement

- In a settlement with the New York State Attorney General, a 403(b) provider, ING, agreed to pay restitution and implement a standard format for retirement product disclosure.
  - Settlement relates to Retirement Program endorsed by NY State Teacher's Union. The 403(b) provider and Union did not disclose to teachers expense reimbursements paid by Insurer to Union.
  - Provider's 403(b) Program competed with 403(b) products offered to teachers by other providers.

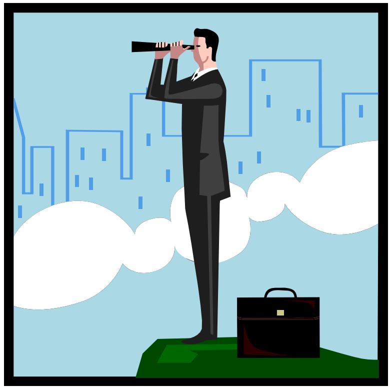
Spitzer Settlement with 403(b) Provider

NY Attorney General Settlement Agreement

- "One-Page Disclosure" to 403(b) Participants
  - States "all-in" investment cost, as a percentage of account balance.
  - Chart shows affect of fees on investor account balances over time.
  - Discloses that fund companies may pay 403(b) provider to be included as investment options, and that 403(b) provider and funds are seeking to make a profit.
    - Does not require disclosure of rates or amounts paid by funds to 403(b) provider, individual fund fees, or contract charges.

Litigation Outlook

- Cases are unlikely to be decided on motions to dismiss.
- More lawsuits, including “copy cat” suits may be filed.
- Service Providers are increasingly being targeted in fee cases.



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Cash Balance Plan Litigation

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Cash Balance Plan Litigation

- Cash balance plans have been under attack from class action claims
- Primary Grounds for Attack
  - Age discrimination
  - Whipsaw
  - Backloading
  - Participant communications
- Overview of recent cases and how PPA may impact future litigation risk

Cash Balance Plan Litigation – Age Discrimination

- Statutory rule – rate of benefit accrual cannot decrease on account of age – Code § 411(b)(1)(H); ERISA
  § 204(b)(1)(H)

- Theory – because interest credits are “frontloaded,” growth in normal retirement age annuity slows as participants age

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Cash Balance Plan Litigation – Age Discrimination (cont.)

- Most common claim in cash balance plan cases
  - Easy to frame issue
  - Theory applies to virtually every cash balance plan, regardless of specific plan formula
- IBM decision (Cooper)
  - District Court ruled cash balance plans are discriminatory based upon age
  - Seventh Circuit reversed initial IBM decision and found no age discrimination (457 F.3d 636)
  - Supreme Court denied cert in 2007

Cash Balance Plan Litigation – Age Discrimination (cont.)

- In 2007, Third Circuit ruled that the cash balance formula is not age discriminatory. (Register v. PNC Financial Srvs., 477 F.3d 56)
- Sixth Circuit recently held that cash balance plans are not discriminatory. (Drutis v. Rand McNally & Co., 2007 WL 2409762 (Aug. 27, 2007)
- Issue on appeal in the Second and Ninth Circuits – except in Second Circuit, district courts have found no discrimination
- PPA "fixes" this issue, at least prospectively
  - Pre-PPA plans still at risk for periods before 6/29/05
  - Possible disparate impact claims for prior conversions

  - ADEA claims against cash balance claims

Cash Balance Plan Litigation – Whipsaw

- Statutory rule – lump sum distribution must not be less than present value of normal retirement benefit, determined using 30-year Treasury interest rate and IRS prescribed mortality table – Code § 417(e)(3); ERISA § 205(g)(3)
- Theory – where plan's cash balance crediting rate exceeds the 30-year Treasury rate, the "round trip" calculation will result in required lump sum payment that exceeds the cash balance account

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Cash Balance Plan Litigation – Whipsaw (cont.)

- Pre-retirement mortality discounts also attacked in some cases
- Claim is plan specific - viable where plan provides interest credits that do not comply with IRS Notice 96-8
- Courts have fairly consistently ruled in favor of participants
- PPA “fixes” this issue for distributions after 8/17/06
  - Pre-PPA plans still at risk for prior distributions; new class actions filed based on pre-PPA claims

Cash Balance Plan Litigation – Backloading

- Statutory rule – the accrual of normal retirement benefits must satisfy one of three permissible accrual rules – Code § 411(b)(1)(A)-(C); ERISA § 204(b)(1)(A)-(C)

- Various theories
  - A wear-away period following the implementation of the hybrid benefit formula will cause later accruals to result in backloading
  - Changes in variable interest rates can result in backloading
  - Where multiple benefit formulas exist in one plan, aggregation of the formulas will cause backloading

Cash Balance Plan Litigation – Backloading (cont.)

- Backloading claims have not yet yielded dividends for plaintiffs
- Wear-away based claims dismissed in several cases, based on statutory rule that says plan amendments treated as in effect for all plan years – i.e., cash balance formula analyzed on its own, without consideration of interplay with prior, frozen traditional benefit formula
- Claim based on variable interest rate in cash balance plan recently dismissed in Boeing case. (Wheeler v. Pension Value Plan for EEs of Boeing Co., 2007 WL 781908 (S.D. Ill. March 13, 2007)
- Possible issue for plans with multiple, ongoing benefit formulas
- PPA did not change the backloading rules

Cash Balance Plan Litigation – Participant Communications

- Participants have alleged communication failures in two areas:
  - ERISA § 204(h) requires advance written notice to participants of an amendment that significantly reduces the rate of future benefit accrual
  - Plan fiduciaries failed to provide an adequate summary plan description (“SPD”)

Cash Balance Plan Litigation – Participant Communications (cont.)

- 204(h) Notices – if notice requirement not met, plan amendment could be ruled ineffective
- In pending cases, issue is how much information was required, and was notice delivered properly
- Law changed 6/7/01 to require more specifics in the notice and added rule to Internal Revenue Code (§ 4980F)

Cash Balance Plan Litigation – Participant Communications (cont.)

- SPD-based complaints include allegations that participants were not informed of details regarding wear-away
- Richards v. FleetBoston, and Engers v. AT&T
- Primary issues
  - How much detail is required in SPD
  - Is there a substantive remedy for an inadequate SPD
- PPA did not change 204(h)/SPD disclosure rules

IRS Reconsideration of “Greater of” Formulas

- IRS recently took the position that cash balance plans that contained an alternative, "greater-of" benefit structure would likely fail to satisfy the anti-backloading rules of Code § 411(b)
- Many plans have benefit structures that continue to provide benefits under the plan's pre-cash balance benefit formula if such benefits would be greater than the new cash balance benefit formula
- Even though both the prior benefit formula and the new cash balance (or other hybrid) formula would independently satisfy the anti-backloading rules, IRS took the position that the year-to-year accrual pattern for a participant whose benefit transitions from one of the formulas to the other may not satisfy the rules

IRS Reconsideration of "Greater Of" Formulas (cont.)

- IRS position penalizes plan sponsors that adopt participant-friendly transition approaches to the implementation of the cash balance design – instead of simply freezing the plan or imposing long "wear-away" periods

- If the IRS position is adopted, these plan sponsors may have to retroactively improve benefits

- IRS has temporarily backed off from enforcing its strict interpretation of these rules. However, the IRS has not yet determined how to resolve the issue

IRS Reconsideration of “Greater Of” Formulas (cont.)

