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1902–2002

EMPLOYEE BENEFITS & EXECUTIVE COMPENSATION

LEGAL PERSPECTIVES | December 2002

IRS Gives Green Light to Cash Balance Plans

The Internal Revenue Service has issued proposed rules on age discrimination in cash balance plans. Before the proposed rules were issued, many companies were wary of adopting cash balance plans in light of the potential age discrimination issues and the moratorium the IRS imposed on issuing determination letters for certain types of cash balance plans.

The proposed rules make it easier for companies to offer cash balance plans. Many sponsors of existing cash balance plans will find that their plans meet the requirements of the proposed rules. In addition, the proposed rules provide detailed guidance on converting existing traditional defined benefit pension plans to cash balance plans. As a result, many companies may consider converting their traditional pension plans to cash balance plans.

These proposed rules are not without controversy. Many companies find that cash balance plans are more suitable for younger, more mobile workers and are often less costly, saving companies hundreds of thousands of dollars per year. However, many labor advocates have attacked cash balance plans as being unfair to older workers, particularly when existing traditional pension plans are replaced with cash balance plans. Although the proposed rules may not end the controversy, they open the door for companies to sponsor cash balance plans with the blessing of the IRS.

IN THIS ISSUE

1 IRS Gives Green Light to Cash Balance Plans

3 DOL Issues Guidance on Blackout Periods For Plans Sponsored By Public and Private Companies

5 Employee Plans — New Law Action Checklist

Comparison of Traditional Pension Plans and Cash Balance Plans

Traditional Pension Plans. Under a traditional defined benefit pension plan, an employee receives a retirement benefit of a fixed amount typically based on the */ continued page 2*

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Cash Balance Plans

continued from page 1

employee's salary and years of service. This method of determining a benefit allows an employee to accrue a significant portion of his or her benefit in the employee's final years of service (as compensation and years of service increase).

New or Non-Converted Cash Balance Plans. A cash balance plan allows an employee to accrue benefits evenly over the course of his or her career. Typically, the benefit in a cash balance plan is equal to a "hypothetical account balance" comprised of certain annual additions equal to a percentage of an employee's annual compensation (called "pay credits") and earnings (called "interest credits"). A younger employee's account will generally yield a higher rate of benefit accrual than that of an older employee, because the younger employee has more years over which to accrue earnings.

Converted Cash Balance Plans. In many cases, traditional defined benefit pension plans are converted to cash balance pension plans. In a typical conversion of a traditional defined benefit pension plan to a cash balance plan, the cash balance plan provides an opening hypothetical account balance for each employee. In some plans, the opening balance is based on the employee's prior accrued benefit under the traditional pension plan. In other plans, the opening balance is set at zero and the employee is entitled to the sum of the employee's accrued benefit under the traditional pension plan and the cash balance account. In some conversions, an employee's opening account balance and subsequent interest credits through retirement age in the new cash balance plan generate benefits that are not as large as the prior accrued benefit under the old defined benefit plan. As a result, an employee may not accrue any additional benefits under the cash balance plan for some period after the conversion. This period, called a "wear-away" period, continues until the employee's account balance in the new cash balance plan exceeds his or her prior accrued benefit. Since many older workers have larger accrued benefits under traditional pension plans, older workers typically take longer to start accruing benefits under cash balance plans. As a result of the wear-away period, many labor advocates have alleged that converted cash balance plans discriminate on the basis of age.

How the Proposed Rules Work

The proposed rules address age discrimination issues for both new (or non-converted cash balance plans) and converted cash balance plans.

New or Non-Converted Cash Balance Plans. In general, the proposed rules provide that a plan does not discriminate on the basis of age if the plan provides older workers with pay credits that equal or exceed the pay credits provided to younger workers. In more technical terms, the proposed rules would permit an "eligible" cash balance plan to provide a benefit accrual rate using additions to a hypothetical account, excluding regular interest credits attributable to previous accruals. Eligible cash balance plans must meet certain requirements: (1) the normal form of benefit must be an immediate payment of the hypothetical account (without regard to whether such immediate payment is actually available under the plan); (2) at the time that an employee accrues an addition to his or her hypothetical account, the employee must also accrue the right to future interest credits at a reasonable rate of interest that does not decrease because of age; (3) such interest credits must be provided for all future periods, including after normal retirement age; and (4) the plan cannot treat such interest credits after normal retirement age as actuarial increases that are offset against required accruals.

Converted Cash Balance Plans. The IRS addressed the wear-away issue for converted cash balance plans by requiring that converted cash balance plans satisfy one of two alternative rules. The first alternative requires that the converted plan determine each employee's benefit as not less than the sum of the employee's benefit accrued under the prior defined benefit plan and the cash balance account. Under this alternative, there is no wear-away. The second alternative requires that the converted plan establish each employee's open- */ continued page 3*

Many companies find that cash balance plans are more suitable for younger, more mobile workers and are often less costly, saving companies hundreds of thousands of dollars per year.

continued from page 2

ing account balance as an amount not less than the actuarial present value of the employee's prior accrued benefit, using reasonable actuarial assumptions. An interest rate assumption is not treated as reasonable if it increases because of an employee's age. If these requirements are met, then the second alternative will permit a wear-away period for some or all of the employees in the plan.

Other Guidance. The proposed rules also provide guidance on age discrimination requirements for defined benefit plans other than cash balance plans and for defined contribution plans, such as 401(k) plans, target benefit plans and profit-sharing plans and cross-testing of cash balance plans.

