

Hybrid Pension Plans: Navigating Complex ERISA and IRC Requirements to Minimize Liability Risks

Complying With Primary Regulations, Reconciling Nondiscrimination,
Age Discrimination, Wear Away, Whipsaw Issues and More

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Hybrid Plans – Past, Present and Future

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Overview

- Introduction
- Primary Requirements
- Controversial Issues
- 2014 Regulations
- What's Next

Introduction

- What is a hybrid plan?
 - IRC § 411(a)(13)(C): “a defined benefit plan under which the accrued benefit (or any portion thereof) is calculated as the balance of a hypothetical account maintained for the participant or as an accumulated percentage of the participant's final average compensation”

Introduction

- Cash Balance Plan
 - hypothetical account
 - principal credits and interest credits
- Pension Equity Plan (PEP)
 - percentage of final average pay
 - typically no annual interest credits



Introduction

- History
- Pension Protection Act of 2006 (PPA)
- 2010 Regulations
- 2014 Regulations

Primary Requirements

- Generally subject to defined benefit (DB) plan rules, including:
 - Nondiscrimination – IRC § 401(a)(4)
 - Accrual Rules – IRC § 411(b)(1)
- Vesting – IRC § 411(a)(13)(B)
 - 3 year cliff
 - entire accrued benefit

Primary Requirements

- Interest Credits – § 411(b)(5)(B)(i)
 - Market Rate of Return
 - rate cannot exceed market rate of return
 - Preservation of Capital
 - cumulative floor of zero

Primary Requirements

- Conversions – § 411(b)(5)(B)(ii) – (v)
 - A + B requirement
- Plan Terminations – § 411(b)(5)(B)(vi)
 - Special rule for variable interest rate
 - Use average rates for 5-year period prior to termination date
 - See 2014 Final Regulations

Controversial Issues

- Age Discrimination
 - General rule – § 411(b)(1)(H)
 - PPA safe harbor – § 411(b)(5)(A)
 - Special requirements – § 411(b)(5)(B)
- Wear-away
 - no longer permitted for conversion amendments
 - but may be permissible in other contexts

Controversial Issues

- Whipsaw
 - Interest crediting rate > § 417(e) rate
 - Notice 96-8
 - PPA – no longer required but some plans still have it

2014 Regulations

- Final Regulations
 - § 1.411(a)(13)-1
 - § 1.411(b)-1
 - § 1.411(b)(5)-1
- Proposed Regulations
 - § 1.411(b)(5)-1(e)(3)(vi)

2014 Regulations

- Market Rate of Return
 - exclusive list of permissible rates
 - fixed, variable, combination
 - rates can be increased or new rates added by Commissioner

2014 Regulations

- Permitted Rates
 - Corporate bond segment rates
 - Government bond-based with margins
 - Cost-of-living indices with margin
 - Fixed rate of **6%**

2014 Regulations

- Permitted Rates (continued)
 - Rate of return on plan assets
 - Subset of plan assets **(new)**
 - diversification
 - employer securities limit
 - FMV assets approx. = adjusted benefit liabilities

2014 Regulations

- Permitted Rates (continued)
 - Annuity contract rates
 - Certain RICs – IRC § 851
 - no more volatile than broad US equities market or similar international equities market
 - e.g., S&P 500 or Russell 2000
 - but not industry- or country-specific

2014 Regulations

- Greater-of rates
 - Permissible floors
 - Segment rate – 4% annual
 - Government bond-based/CPI – **5%** annual
 - Investment-based rate – 3% cumulative
- Lesser rates permitted

2014 Regulations

- Other Guidance
 - Pension Equity Plans (PEP)
 - Plan terminations
 - Participant-direction

2014 Regulations

- Proposed Regulations
 - Anti-cutback relief
 - Silo approach
 - modify each non-compliant feature separately
 - various examples
 - Effective date

What's Next?