- Boeing case: S.D. Ill. this year ruled that that multiple, greater-of formulas do not violate anti-backloading rules

- Court considered plaintiffs' position that IRS regulations require that the accrued benefits under all of a plan's multiple formulas be "aggregated" in order to determine compliance with the anti-backloading rules. The court found that the regulation was intended to apply to benefits calculated under a sequence of formulas over time and not to greater-of benefit formulas

- Court: anti-backloading rules prohibit benefit structures that provide significant increases in benefit accrual rates based on a participant's increased age and years of service. Accrual rates of the Boeing plan's formulas were not tied to distinctions of age and service intended to favor older employees. Because the plan's two formulas were mutually exclusive, the plan would satisfy the backloading restrictions as long as each formula independently met the rules

Cash Balance Plan Litigation - Summary

- ERISA is now a very active area for class actions
- While the PPA should reduce various areas of exposure for cash balance plan sponsors, scrutiny will continue for cash balance pension plans, and new theories of attack may develop

Cash Balance Plans – IRS Determination Letters

- Moratorium lifted
- Notice 2007-6 guidance on IRS review process
  - Age discrimination
    - Front-loaded interest credits are not age discriminatory
    - Will not rule on impact of prior conversion, including on whether wear-away could be age discriminatory
  - Lump sums must comply with Notice 96-8
  - Will review compliance with existing backloading rules
  - Post 6/29/05 conversions must comply with PPA

Cash Balance Plans – IRS Determination Letters (cont.)

- Apparent review process
  - Plans are being reviewed by a special group of agents who were recently trained on cash balance issues
  - Cash balance related issues are communicated to plan sponsor
  - After any identified issues are resolved, plans will be sent to original office for final resolution

- EGTRRA determination letter filings are required in the normal course, even if the prior application is still pending

LaRUE v. DeWOLFF AND THE POSSIBLE BARRIERS TO RECOVERY UNDER ERISA

This past summer, the Supreme Court agreed to review the Fourth Circuit's decision in *LaRue v. DeWolff, Boberg & Assocs., Inc.*, 450 F.3d 570. That decision implicated two questions under the civil enforcement provisions of ERISA: (1) can a participant in a defined contribution pension plan sue under ERISA Section 502(a)(2) to recover losses to the plan caused by a breach of fiduciary duty, even when those losses only affected the participant's individual account, and (2) can a participant seek monetary relief against a fiduciary to recover losses caused by a fiduciary under ERISA Section 502(a)(3). In answering those two questions, the Supreme Court has an opportunity to draw clear lines concerning the nature and scope of the remedies available to participants under ERISA.

I. The Facts in *LaRue*

The defendant, DeWolff, Boberg & Associates, sponsored a 401(k) plan that allowed participants to choose investments from a menu of options. The plaintiff, James LaRue, alleged that DeWolff had failed to follow his instructions as to how to direct his investments, resulting in a loss to his account of roughly $150,000. LaRue sued under ERISA Section 502(a)(3) and claimed that DeWolff had breached its fiduciary duties and should restore the $150,000 to his individual account.

II. The Fourth Circuit's Decisions

On appeal, LaRue switched gears and argued for the first time that he was seeking relief under ERISA Section 502(a)(2). The Supreme Court first addressed the issue of availability of that remedy to individual plan participants in *Massachusetts Mut. Life Ins. Co. v. Russell*, 473 U.S. 134 (1985). In *Russell*, the Supreme Court held that recovery under Section 502(a)(2) must be for the benefit of the plan "as a whole" and must "protect the entire plan, rather than . . . the rights of an individual beneficiary." Relying on this broad principle, the Fourth Circuit found that LaRue was seeking to recoup a loss suffered by LaRue alone and to be paid into LaRue's account, "an instrument that exists specifically for his benefit." Because the relief sought by LaRue only benefited LaRue, the Fourth Circuit concluded that he could not sue under ERISA Section 502(a)(2). In so concluding, the Fourth Circuit distinguished LaRue's case from other actions where an individual plaintiff seeks relief on behalf of a class of similarly situated participants, and the remedy sought will benefit the plaintiff as well as other class members.

Turning to LaRue's other ground for relief, the Fourth Circuit noted that the Supreme Court has restricted the scope of "equitable relief" available under ERISA Section 502(a)(3) to "those categories of relief that were *typically* availably in equity." *Sereboff v. Mid Atl. Med Servs.*, 126 S. Ct. 1869 , 1873 (2006). According to the Fourth Circuit, the Supreme Court in *Great-West Life & Annuity Ins. Co. v. Knudson*, 534 U.S. 204 (2002), concluded that the remedy of restitution was typically available in equity. The Fourth Circuit noted, however, that the Court in *Great-West* had clarified that equitable restitution applies only where the claimant is asserting a right to specific, identifiable property or proceeds in the defendant's possession. *Id.* at 214.

Relying on *Great-West*, the Fourth Circuit determined that LaRue had not satisfied the requirements for obtaining equitable restitution. In this regard, the Fourth Circuit pointed out that LaRue had not "allege[d] that funds owed to him are in defendants' possession, but instead that funds never materialized at all." In the Fourth Circuit's view, LaRue's claim was a classic claim for money damages, not equitable relief. As a result, the Fourth Circuit held that LaRue had no legal recourse under ERISA Section 502(a)(3).

Dissatisfied with this result, LaRue petitioned the Fourth Circuit for a rehearing and a rehearing *en banc*. The Fourth Circuit denied the petitions and, in so doing, the appeals court again rejected LaRue's contention that he was seeking plan-wide relief. The Fourth Circuit reiterated that LaRue was merely "a single plaintiff who sought to recover for an individual loss and did not even allege a 'loss to the plan' but only to his 'interest in the plan.'" The Fourth Circuit also rejected an argument advanced by the Department of Labor that all relief sought against a breaching fiduciary is inherently equitable relief. The Fourth Circuit therefore rebuffed LaRue's contention that he could characterize his case as a breach-of-trust action by a beneficiary seeking to recover lost trust profits, and that he could seek a "surcharge" for the losses resulting from the alleged breach. Although that kind of "make whole" relief has been recognized in equity, the Fourth Circuit declined to apply the remedy to LaRue's case.

III. The Significance of *LaRue*

There is considerable debate in legal circles as to whether the Supreme Court will reverse the Fourth Circuit's holdings. Some see reversal on the plan-wide relief issue. In this regard, the Court may follow the narrow rationale set out by the Third Circuit in *In re Schering-Plough Corp. ERISA Litig.*, 420 F.3d 231 (3d Cir. 2005). That rationale views the plan itself as the entity that sustained the investment losses, even though those losses are allocated, as an accounting matter, to fewer than all participant accounts. Based on this, a claim to recover the plan's investment losses can be maintained under ERISA Section 502(a)(2), even though any recovery obtained for the plan will be allocated among fewer than all plan accounts.

Some also hope for a more radical change to ERISA's civil enforcement provisions. In particular, some see *LaRue* as an opportunity for the Court to expand the remedies under ERISA Section 502(a)(3) to include "make-whole" monetary relief.

IRALERT

September 21, 2007

TO: IRA Group Distribution

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RE: Emerging IRA "Rollover Desk" Issues

Several recent developments draw attention to the operation of financial institution IRA "rollover desks" and similar practices geared to attracting IRA rollovers from qualified retirement plans.

