

What Will Judge Posner Do Next? Balm or Bomb for Cash Balance Plans?

By Alvin D. Lurie

If the *IBM* case and its expected appeal to the 7th Circuit had not already dominated the pension landscape, recent actions in the Congress have given the case even more significance, because if the compromise agreed to by the conferees on the Treasury 2004 appropriations bill (H.R. 2989) is adopted by the Congress – most likely at this writing – the *IBM* opinion in the appeal will be the only authoritative guidance available on the all-important question of age discrimination for a considerable time.

So, once again the pension community – at least, the segment that cares about cash balance plans: some 1,200 plan sponsors with an estimated 7 million of participants, and their thousands of pension consultants – is bracing for more bad news. The 11th hour version of the Sanders-Harkin amendment adopted by the conferees would have the effect of stopping the Treasury's issuing the cash balance regulations proposed last December until Treasury submits to Congress legislation providing relief to workers adversely affected by conversions from defined benefit to cash balance plans.

Power of the Purse

It is not clear what effect this bill, if enacted, will have on the outcome of the *IBM* case. There is no doubt what the immediate effect of the original Sanders amendment that passed the House would have had: it would have blocked the Treasury from “the use of funds to assist in overturning the judicial ruling” of the trial judge. The conferees' compromise is less frontal (and, I submit, more legal), stopping only the issuance of the proposed regulations, but again by way of the problematic use of the control of the purse strings. Existence of final regulations, that would have been effective for plan years beginning after 1987, would have assuredly carried *Chevron*-imposed deferential, although not necessarily dispositive, effect; but their absence does not prevent the appellate court from reaching a result consistent with the already published proposed regulations.

However, stalling the regulations will have an unfortunate, dampening effect on the state of cash balance plans generally, because of denying necessary guidance to sponsors with existing plans or who are considering adopting such plans. The consequences are already being felt, with the *IBM* decision of the lower court having cast a decided pall over the scene. The U.S. Chamber of Commerce, in a letter to the leadership of both Houses, calls it “a state of suspended uncertainty”, surely an understatement. Benefit consultants almost universally are counseling great caution, to the extent of halting new adoptions, if not recommending massive plan terminations.

This widespread attitude among pension pundits can be traced directly to two events this past summer. The pension community, hit by a high-intensity shock wave when *Cooper v. IBM* (D.C.S.D. Ill. No. 99-829-GPM) was decided July 31, received another sharp jolt when *Berger v. Xerox* (338 F.3d 755) was reported a day later. The cumulative impact of these decisions in close

conjunction was considerably greater than the effect of either of them alone. That IBM would appeal the decision of the trial court quickly became known, but hopes for a reversal were tempered by the knowledge of the cash balance cognoscenti that the appeal would go to the same court that had just decided *Xerox*: the 7th Circuit, with the author of that opinion, Judge Richard Posner, the likely author of an opinion on the *IBM* appeal.

Speculation is rampant that Judge Posner, if he is indeed sitting on the appeal panel, will not overturn the lower court decision. That “common wisdom” is based on the not-surprising assumption that Posner has closed the book on the cash balance design, and would be most unlikely to give relief to IBM that he had denied to *Xerox*.

IBM Has a Chance

I submit the inference is unwarranted, and that the better guess is that IBM has a fair chance of prevailing in his court, if the judge has his way. I base this principally on several grounds. First, *IBM* is a vastly different case than *Xerox*, implicating issues and rules not present in the *Xerox* litigation. Second, Posner is no mere legal technocrat, rather more a legal philosopher given to case-by-case solutions grounded in economic consequences and behavioral effects. Third, he adjures legal formalism and strict constructionism in a vacuum. As important as all of these, he is an original, one might almost say a contrarian, who is not about to be “typed.” He is very much his own man (how else to describe an appeals court judge who does not feel constrained from very publicly criticizing Supreme Court decisions in such high-profile cases as *Bush v. Gore* and *Clinton v. [Paula] Jones?*).

Xerox involved one of the more confounding-- one might say exasperating-- aspects of the debate over cash balance plans, the so-called whipsaw effect that can obtain in the calculation of lump-sum benefits participants generally become entitled to elect upon their separation from service before normal retirement age. Whipsaw occurs when a plan sponsor establishes an interest rate for accumulating benefit credits under a cash balance plan that is higher than the interest rate that IRS has asserted is required to be used to ascertain the present value, at the time of separation, of the participant’s lump-sum benefit. (We will return momentarily to this “requirement,” which is at the core of the problem.)