- Review application of regulations
- (Carefully) consider options
- Consult with experts
- Wait for final regulations to amend



ERISA Litigation regarding Cash Balance Plans

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ERISA Litigation Generally

- ERISA has limited remedies and causes of action
- Participants must fit their claim into one of the limited claims to bring them forward
- Traditionally courts are skeptical of efforts to expand relief beyond basic relief
- This trend is changing slowly though, so stay tuned



What key causes of action may a participant bring under ERISA relating to a cash balance plan?

- ERISA Section 502(a)(1)(B) – Standard breach of contract claim for benefits. The claim must rest on a provision in a plan that guarantees the benefit at issue.
- ERISA Section 502(a)(2) – Relief on behalf of the plan for losses to the plan itself.
- ERISA Section 502(a)(3) – Catchall relief provision. Most frequent citation for breach of fiduciary duty claim.



Where do we see the most litigation regarding cash balance plans?

- Cash balance conversions from traditional final average pay pensions
- Lump sum pay out (aka the “whipsaw” claim)
- Statute of limitations is often key
- Age discrimination related claims have died down



What claims may be brought relating to a conversion?

- The key claims often relate to misrepresentation about the conversion itself.
- Participants will allege some lack of clarity or truthfulness relating to the conversion itself.



What is the key case in this regard?

Cigna Corp. v. Amara, 131 S. Ct. 1866 (2011)

- Supreme Court decision addressing the lawfulness of a cash balance conversion
- Focus by the Court on the available remedies for participants based on the plan vs. SPD
- Guiding case for all ERISA litigation matters going forward



Cigna v. Amara

Background

- CIGNA converted its traditional defined benefit pension plan to a cash balance (CB) plan in 1998.
- Employee newsletter in 1997 announced –
 - CB plan would “significantly enhance” benefits with “the same benefit security”
 - Initial deposit = “full value of the benefit earned for service before 1998”
 - CIGNA “will not get . . . cost savings”
- CIGNA summary plan description (SPD) in 1998 described the conversion.
 - Old plan = annuity based on final salary and length of service
 - CB plan = individual account based on defined contribution and compound interest
 - Employee to elect lump sum or annuity at retirement
 - Initial balance = sum of annuity benefits accrued under old plan discounted to present value
 - Employee to receive greater of old plan accruals as of 1/1/98 or amount in CB individual account



Cigna v. Amara: Background

- Some elements were not described in the newsletter or the SPD.
 - Initial deposit calculation did not compensate for value of early retirement subsidy under old plan
 - Initial deposit adjusted downward to account for cost of survivor benefits
 - CB plan shifted risk of fall in discount rate to employees, meaning value of initial balance could be less than value of accrued benefits under old plan
 - Not surprisingly, CIGNA *did* get cost savings -- \$10M annually
- Many employees asked for comparisons of their individual benefit profiles before and after conversion.
 - CIGNA refused
 - Internal document said CIGNA “focus[ed] on NOT providing employees before and after samples of the Pension Plan changes”



Cigna v. Amara: Background

- Amara brought a class action claiming that CIGNA had not given employees proper notice of the changes to their benefits, especially because the CB plan was less generous.
- Amara sought relief under ERISA sections 502(a)(1)(B) ("to recover benefits due to him under the terms of the plan") and 502(a)(3) (to recover "other appropriate equitable relief . . . to redress violations of ERISA").




Cigna v. Amara: Supreme Court's Holding

- Supreme Court vacated and remanded in a two-part decision.
 - Court held 8-0 that no relief was available under section 502(a)(1)(B), and remanded on that basis.
 - Justice Breyer, for 6 Justices, then commented on possible section 502(a)(3) relief; Justices Scalia and Thomas did not join in those comments.
- ERISA Section 502(a)(1)(B) analysis:
 - The statute speaks of "enforcing" the terms of the plan, and not of "changing" the terms of the plan.
 - The SPD could not be enforced under section 502(a)(1)(B) because the information it provided "about" the plan was not itself "part of" the plan, and because its drafter was not the plan sponsor, but rather was a plan fiduciary.
 - Having to put all of the plan provisions in the SPD would defeat the purpose of explaining the plan in lay language.
 - Thus, the SPD does not "trump" the plan.
- But hold your excitement – the Court remanded for the District Court to consider whether section (a)(3) provided a remedy.