<u>Citigroup Settlement</u>. In June, Citigroup Global Markets entered into a $15 million settlement with the NASD (now FINRA) to settle allegations that several of its employees held seminars and used misleading and inadequate disclosures to induce over 400 BellSouth employees – most below age 60 – to take lump sum distributions from their retirement plans and roll them over into Citigroup brokerage IRAs. It appears that the settled claims related to alleged violations of securities laws, rather than ERISA. FINRA's press release can be found at: http://www.finra.org/PressRoom/NewsReleases/2007NewsReleases/P019240. A similar recent settlement involved Securities America, Inc. of Omaha, Nebraska, and a group of ExxonMobil employees in Texas. In a September 10 speech at the SEC Seniors Summit, FINRA's CEO announced that it is conducting several brokerage industry "sweeps" aimed at sales practices targeting investors age 50 and over, including early retirement seminars similar to those in the Citigroup and America, Inc. settlements.

<u>Principal Class Action Lawsuit</u>. On August 28, 2007, two former participants of 401(k) plans administered by Principal Financial Group ("Principal") filed a class action suit against Principal and its broker/dealer subsidiary, Princor Financial Services ("Princor"), alleging ERISA fiduciary violations. In this lawsuit, styled <u>Young, et al. v. Principal Fin. Group, Inc., et al.</u>, Civil Action No. 4:07-CV-386 (S.D. Iowa), plaintiffs allege that Principal sent letters to participants in Principal-managed 401(k) accounts who were nearing retirement age, "urging" them to call Principal about their accounts. Concurrently, Plaintiffs filed a separate lawsuit against Principal and Princor alleging violations of federal securities laws – <u>Young, et al. v. Principal Fin. Group, Inc., et al.</u>, Civil Action No. 4:07-CV-387 (S.D. Iowa).

The suit alleges that Principal intentionally misled the plaintiffs into believing that they would be calling Principal's plan administration department when, instead, the number they were given was for sales agents at Princor. Plaintiffs allege that Principal instructed Princor sales agents to encourage plaintiffs and other 401(k) participants not to leave their money in their retirement accounts, but to "rollover" their accounts to Principal IRAs offering "J-Share" class Principal mutual funds. Plaintiffs claim that Princor sales agents were instructed to offer only J-Share class mutual funds, even though Principal allegedly has several classes of less expensive funds available. Plaintiffs claim that Princor sales agents received bonuses and commissions for persuading participants to move their retirement accounts over to Principal IRAs.

The Principal complaint alleges that – like many financial institutions – Principal offers "full service" retirement plans to sponsoring employers, including a menu of mutual funds from which an employer can select funds to be offered to plan participants for investment. According to the complaint, once an employer has made its selections, Principal retains the authority to substitute mutual funds from those selected by the employer and to close funds to new investment. The complaint also alleges that Principal exercised discretion by sending letters urging participants to call Principal about their retirement accounts and by instructing Princor sales agents to encourage participants to rollover their accounts to Principal-managed IRAs. Plaintiffs contend that these actions by Principal make the companies fiduciaries pursuant to section 3(21)(A)(i) and (iii) of ERISA. In addition, plaintiffs allege that Principal and Princor provide "investment advice" to plans within the meaning of section 3(21)(A)(ii) of ERISA because (1) Principal represents that all the mutual funds on its platform are appropriate for its plan customers; (2) Principal provides investment advice to plan sponsors when it recommends mutual funds on the Principal platform; and (3) Princor recommends that participants rollover their retirement accounts and invest in Principal J-Shares.

Observations. The question of whether a service provider has acquired fiduciary status by creating, offering, and maintaining a menu of investment options has been raised in "401(k) fee" lawsuits brought against Principal and other plan service providers. While review of these issues is beyond the scope of this article, a new twist to the new Principal case is the allegation that Principal/Pincor acted as fiduciaries by "advising" participants to take plan distributions and roll the proceeds into Principal IRAs. In late 2005, the Department of Labor ("DOL") addressed this issue in an advisory opinion to Deseret Mutual Benefit Administrators. Advisory Opinion No. 2005-23A (Dec. 7, 2005) (Qualified Plans 2005-12). DOL concluded there that, where a person who is not otherwise a fiduciary advises a participant to take an otherwise permissible plan distribution and to invest the proceeds in an IRA, such advice does not make the person a fiduciary. DOL cautioned, however, that the propriety of the non-fiduciary's investment advice may be subject to non-ERISA (e.g., securities) laws and regulations. With respect to an existing plan fiduciary, on the other hand, the DOL indicated that if the fiduciary were to advise participants to roll over their accounts to an IRA, the advice would be subject to ERISA's fiduciary provisions and could involve self-dealing.

The reasoning behind the Deseret Advisory Opinion remains unclear. The crux of the opinion appears to be that, by itself, advising a participant to take a distribution is not a fiduciary act, as it is not advice regarding the management or disposition of plan assets, but relates to a "settlor" decision. At the same time, advising a participant to roll the proceeds over into an IRA cannot be a fiduciary act, as the proceeds are still "outside" the IRA when the recommendation is made (indeed, the IRA may not yet exist). Informally, senior DOL staff members have generally confirmed that this is their reasoning. Nonetheless, those staff members somehow reach a different conclusion when the person making the recommendations is already a plan fiduciary. Under those circumstances, they indicate that the combined acts of recommending a distribution and recommending the rollover of the distributed assets are tantamount to providing (fiduciary) advice as to the investment of plan assets (notwithstanding the fact that they will cease to be plan assets before the investment occurs). In other words, an otherwise non-fiduciary act somehow can be "converted" into a fiduciary act merely because it is performed by a fiduciary. Beneath the surface, DOL appears to be reluctant to let a fiduciary take advantage of its position of authority to "mislead" participants into believing that it looking out for their best interests, when it is really making a sales presentation.

We expect this area of the law to develop significantly in the coming years – alongside 401(k) fee, revenue-sharing and similar claims.

Please feel free to direct questions to any of the Groom principals listed above or to IRA@groom.com.

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We will explore these issues in more detail at our October 2 meeting. Please join us or arrange to participate by telephone.

RECENT DEVELOPMENTS IN
CASH BALANCE PLAN LITIGATION

I. Three Appellate Courts Rule That Cash Balance Plans do Not Violate ERISA's Age Discrimination Rules

The Seventh, Third, and Sixth Circuits (in that order) have ruled that cash balance plans do not violate ERISA § 204(b)(1)(H), which prohibits the reduction in a participant's "rate of benefit accrual" because of "the attainment of any age."

A. Cooper v. IBM Personal Pension Plan, 457 F.3d 636 (7th Cir. 2006), cert. denied, 127 S. Ct. 1143 (2007).

The Seventh Circuit reversed a district court decision that had found that cash balance formulas discriminate against older participants by reducing the rate of an employee's benefit accrual, measuring the "benefit accrual" as an annuity available at normal retirement age. First, the Seventh Circuit observed that defined contribution plans are typically structured to provide, in a particular year, the same dollar allocation to all participants, without regard to age. Due to the time value of money, a younger participant's cash allocation will grow to a much larger account balance by normal retirement age than would the same cash allocation made to an older participant. "Why," the court asked, "should it become unlawful because the account balances [in a cash balance plan with age-neutral terms] are book entries rather than cash?" Second, the court did a technical review of statutory language and concluded, "[t]he phrase 'benefit accrual' reads most naturally as a reference to what the employer puts in (either in absolute terms or as a rate of change), while the defined phrase 'accrued benefit' refers to outputs after compounding."