How Whipsaws Happen

The whipsaw metaphor describes the double hit to a plan sponsor that chooses, as a matter of sponsor discretion, to set the interest component of its plan’s notional annual credits at an above-market level, say 7%, as a way of enhancing the normal benefits under the plan, when the discount rate established by regulatory fiat for calculating present value at the time of a participant’s pre-retirement separation from service reflects the market rate, say 5%, thereby enabling a participant to “select against” the plan by claiming a lump-sum cashout greater than the value of one’s account balance. That was the precise effect of the holding in the *Xerox* case, and will cost the plan (but not immediately the company) \$239 million in additional benefits, under a settlement recently announced by the company.

Here’s the mechanism by which the whipsaw can come about. The plan first constructs a participant’s normal retirement benefit by projecting the account balance forward to the

participant's normal retirement age at the plan's stated interest crediting rate. It then converts the resulting account balance to an annuity. Finally it commutes the annuity to a lump sum by discounting it back to the benefit distribution date at the government-prescribed interest rate. If the plan interest crediting rate exceeds the government rate prescribed for discounting, the commuted lump sum will be greater than the participant's notional account balance at the benefit distribution date. It's simple mathematics: if you project a 50-year old's account balance forward 15 years (to normal retirement age) at 7%, and then commute it back 15 years to the starting date at 5%, the account balance will be substantially enhanced. The problem is not with the math but the method.

Obviously that is because of the mismatch of the interest crediting rate and the discount rate, and it occurs solely in the cash balance environment because the traditional defined benefit plan does not employ the interest crediting mechanism in the accrual of benefits. There is nothing in the relevant statutes or regulations that compels the use of such simultaneous forward-crediting reverse-discounting to determine a participant's lump-sum cash value benefit. The tortuous methodology derives entirely from an IRS announcement, Notice 96-8, which tentatively "proposed" an approach to present-valuing a pre-age-65 distribution. (I say "proposed" because the notice was published only for the purpose of soliciting public comment preliminary to issuance of a proposed regulation). The projected regulation – still not issued seven years later – "will be effective prospectively," said the notice very explicitly. That its method would receive the imprimatur of adoption by three circuit courts -- first in *Georgia-Pacific* (221 F.3d 1235), then in *Bank of Boston* (229 F.3d 154), and finally in *Xerox* – before issuance of the proposed regulation, let alone its finalization, surely was not anticipated by the Service.

The origin of this concept of projecting forward an annuity at retirement age that must then be discounted to its present value at the time of actual distribution presumably stems from the traditional view of a defined benefit plan as one that will deliver an annuity at normal retirement age. But that concept pre-dates and is inapposite to the development of cash balance plans, which normally provide lump-sum benefits. The underlying problem is the supposed need to test cash balance plans under rules that obviously were not designed for them. Further evidence for this conclusion is the proposal in Notice 96-8 to set the discount rate at the IRC section 417(e) rate for determining the present value of involuntary cashouts of qualified joint and survivor annuities, which was inserted in the Code and ERISA before development of the cash balance concept and obviously not intended to apply to the calculation of cash balance benefits, or *a fortiori*, to sanction the whipsaw result.

Through A Dense Thicket Not So Warily

The foregoing is an oversimplified recounting of an issue bound up in a dense thicket of statutes, regulation and IRS announcements, which thicket is far more within the competence of actuaries to navigate through than other benefit practitioners. Judge Posner, who admits to "enjoy(ing) ERISA cases" which he finds "frequently difficult and fascinating" (see Posner, "How I Approach the Decision of an ERISA Case," *NYU Review of Employee Benefits and Executive Compensation 2002*, ch. 14, hereafter "NYU"), waded into this unforgiving terrain with gusto and acumen, and has produced in *Xerox* a quite remarkable explication of the underlying

actuarial principles. But the opinion does not always illuminate his reasoning, seeming at times to lapse into obscurantism (albeit unwittingly). Admittedly, the problem might be not so much the reasoning as the inadequacy of English grammar (even in the hands of a master rhetorician) to describe functions best expressed in mathematical notation.

That said, it is clear that the judge bought into this forward-backward conflict of interest rates without a qualm. One might have expected him to balk at so counterintuitive and inequitable a result as flows from the asymmetry of the Notice 96-9 modality and to press harder to find a symmetrical schema for working justice. It may be that the judge, whose own prodigious feats are no slight thing, was awed by the obvious mastery of the actuarial intricacies displayed by the author of Notice 96-8 – I admit to that myself – and dared not challenge its underlying concepts.