Cigna v. Amara: dicta on 502(a)(3) Remedies

- "Equity suffers not a right to be without a remedy."
- Reformation is a power of equity, to prevent mistake or fraud.
- Estoppel is another power of equity, intended to place the beneficiary in the same position she would have held had the representation been true.
- "Surcharge" is another power of equity, and allows an award of compensation resulting from a loss due to a breach of fiduciary duty.



Cigna v. Amara: 502(a)(3) & Detrimental Reliance

- In equity, detrimental reliance is not always a prerequisite to recovery.
- Detrimental reliance is an element of estoppel, but not of reformation.
- Detrimental reliance also is not an element of surcharge. But actual harm and causation are. Actual harm can be shown with evidence of the loss of a right protected by ERISA.
- "[I]t is not difficult to image how the failure to provide proper summary information, in violation of the statute, injured employees even if they did not themselves act in reliance on summary documents -- which they might not themselves have seen -- for they may have thought fellow employees, or informal workplace discussion, would have let them know if, say, plan changes would likely prove harmful."



What happened on remand?

- District court allowed equitable reformation of the plan
- Fiduciaries breached their fiduciary duty to the participants
- As a result, the participants also suffered a loss “related” to employer's breach, as required for them to obtain make-whole surcharge as equitable remedy.
- Second Circuit just recently upheld this decision in late 2014.



Misrepresentation Issues

Osberg v. Foot Locker, Case No. 13-187-cv (2d Cir. Feb. 13, 2014) (summary order),

- Plaintiff alleged defendants had violated ERISA by: (i) issuing false and misleading SPDs in violation of ERISA Section 102(a) disclosure requirements; (ii) breaching fiduciary duties in violation of ERISA Section 404(a) by making such materially false statements; and (iii) failing to provide proper notice as required by ERISA Section 204(h) that the cash balance plan would reduce benefit accruals.
- The district court granted summary judgment in favor of defendants, and the plaintiff appealed.



Misrepresentation Issues

Osberg, contd.

- The Second Circuit Court of Appeals upheld the summary judgment as to the Section 204(h) claim, because the remedy plaintiff sought, the invalidation of portions of the plan amendment, was not achievable.
- The only available remedy for such a purported violation was the complete invalidation of the plan amendment.



Misrepresentation Issues

Osberg, contd.

- Regarding the disclosure claims, the district court had found plaintiff had failed to raise a genuine issue of material fact as to whether he suffered the type of “actual harm” necessary to obtain the equitable relief of reformation and surcharge. On that issue the Second Circuit found that the district court erroneously applied an “actual harm” requirement. Citing to *Amara*, the Second Circuit found that equity does not demand a showing of “actual harm” to obtain contract reformation.
- Court remanded this issue to the District Court



Other Cash Balance Litigation Issues

Whipsaw Litigation

- The most significant risk relates to ensuring that participants are paid the "accrued benefit" when they receive payment as a lump sum at termination.
- To distribute a lump sum, the plan must calculate what the hypothetical account balance would be at normal retirement age under the plan (typically age 65) and then discount that value to present value at date of distribution at certain rates.
- Litigation continues to percolate regarding whether this has been done correctly.
- Cases have high settlement value; see Colgate litigation in SD of NY that settled for \$49 million in 2013



Other Cash Balance Litigation Issues

Statute of limitations

- One of the key issues in cash balance cases for defendants is often statute of limitations
- Many times these claims relate to communications made to participants 5, 10 or even 20 years ago
- Defendants like to point to the early communications to the participants regarding the calculation or plan changes and courts are at times willing to honor those defenses to at least limit the class size, if the communication is clear.
- *See, e.g., Berger v. Axa Network* 459 F.3d 804 (7th Cir. 2006); *Gelesky v. AK Steel* 828 F.Supp.2d 935 (ND Oh. 2011).