B. Register v. PNC Financial Services Group, Inc., 477 F.3d 56 (3d Cir. 2007).

The Third Circuit held that PNC's cash balance plan did not violate ERISA's antidiscrimination rules. In 1999, the pension plan was converted from a final average pay benefit formula to a cash balance benefit formula. It provided for opening account balances based on the present value of each participant's existing accrued benefit. Accounts thereafter grow with credits based on a percentage of pay and interest. After considering all prior court decisions, the court found that ERISA § 204(b)(1)(H) does not require an analysis of the change in the normal retirement age annuity benefit as a measure of the rate of accrual. Instead, in a cash balance plan, the rate of benefit accrual is determined by the change in the account balance from year to year. Consequently, the cash balance formula was found not to be age discriminatory.

C. Drutis v Rand McNally & Co., -- F.3d --, 2007 WL 2409762 (6th Cir. Aug. 27, 2007).

Drutis arose from Quebecor World's acquisition of Rand McNally's printing business in 1997. The factual underpinnings of plaintiffs' claims are complex because the cash balance plan only existed for few years. Following the acquisition, Quebecor merged Rand McNally's defined benefit plan into the Quebecor plan, which was a cash balance plan. Later, Quebecor merged with World Color and, in December 2000, the defined benefit plan was merged into the Quebecor World pension plan, which was not a cash balance plan. In 2003, four participants filed a putative class action challenging the cash balance plan, which no longer existed because of its merger into the Quebecor World plan.

The complaint asserted, inter alia, that the plan violated ERISA § 204(b)(1)(H) which prohibits the reduction in a participant's "rate of benefit accrual" because of "the attainment of any age." The district court granted defendants' motion for summary judgment, holding that two participants lacked standing because they were protected by grandfather provisions, that none of the plaintiffs could assert claims under that section because they were under the age of 65, and that the plan did not violate the statute. On appeal, the Sixth Circuit affirmed.

The Sixth Circuit found that two plaintiffs lacked standing because they were shielded by grandfather provisions, i.e., they suffered no injury as they were entitled to the full benefits of the prior plan. The court declined, however, to address the issue of whether the statute is limited to participants over the age of 65. The court assumed without deciding that two plaintiffs could assert claims.

Turning to the merits, the court observed that cash balance plans are defined benefit plans which resemble defined contribution plans in their operation. Cash balance plans have a hypothetical account which contains pay credits and interest credits. The age discrimination claim arises, the court explained, because younger employees receive greater projected interest credits because they have a longer period of time before they reach retirement age. Thus, if the "rate of benefit accrual" must be determined by taking into account the projected interest credits, the cash balance formula would appear to be age discriminatory. The court held, however, that the "better view" is the statutory phrase "'rate of benefit accrual' refers to the employer's contribution to a plan, and therefore any difference in output as a result of time and compound interest does not violate § 204(b)(1)(H)." Since neither the plan's contribution rate nor interest rate change with age, the plan did not violate ERISA and defendants were entitled to summary judgment.

D. District Court Cases: District courts in the Eighth Circuit and Tenth Circuit have also held that cash balance plans are not age discriminatory. See Sunder v. U.S. Bank Pension Plan, 2007 WL 541595 (E.D. Mo. Feb. 16, 2007); Tomlinson v. El Paso, 2007 WL 891378 (D. Co. Mar. 22, 2007). See also, Charles v. Pepco Holdings, Inc., -- F. Supp. 2d --, 2007 WL 2719857 (D. Del. September 19, 2007).

E. Cases on Appeal: The age discrimination issue remains in play primarily in the Second Circuit, where several district courts have held that a cash balance formula is age discriminatory, and at least one court has held it is not. Compare In re J.P. Morgan Chase Cash Balance Litig., 460 F. Supp. 2d 479 (S.D.N.Y. 2006) and In re Citigroup Pension Plan ERISA Litig., 470 F. Supp. 2d 323 (S.D.N.Y. 2006), with Hirt v. Equitable Retirement Plan, 441 F.Supp.2d 516 (S.D.N.Y. 2006).

The Hirt case is on appeal to the Second Circuit and we expect a decision by the end of the year. An appeal on the age discrimination issue is also pending in the Ninth Circuit, and we expect arguments on that case this Fall. Plaintiffs are hoping to prevail in one of these cases, creating a circuit split that the Supreme Court could then be asked to resolve. The plaintiffs' best shot may be in the Ninth Circuit, which is known for breaking ranks on many occasions.

F. Other Selected Cases Addressing Age Discrimination

Second Circuit

1. Hirt v. Equitable Ret. Plan for Employees, Managers, & Agents, 441 F. Supp. 2d 516 (S.D.N.Y. 2006), on appeal to Second Circuit.

   Over a period of several years, Equitable converted its defined benefit plan from a traditional pension to a cash balance plan. Participants of the plan brought a class action for claims relating to the switch. The plaintiffs claimed that cash balance plans are inherently discriminatory in violation of ERISA. They alleged that under a cash balance formula, older workers receive less of a benefit than similarly situated younger workers because, although the value of the credit added to each participant's account is equal at the time the credit is issued, accrual should be measured by looking at the benefit to be received at the age of retirement. The district court rejected the claim, reasoning that the rate of benefit accrual is properly measured based on yearly inputs to the account balance. The decision is currently on appeal to the Second Circuit.

2. Richards v. FleetBoston, 427 F. Supp. 2d 150 (D. Conn. 2006).

   FleetBoston participants claimed that the cash balance formula is age discriminatory because pay credits made to younger employees will have more time to grow with interest than similar credits made to an older employee's account. The court in FleetBoston concluded that the statutory language "rate of benefit accrual" in ERISA § 204(b)(1)(H) refers to the rate of change in the participant's "accrued benefit." In turn, the term "accrued benefit" is defined by ERISA as the participant's annual benefit commencing at normal retirement age. The court refused to consider that legislative history may not support this conclusion and that the U.S. Department of Treasury (the agency charged with interpreting this section of ERISA) has consistently indicated that the statute should not be read in this manner for cash balance plans. Consequently, the plan was found to be discriminatory.

3. In re J.P. Morgan Chase Cash Balance Litig., 460 F. Supp. 2d 479 (S.D.N.Y. 2006).

   The court denied the defendant's motion to dismiss, finding that ERISA referred to an employee's retirement benefit, rather than the employer's contribution, and thus a cash balance plan that gave a worker who began work at an older age a smaller retirement benefit compared to similarly situated employee who began work at younger age violated the provision, even if disparity was result of time value of money, and plan's terms appeared age neutral.

4. In re Citigroup Pension Plan ERISA Litigation, 470 F. Supp. 2d 323 (S.D.N.Y. 2006).

   Plan participants brought suit claiming, among other things, that Citigroup's cash balance plan impermissibly discriminated against older workers. In 1999, Citigroup converted its traditional pension plan into a cash balance plan. The court, agreeing with the plaintiffs, concluded that because of the conversion to an age 65 annuity, younger workers were being credited with more years to accumulated interest on their hypothetical accounts, and as a result, a greater value was being added to a younger participant's account than to an older participant's account. The judge has certified a class action.