But the point of this piece is not to criticize *Xerox*, but rather to describe it sufficiently to delineate its difference from the “rate of accrual” issue, as relates to the statutory test for age discrimination, which is the focus of the *IBM* litigation. (I will assume readers have a sufficient familiarity with *IBM* not to require further discussion of it here; but for a brief refresher, refer to the author’s “The Curse of Murphy’s Law – or Is It IBM That’s Cursing,” *LISI Employee Benefit & Retirement Planning Newsletter* # 197.) It is immediately apparent that the matter decided in *Xerox* has no bearing on the discrimination issue in *IBM*, save that the decisions in both cases are heavily influenced by the “frontloaded” cash balance formats at issue, that is, “interest adjustments to a hypothetical (pay-based) allocation ... provided through normal retirement age, even though the employee terminates employment ... before that age”. (Treas. Reg. Sec. 1.401(a)(4)-8(c)(3)(iv).) Neither the issue of the proper discount rate that so dominated the *Xerox* decision nor the matter of the effect of pre-retirement cashouts has pertinence to *IBM*.

Peering Into Judge Posner’s Head

What then would be the likely concerns of Judge Posner in adjudicating the *IBM* appeal, if he were to sit on the reviewing 7th Circuit panel? For the possible answer to this question I have examined two sources of the judge’s non-judicial writings: (1) *NYU, supra* and (2) Posner’s most recent book, “Law, Pragmatism, And Democracy.” I also rely on my admittedly vague recollection of his classic, “The Economic Analysis of Law,” which is credited with launching the school of law and economics. While these offer many clues to the judge’s possible approach to deciding the *IBM* appeal, I will cite just a few.

Most relevant, I submit, are his bias for elevating above high principle the consequences of what is done in a case, and paying attention to incentives, i.e., how a decision will affect behavior of employers and employees. He prefers “Legal Pragmatism” to a “formalist” view of law which admits only of the single question, what does the law require? Thus, he would not limit the judge to finding and declaring the answer to that sole inquiry. A “big picture” judge, one would have to call Judge Posner.

Pragmatic adjudication, in Posner’s view, requires the judge to recognize his limitations, principally to matters of legislation and case precedents, and to defer to experts in non-legal fields to provide the foundation for the judge’s interpretive and decisional functions. Even in traditionally legal matters of statutory interpretation, he argues (e.g., where dealing with complex

statutes), the text is not sufficient unto itself and its mere reading does not answer all questions that arise under it. Specifically, in complicated statutes like ERISA, the judge must recognize that he is a generalist, and must look to specialists in the bar to “educate and guide” him. Posner lays great weight on the “structure and purpose” of the transaction or instrument *sub judice*, and there too the judiciary must call upon the bar for assistance. The judge also puts much stress on “the social value of certainty of legal obligation,” and even goes to the point of including safe harbor language in some of his opinions, with the very object of insulating a pension plan from challenge based on alleged ambiguity.

A Pro-Employer Tilt?

There is one other point – not so much a view into the mind of Posner perhaps, but a most interesting observation -- which the judge acknowledges: “[F]ederal judges tend to be less plaintiff-oriented than state judges, and so employers probably fare better on average in federal than state courts ...” (See *NYU, supra*, at page 14-5.) No promises, of course. This absence of bias toward employee claimants, or, at least, *against* employers, which the judge does not dissociate himself from, is consistent with these further Posner observations: “[E]mpirical study has shown that employers’ pension practices were rarely exploitive before ERISA” (*id.*, page 14-2); “[T]here is still the danger, easily exaggerated but more than theoretical, of the employer’s renegeing on his commitment.” (*Id.*, page 14-3.) No evidence there of a judge determined to drive the money-changers from the temple, with or without ERISA in hand.

I find it difficult to see in these gleanings a judge who would approach the *IBM* appeal in a doctrinaire manner, unmindful of its potentially far-reaching consequences for the future not only of cash balance plans, but of defined benefit plans written large, and, in a larger sense still, of the economic health of the nation. On the other hand, one should not read too much into comments made in another context. I would draw the reader’s attention to this comment by the judge, speaking of the compulsory annuitization of pension benefits under ERISA, which he characterized as “a requirement intended to prevent retired people from freeloading on the taxpayer ... by assuring that they don’t squander their pension benefits, as they would be more likely to do if they received them all at once in a lump sum upon retirement ...” (*NYU, supra* page 14-4.)

One would not have guessed that the person who wrote that statement also would have authored an opinion that produces incentives to take early retirement so as to earn an oversized lump-sum benefit beyond that contemplated by the plan sponsor (or even assuredly by the participants themselves, until recruited by lawyers to go into court for the windfall). Maybe plaintiffs’ lawyers proved to be better “educators and guides” than the defendant’s. Good lawyering still affects the outcome of cases, almost as much as good judging.

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