Third Circuit

Register v. PNC Financial Services Group, Inc, 477 F.3d 56, 2007 WL 222019 (3d. Cir. 2007).

Discussed above.

Sixth Circuit

Drutis v. Quebecor World (USA), Inc., -- F.3d --, 2007 WL 2409762 (6th Cir. Aug. 27, 2007).

Discussed above.

Seventh Circuit

Cooper v. IBM Personal Pension Plan, 457 F.3d 636 (7th Cir. 2006), *cert. denied*, 127 S. Ct. 1143 (2007).

Discussed above.

Wheeler v. Pension Value Plan for Employees of the Boeing Co., 2007 WL 781908 (S.D. Ill. Mar. 13, 2007).

Plaintiffs were Boeing employees who worked for McDonnell Douglas prior to the merger of Boeing and McDonnell Douglas in 1997. In 1999, the plaintiffs became participants in Boeing's cash balance plan. Under the plan, each participant received "benefit credits" that were allocated to each participant's hypothetical account as of the last day of each plan year as a percentage of the participant's salary based on the participant's age. In addition, participants were allocated "interest credits" at the end of each year at a rate equal to the annual rate on 30-year Treasury securities for November of the prior plan year. The plan set 5.25 percent as the minimum possible interest rate.

The employees alleged the plan violated ERISA § 204(b)(1)(H)(i), and further alleged that the plan violated ERISA Section § 204(b)(1)(B) by using a variable interest rate for the plan's interest credits. Section 204(b)(1)(B), known as the anti-backloading rule, prohibits plans from establishing minimum rates for accrual of benefits that cause a participant's benefits to accrue very slowly until the participant is near retirement age.

The court dismissed the plaintiffs' age discrimination claim, holding that it was bound by the Seventh Circuit's decision in Cooper, which concluded that IBM's cash balance plan did not discriminate against older workers. According to the court, Cooper "makes clear" that the term "benefit accrual" in ERISA's age discrimination rule must be measured in terms of what an employer puts into a cash balance account, not the final account balance. "The reduction in Plan benefits asserted by [the Boeing employees] obviously is not the product of a reduction of employer inputs into the accounts of Plan participants and no doubt is attributable to the time value of money, which, as Cooper also makes clear, is not age discrimination."

In addition, the court rejected the claim that the plan violated ERISA's anti-backloading rules by using a variable interest rate to compute "interest credits." This issue is discussed below, in the section entitled "Backloading."

Ninth Circuit

Hurlic v. Southern Cal. Gas Co., No. CV05-5027 R (MANx) (C.D. Cal Oct. 18, 2005), on appeal to Ninth Circuit.

Plaintiffs brought a class action lawsuit against the Southern California Gas cash balance plan, claiming that the plan was age discriminatory because the rate of a cash balance participant's benefit accrual decreased on account of the participant's age. Specifically, the claim was that a younger participant will always have more time to accrue interest on his or her retirement account balance, so within each plan year, the younger participant will always accrue a greater increase in his or her annuity payable at normal retirement age than the older participant does. In a summary order with no opinion issued, a California federal district court dismissed all claims against the plan. The case is on appeal to the Ninth Circuit.

II. ADEA Claims Involving Cash Balance Plans

Recognizing that age discrimination claims under ERISA § 204(b)(1)(H) are facing increasing difficulties in light of the recent appellate decisions, plaintiffs' lawyers have resorted to filing disparate-impact age discrimination claims involving cash balance plans under the Age Discrimination in Employment Act (the "ADEA"). See, e.g., Engers v. AT&T, 2007 WL 1557163 (D.N.J. May 24, 2007); Tomlinson v. El Paso Tenn. Pipeline Corp., 2007 WL 891378 (D. Colo. March 22, 2007).

In Engers, 2007 WL 1557163 (D.N.J. May 24, 2007), the U.S. District Court for the District of New Jersey granting conditional approval of an ADEA collective action, rejecting AT&T's contention that the class should include only employees who were age 40 or older when the company adopted its cash balance plan on Jan. 1, 1998. Instead, the court found that under a disparate impact theory, when an employer adopts a discriminatory policy with a certain effective date, a cause of action for a particular plaintiff accrues on the date when the policy has a discriminatory *effect* against that plaintiff. Specifically, the court held that "when an employer adopts a discriminatory policy with a certain effective date, a cause of action for a particular plaintiff accrues on the date that the policy has a discriminatory effect against him or her." "The operative event is not the creation of the policy, *but the use of it to discriminate against an individual*." (Emphasis added).

In Tomlinson, 2007 WL 891378 (D. Colo. March 22, 2007), the company converted its pension plan from a final average pay formula to a cash balance formula. Under the old plan, the amount of a retiree's monthly pension was based upon his years of credited service and a final average of salary. Under the new plan, this amount was based upon the amount of credits employees accumulated throughout their years of service. Each participating employee was given a hypothetical account, and each quarter the employee earned "pay credits" based upon a percentage of their salary, and "interest credits" based upon the yield of a five-year U.S. Treasury Bond.

During a transition period between January 1, 1997, and December 31, 2001, participating employees accrued benefits under both the new and old plans, and retiring employees could elect whichever option benefited them the most. Once this transition period expired retirees could still choose either option, but the old plan was "frozen" at whatever benefits the employee had earned as of December 31, 2001. The plaintiffs alleged that El Paso set the initial cash balance accounts for older, longer-service employees at levels significantly below the value of their accumulated annuities under the old plan. Thus, plaintiffs alleged that the freezing of old plan accruals discriminated against older workers in violation of the ADEA, in addition to violating various provisions of ERISA.

El Paso argued that the ADEA claim was barred because the plan was exempt from suit as a bona fide plan under 29 U.S.C. § 623(f). This subsection makes it permissible for employers:

> [T]o observe the terms of a bona fide employee benefit plan-(i) where, for each benefit or benefit package, the actual amount of payment made or cost incurred on behalf of an older worker is no less than that made or incurred on behalf of a younger worker, as permissible under [29 C.F.R. § 1625.10].[1]

According to El Paso, the plaintiffs' complaint itself established that the new plan satisfied the "cost incurred" prong of this test, since it clearly indicated that older workers actually received *higher* pay credits than younger employees. The court, on a motion to dismiss, found that there was an absence of authority establishing that a cash balance formula like the one implemented by El Paso was immune from suit as a bona fide plan. The court further found that it was "far from clear that the hypothetical payments made to older employees' cash balance accounts (or 'pay credits' attributed to these accounts) should qualify as a 'cost incurred' under § 623(f), especially if the company knows that the vast majority of older workers will never cash in these 'payments' but will rather elect the (now-frozen) benefits they had earned under the old plan." Accordingly, the court refused to dismiss the ADEA claim, and allowed that claim to proceed.

III. "Whipsaw" Cases

A. Sixth Circuit Decision

In April, the Sixth Circuit decided West v. AK Steel Corporation Retirement Accumulation Pension Plan, 484 F.3d 395 (6th Cir. 2007). This case primarily involves application of the whipsaw in a cash balance plan, but also addresses the use of a pre-retirement mortality decrement in determining the value of a lump-sum payment made to a participant before attaining normal retirement age.

Whipsaw Issue – The plan defined a participant's accrued benefit as the accrued benefit expressed as an annual benefit commencing at normal retirement age. The court ruled in favor of the plaintiff class that a portion of the plan benefit was impermissibly forfeited because the plan did not perform the whipsaw calculation when it paid out pre-retirement lump sums between January 1, 1995 and April 1, 2005. Relying on the Eleventh Circuit's decision in Lyons v. Georgia-Pacific Corp. Salaried Employees Ret. Plan, 221 F.3d 1235 (2000), the Second Circuit's decision in Esden v. Bank of Boston, 229 F.3d 154 (2000), and the Seventh Circuit's decision in Berger v. Xerox Corp. Ret. Income Guar. Plan, 338 F.3d 755 (2003), the court rejected the defendant's arguments that (1) ERISA did not

[1] 29 C.F.R. § 1625.10 provides that plans will be considered compliant with § 623(f)(2) if "the actual amount of payment made, or cost incurred, in behalf of an older worker is equal to that made or incurred in behalf of a younger worker, even though the older worker may thereby receive a lesser amount of benefits or insurance coverage."

mandate a whipsaw calculation and (2) even if it did, the calculation was a wash because a plan can use the same interest rate projecting the account balance forward and discounting it back to the distribution date. The court noted that the interest credit for the portion of a participant's account balance attributable to the opening balance was higher than the Code § 417(e)(3) interest rate. Significantly, the court also rejected the defendant's argument that the whipsaw was no longer required, based on the Pension Protection Act (the "PPA") provision that no whipsaw calculation is necessary, noting that the PPA was not in effect when these distributions were made.

Use of Pre-Retirement Mortality Decrement – A pre-retirement mortality decrement is an actuarial factor used to reflect the possibility that a participant might die before retirement, in which case, the amount of benefits payable to a beneficiary would be reduced or even entirely forfeited. In other words, the factor reflects the possibility that the participant might forfeit his benefit if he delays distributions until normal retirement age. The crux of the issue addressed by the Sixth Circuit is whether it is reasonable to apply this decrement if the beneficiary will receive 100% of the participant's benefit after the participant's pre-retirement death, i.e., where no amount would be forfeited if the participant delayed distributions until normal retirement age.

Two district courts addressed this issue in the context of cash balance plans before the Sixth Circuit. Berger v. Xerox Retirement Income Guaranty Plan, 231 F. Supp. 2d 804 (N.D. Ill. 2002); Crosby v. Bowater, 212 F.R.D. 350 (W.D. Mich. 2002), vacated and remanded on other grounds, 382 F.3d 587 (6th Cir. 2004). These courts concluded that use of the pre-retirement mortality decrement in this context resulted in a forfeiture under Code § 411, and also violated the rules for calculating lump-sum distributions in Code § 417(e). The Sixth Circuit agreed with these lower courts. It should be noted that this holding also would appear to apply to traditional defined benefit plans that do not forfeit benefits upon the participant's death before normal retirement age.

B. Other Whipsaw Cases

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

In Berger, employees of Xerox enrolled in the cash balance plan who left Xerox between 1990 and 2000 and elected to take a lump sum in lieu of a pension brought a claim alleging that the method of determining the lump sum distributions violated ERISA's valuation and forfeiture rules. The court agreed with the plaintiffs and found that a participant's hypothetical account balance must be projected to normal retirement age using the plan's interest crediting rate, converted to an annuity, and then discounted to a lump sum using the § 417(e) interest rate. If the plan's interest crediting rate is the § 417(e) rate, the present value of the normal retirement age annuity will be the same as the hypothetical account balance. However, because the Xerox plan's interest crediting rate (one year T-bill rate plus 1%) was higher than the § 417(e) rate (PBGC rate at that time), the present value of the normal retirement age annuity and the amount of any lump sum distribution was greater than the hypothetical account balance. The court also held that a pre-retirement mortality discount could not be applied.

2. Esden v. Bank of Boston, 229 F.3d 154 (2d. 2000), cert. denied, 531 U.S. 1061 (2001).

In Esden, the Second Circuit held that Bank of Boston's cash balance plan violated ERISA's valuation and forfeiture rules when its lump sum payouts were equivalent to the balance of the participant's cash balance account and not the actuarial equivalent of accrued benefit expressed as annual benefit payable at normal retirement age. The plan credited interest to participants' hypothetical accounts annually, at a rate equal to the average of the three-month T-bill rates in effect on the first day of each month plus 0.5%. However, the rate of the Interest Credit could never exceed 10.0% or be less than 5.5%. The court held that a defined benefit plan making a lump-sum distribution prior to retirement is not free to choose its own methodology for determining the actuarial equivalent of the accrued benefit, so calculating the lump-sum pension plan distribution by projecting the balance of the participant's hypothetical account forward to normal retirement age using a projection rate that was lower than interest credits guaranteed under cash balance pension plan resulted in a failure to pay the true actuarial equivalent of normal retirement benefit. In short, part of participant's benefit was conditional on the form of payment chosen in violation of the valuation and forfeiture rules set forth in ERISA.

3. Lyons v. Georgia-Pacific Salaried Employees Retirement Plan, 221 F.3d 1235 (11th Cir. 2000), cert. denied, 532 U.S. 967 (2001)

Upon leaving Georgia-Pacific, Lyons, a participant with a vested benefit in the company's cash balance plan, took at lump sum payout in the amount of his then-current account balance. Lyons filed a class action suit alleging that rather than using his account balance, which had been adjusted for interest using the PBGC twelve-month immediate annuity interest rate plus .75%, the plan should have calculated the payout with reference to the present value of a normal retirement benefit as calculated using the prescribed maximum PBGC rate. The court, reversing the district court, held that distribution of the hypothetical account balance alone was not enough because the interest credit rate used by the plan exceeded the PBGC rate. The Eleventh Circuit based its decision on IRS rules requiring defined benefit plans to calculate the lump sum distributions by determining what would have been the normal retirement benefit had the participant not elected to take an early lump sum distribution and then discounting that amount to present value using the PBGC rate.

IV. Backloading

A. Eaton v. Onan Corp., 117 F. Supp. 2d 812 (S.D. Ind. 2000).

In Eaton, a federal district court denied the defendant's motion for summary judgment, finding the plaintiffs' claim that various plan provisions caused the plan to violate the anti-backloading rules raised a genuine issue of material fact as to whether the cash balance plan allowed benefits accrued by plan participants to be greater than 133 1/3% of the benefit in prior plan years in violation of ERISA's benefit accrual rules. One problematic feature of the Onan plan was an additional accrual made only for participants with 30 years of service. In a settlement involving the participants and the IRS, Onan agreed to amend the plan retroactively to assure technical compliance with the backloading requirements.

B. In re Citigroup Pension Plan ERISA Litigation, 470 F. Supp. 2d 323 (S.D.N.Y. 2006).

Granting summary judgment to the participants on their backloading claims, the court found that the cash balance plan impermissibly postponed the participants' accrual to their later years of service. Specifically, the court found that the cash balance plan's use of the fractional rule violated the minimal accrual standards in ERISA § 204(b)(1)(B)(i) and IRC § 411(b)(1)(C) and was unlawfully structured to allow for impermissible backloading because as a career average plan, the only applicable test was the 133 1/3 rule. Specifically, the plan documents called for the use of the fractional rule, calculating average compensation based only on the last ten years of an employee's service. If the calculation revealed that an individual's hypothetical account balance was less than the minimum amount required by the 133 1/3 rule, the plan would credit the participant the difference. The court ordered the plan to reform its accrual method retroactively in a manner consistent with the requirements of ERISA. The case was certified as a class action on 12/19/2006.

C. Register v. PNC Financial Services Group, Inc, -- F.3d --, 2007 WL 222019 (3d. Cir. 2007).

The Third Circuit affirmed a district court's decision that the plan did not violate ERISA's anti-backloading provisions. Under the PNC plan, the conversion of existing accrued benefits into opening cash balance accounts caused the benefit of some employees to remain stagnant for a period of time following the cash balance conversion. This was primarily due to the fact that the opening balances did not include any value attributable to early retirement subsidies that applied to the existing accrued benefits. As a result, the annuity value of some participants' benefits remained based on the frozen traditional benefit until the future growth in the cash balance account exceeded that value. Plaintiffs contended that once the wear-away period expired, the future benefit accruals would exceed the prior percentage of accrual by more than an amount permitted under the anti-backloading rules. The court found that any amount of accrual following a year of no accruals would exceed 133 1/3%, but concluded that the backloading analysis must be based only on the relative change in the cash balance benefit, without taking into account the prior accruals under the traditional benefit. Consequently, the cash balance formula, standing alone, satisfied the anti-backloading rules.

D. Wheeler v. Pension Value Plan for Employees of the Boeing Co., 2007 WL 781908 (S.D. Ill. Mar. 13, 2007).

In addition to rejecting the plaintiffs' claim that the Boeing cash balance plan violated ERISA's age-discrimination rules (discussed above), the court rejected the claim that the plan violated ERISA's anti-backloading rules by using a variable interest rate to compute "interest credits." The court found that this variable interest rate, calculated as the annual rate on 30-year Treasury securities, actually made the plan frontloaded and was permissible under Treasury regulations.

According to the court, Boeing demonstrated that, assuming interest credits were allocated to a plan participant's account at a constant rate of 5.25 percent (the bottom rate under the plan), a participant's benefit would never increase at a rate more than one-third in any given plan year. The court rejected the employees' argument that the "real-world" effect of the plan's use of a variable interest rate to compute interest credits created a situation in which variations in the 30-year Treasury rate were likely to cause backloading. The court said, "this argument is simply wrong. The Plan clearly is a 'frontloaded'--not backloaded--cash balance plan within the meaning of applicable Treasury regulations."

The court also noted that Treasury guidance regarding cash balance plans provides that a plan will be deemed frontloaded if, among other things, a plan calculates interest credits using a variable outside index such as the 30-year Treasury rate. The court said, "even if it is the case that variations in the 30-year Treasury rate can result in 'Interest Credits' causing a Plan participant's [cash balance account] to grow by more than one-third in a given Plan year--and this seems mathematically implausible--it is not actionable as backloading" under ERISA regulations and Treasury guidance.

E. Charles v. Pepco Holdings, Inc., -- F. Supp. 2d --, 2007 WL 2719857 (D. Del. September 19, 2007).

In another decision addressing the alleged "backloading" of benefits in a cash balance plan, the District Court for the District of Delaware ruled that a cash balance plan's use of variable interest rates did not cause the plan to become backloaded in violation of ERISA.

The plaintiffs were employed by Conectiv, which has been a wholly-owned subsidiary of Pepco since Aug. 1, 2002. Conectiv maintained several pension plans for its employees, including a cash balance plan that was created on Dec. 30, 1998, when its predecessor traditional defined benefit plans were merged. Affected Conectiv employees were given information regarding the conversion of the plan on three occasions between the spring of 1998 and the summer of 1999. The notices informed the employees that each would receive credit in their individual accounts for interest each year based on the 30-year U.S. Treasury bond rate. According to the court, the notices stated the then-current interest rates and also stated that the average historical rate on a Treasury bond was 8 percent.

The employees sued Pepco, Conectiv, and the plan in September 2005 alleging that the plan violated ERISA's minimum accrual requirements, as well as ERISA's age discrimination prohibition. In addition, the employees alleged the defendants violated ERISA's notice requirements, which provide that participants must receive 15 days notice prior to a plan amendment that results in a significant reduction in the rate of future benefit accrual.

The court found that the plan did not violate ERISA § 204(b)(1)(B), which requires that the value of the benefit accrued in any year may not exceed the value of a benefit accrued in any particular year by more than 33 percent. The court acknowledged that, if read and applied literally, many cash balance plans that use variable interest rates would not pass muster under ERISA § 204(b)(1)(B) because their accrued benefits would increase in some years and decrease in others based on the interest rate on a 30-year Treasury bond. The court found, however, that the purpose of § 204(b)(1)(B) is to prevent plans from being unfairly weighted against shorter-term employees and there was no evidence that the shift in the rate of benefit growth that resulted from fluctuating interest rates was unfairly weighted against shorter-term employees. Moreover, the court said the fact that cash balance plans satisfy the accrual requirements established by the Internal Revenue Service in IRS Notice 96-8 indicated that they are consistent with the purpose of the anti-backloading requirements of ERISA § 204(b)(1)(B).

In addition, the court noted that under regulations to § 204(b)(1)(B), in calculating whether a plan satisfies the 133 1/3 percent test, Social Security benefits and other relevant factors used to compute benefits "shall be treated as remaining constant as of the current year for all years after the current year." According to the court, while the language of this regulation did not specifically direct that interest rates be kept static to test compliance, cash balance plans using variable interest rates "have been upheld to date."

Finally, the court dismissed the employees' claim that the defendants violated ERISA § 204(h) by failing to provide adequate notice of the amendment establishing the cash balance formula. Noting that an amendment is subject to the notice requirement only if it is reasonably expected to change the amount of the future annual benefit commencing at normal retirement age, the district court said that as of the effective date of the amendment, the employees' rate of future benefit accrual would *not* be reduced under the cash balance plan and thus notice under § 204(h) was not required.

V. Participant Communications

A. Hirt v. Equitable Ret. Plan for Employees, Managers, & Agents, 441 F. Supp. 2d 516 (S.D.N.Y. 2006), on appeal to Second Circuit.

After rejecting the plaintiffs' discrimination claim, the court found that Equitable's ERISA § 204(h) notice of the plan amendment was insufficient. The sponsor initially implemented a cash balance formula in 1988 that excepted certain grandfathered participants from conversion to the cash balance formula. Later, in 1990, when the sponsor applied the cash balance formula to some of the grandfathered participants, the sponsor did not, the court concluded, explain "how the Cash Account formula would calculate benefits, how the benefits accrued while they were grandfathered would be treated, or how their final benefit would be determined." Although the 1990 notice referred to an earlier 1988 notice that described the cash balance formula, it did not enclose the earlier notice. Accordingly, the court observed, affected participants would have needed to review the 1988 notice "that they had received two years earlier, if they still had it," and perform "sophisticated calculations and comparisons" in order to understand the reduction in their benefits. The court found the 1990 notice to be insufficient. The court also refused to rule that delivery through interoffice mail should be presumed to be a "method reasonably calculated to ensure actual receipt." Finally, the court criticized the notice because it was "not accompanied with instructions regarding who was to receive it," and was "separated into two documents, a cover letter with an executive summary and a one-and-one-half page letter with a longer description of the amendment" (which gave it an "insignificant appearance"). The decision is currently on appeal to the Second Circuit.

B. Richards v. FleetBoston, 427 F. Supp. 2d 150 (D.Conn. 2006).

The court refused to dismiss a claim that the plan sponsor had violated its fiduciary duties by providing a summary plan description ("SPD") that inadequately described a cash balance conversion. The court credited the plaintiff's allegation that the SPD did not adequately explain the "wear-away effect" on particular participants, and that the SPD did not alert participants that assumptions used to calculate participants' opening account balances "included less than the full value of frozen traditional benefits."

The court also refused to dismiss a claim that the sponsor made "materially false statements" regarding the cash balance conversion, including a statement that the conversion to a cash balance formula "makes good sense" for employees and that "you will never receive less than the benefit you earned as of [the conversion date]," on the grounds that these statements could have "misled a reasonable participant into believing that his or her periodic benefit accruals would remain constant or increase."

C. Engers v. AT&T, 428 F. Supp. 2d 213 (D.N.J. 2006).

The court granted partial summary judgment in favor of AT&T on claims involving the alleged failures: (1) to provide a proper notice to participants under ERISA § 204(h); (2) to set forth the plan's "wear-away" rule in the written plan document; and (3) to disclose the plan's "bad parts" in the SPD.

Section 204(h) Notice: The court held that although ERISA § 204(h) requires notice to be issued to plan participants where there is a significant reduction in the *rate* of future benefit accruals, the proper threshold determination was whether there had occurred a significant reduction in the *amount* of normal retirement benefits. Expert testimony was provided that none of the named plaintiffs would experience a reduction in the amount of benefits payable at normal retirement. (In fact, each plaintiff's post-amendment accrued benefit was projected to be higher than under the pre-amendment plan). The court, therefore, determined that a § 204(h) notice was not required.

Wear-Away: The plaintiffs claimed that the wear-away period (during which benefits would not accrue because the new cash balance benefit did not yet exceed the frozen prior benefit) was not expressly set forth in the plan document in a timely manner. The court held that the determination of whether the wear-away was, in fact, applicable, involved the interpretation of the terms of the plan document, which had to first be made under the plan's claim procedures. Because the plaintiffs had not followed the plan's claims and appeals procedures, this claim was dismissed without prejudice for a failure to exhaust administrative remedies.

Misleading SPD: The plaintiffs contended that the SPD for the AT&T plan was misleading, in that it overemphasized the "best" features of the plan and downplayed the "worst" plan features. In particular, the plaintiffs claimed that the SPD did not properly disclose: (1) that benefits for older employees may be reduced; (2) that the factors used to determine the opening cash balance benefit were not the most valuable factors that had applied under the old plan; and (3) that the new plan did not provide any early retirement subsidies. The court held that a substantive remedy for failure to comply with ERISA's reporting and disclosure requirements would be available only if the plaintiffs could demonstrate "extraordinary circumstances." According to the court, AT&T may have put a favorable "spin" on the description of the cash balance plan's benefits, but such "spin" did not rise to the level of "active concealment," which would be required to show extraordinary circumstances to support a claim for a substantive remedy.

D. Finely v. Dun & Bradstreet Corp., 471 F. Supp. 2d 485 (D.N.J. 2007).

Participants of the Dun & Bradstreet cash balance plan brought claims alleging that plan failed to provide an adequate ERISA § 204(h) notice of the plan amendment converting the plan to a cash balance formula and failed to provide an SPD that explained the terms of the new formula in a manner the average participant could understand as required by ERISA § 102. The court dismissed the claims, explaining that the plaintiffs had neither stated a cause of action under ERISA § 502 nor satisfactorily pled the "extraordinary circumstances" necessary for a substantive remedy. However, the court allowed a fiduciary breach claim based on the same communications to survive summary judgment. Citing prior Third Circuit cases, the court held that an affirmative showing of material misrepresentation is not required to sustain such a claim. The law only requires an allegation that plan fiduciaries breached their duties under ERISA § 404 by materially misleading plan participants. The plaintiffs in the case were held to have met that requirement.

VI. IRS Reconsidering "Greater of" Formulas, But Court Finds No Backloading

A. IRS Reconsideration of "Greater Of" Benefit Structures

Earlier this year, the IRS surprised the defined benefit plan community by taking the position that cash balance pension plans that contained an alternative, "greater-of" benefit structure would likely fail to satisfy the anti-backloading rules of Code § 411(b). The issue began to arise as the IRS started to process the determination letter applications for the backlog of more than 1,200 cash balance plans it had put on hold since late in 1999. Many of these plans had included a benefit structure that continued to provide benefits under the plan's pre-cash balance benefit formula if such benefits would be greater than the new cash balance benefit formula. Even though both the prior benefit formula and the new cash balance (or other hybrid) formula would independently satisfy the anti-backloading rules, the IRS took the position that the year-to-year accrual pattern for a participant whose benefit transitions from one of the formulas to the other may not satisfy the rules. Surprisingly, the IRS position would penalize plan sponsors that chose to adopt participant-friendly transition approaches to the implementation of the cash balance design – instead of simply freezing the plan or imposing long "wear-away" periods. If the IRS position is adopted, these plan sponsors may have to retroactively improve benefits.

In response to substantial objections from the plan sponsor community and from members of Congress, the IRS has temporarily backed off from enforcing its strict interpretation of these rules. However, the IRS has not yet determined how to resolve the issue, and it appears that the determination letter applications for affected plans have again gone into a holding pattern pending final resolution. Andy Zuckerman, Director of IRS Employee Plans Rulings and Agreements, was recently reported as indicating that IRS is "diligently" working on resolving the issue and hopes to have "something out" by the end of the year, but there are no guarantees.

B. Court Rules that "Greater Of" Formula Does Not Constitute Impermissible Backloading

Meanwhile, a federal district court in Illinois considered this exact issue and ruled that multiple, greater-of formulas do not violate the anti-backloading rules. In Wheeler v. Pension Value Plan for Employees of the Boeing Company, 2007 WL 2608875 (S.D. Ill. Sept. 6, 2007), the court found that the Boeing plan's multiple, "greater-of" benefit formulas satisfied the anti-backloading requirements because each formula independently satisfied those requirements. The court considered plaintiffs' position that IRS regulations require that the accrued benefits under all of a plan's multiple formulas be "aggregated" in order to determine compliance with the anti-backloading rules. The court found that the regulation was intended to apply to benefits calculated under a sequence of formulas over time and not to greater-of benefit formulas. It held --correctly we think-- that the policy of the anti-backloading rules was to prohibit benefit structures designed to provide significant increases in benefit accrual rates based on a participant's increased age and years of service. The court found that the accrual rates of the Boeing plan's formulas were not tied to distinctions of age and service intended to favor older employees. Because the plan's two formulas were mutually exclusive, the plan would satisfy the backloading restrictions as long as each formula independently met the rules.

Finally, the court also addressed plaintiffs' contention that the IRS had interpreted the relevant longstanding regulation as requiring the aggregation of the annual rates of accrual under the plan's benefit formulas. The court found ample evidence of inconsistency in the enforcement of this position by the IRS, and indicated that "agency interpretations that change without rational explanation or vacillate between positions receive little deference."

Hopefully, the analysis and decision in Boeing will help IRS develop a position that allows them to approve the many plans that contain "greater-of" benefit formulas.