Effective Date

The proposed rules are subject to public comment for 90 days before they may be put into final form. The final rules will apply to plan years beginning after the IRS publishes the final rules, which are expected to be published in 2003. Once the rules are finalized, the IRS will lift its moratorium on issuing determination letters with respect to converted cash balance plans.

Action

Cash balance plan sponsors should review their existing plans to ensure that they meet the requirements of the proposed rules. Companies may wish to evaluate their existing traditional benefit plans to determine the advantages and disadvantages of converting to a cash balance plan and to determine whether the new guidance will benefit their existing traditional benefit plans.

If you have any questions about how these rules apply to your plan or if you are interested in learning more about converting your defined benefit plan to a cash balance plan, please contact us. ◎

DOL Issues Guidance on Blackout Periods For Plans Sponsored By Public and Private Companies

The Department of Labor has issued interim final regulations relating to the required 30-day advance notice which must be provided by plan administrators to all participants and beneficiaries before a "blackout period" in individual account plans, such as 401(k) plans. These regulations are required by the Sarbanes-Oxley Act of 2002, which enacted the blackout notice requirements. Unlike most provisions of the Sarbanes-Oxley Act, which apply only to public companies, the blackout notice requirements apply to both public and private companies.

Blackout Period. The regulations define "blackout period" as any period of three or more consecutive business days during which the ability of any participant or beneficiary under the plan to direct or diversify assets credited to his or her accounts, to obtain loans from the plan or to obtain distributions from the plan, is temporarily suspended, limited or restricted and such ability is normally available under the plan's terms. The term "blackout period" specifically excludes regularly scheduled trading suspension periods, suspensions required by securities laws and suspensions related to qualified domestic relations orders. Blackout periods often occur as a result of a change of investment alternatives or recordkeepers or as a result of a corporate merger, acquisition or spin-off.

Notice Recipients. Notice must be provided to all plan participants and beneficiaries and to the issuers of employer securities that are held by the plan (by service to the issuer's agent for legal process).

Content of Notice. The regulations provide that blackout notices must be written in a manner that would be understood by the average plan participant and must include:

- the reason(s) for the blackout period;
- a description of the rights otherwise available to participants under the plan that are being temporarily suspended;
- the expected beginning and ending dates of the blackout period;

/ continued page 4

Blackout Periods

continued from page 3

- a statement advising that participants and beneficiaries review current investments in light of their inability to direct or diversify assets during the blackout period;
- the name, address and telephone number of the person who may answer questions relating to the blackout period (such as the plan administrator); and
- for notices not provided at least 30 days before the blackout period the following additional information must be provided:
  - a statement that Federal law generally requires that notice be provided to participants and beneficiaries at least 30 days before a blackout; and
  - an explanation of the reason(s) why the 30-day advance notice was not timely provided.

  (*Note:* These two additional statements are not required for notices provided in connection with a blackout period arising from a merger, acquisition, divestiture or similar transaction involving the plan or the plan sponsor.)

Model Form of Notice. The regulations include a model form of blackout notice. The regulations provide that certain portions of the model notice will satisfy certain content requirements prescribed by the regulations. This notice is not mandatory, but the employer must ensure that if this model is not used that the notice includes all the required elements.

Delivery of Notice. Notice may be delivered by first class mail or electronically. The notice is considered delivered on the day it is mailed, if by first class mail, or the date on which there was an electronic transmission, if delivered electronically. If there is a change in the dates of the blackout period, a revised notice must be provided as soon as reasonably possible.

Time of Notice. The regulations provide that notice must be provided at least 30 calendar days, but not more than 60 calendar days, before the last day on which participants and beneficiaries may exercise the rights that are being restricted. The Department of Labor provides two examples of how the notice requirements are calculated:

- *Example 1:* Assume the plan provides for daily transactions. The 30- and 60-day advance notice periods would be counted back from the day before the blackout period begins.
- *Example 2:* Assume that the plan permits trading monthly on the first 15 days of the month, and the blackout period is to be May 1 through May 15. If the notice is provided on April 1, then participants and beneficiaries would only be given 15 days (April 1 through April 15) to exercise their rights under the plan before the blackout period begins. Therefore, the notice must be provided by March 16. Note that many benefits practitioners find this second example to be confusing and have submitted comments to the Department of Labor asking for clarification on this example.

Exceptions to 30-Day Advance Notice Requirements. The regulations provide that the requirement to provide at least 30 days' advance notice is not applicable if:

- a deferral of the blackout period would violate fiduciary duties (for example, if the blackout period is caused by the employer's impending bankruptcy and it would not be prudent under ERISA to permit participants and beneficiaries to continue to invest in employer stock which will most likely decline in value) *and* a fiduciary of the plan determines in writing that it would be a violation of its fiduciary requirements to defer the blackout period;
- the events causing the blackout period were unforeseeable or on account of circumstances beyond the reasonable control of the plan administrator *and* a fiduciary of the plan determines in writing that the */ continued page 5*

Because the penalties are so onerous for missing the advance notice deadline, if an employer misses the deadline, the employer should consider moving the blackout period to a later time to avoid the penalties.

continued from page 4

circumstances causing the blackout period are beyond the reasonable control of the plan administrator; or

- the blackout period applies only to one or more participants solely in connection with their becoming or ceasing to be participants or beneficiaries of the plan as a result of a merger, acquisition, divestiture or similar transaction involving the plan or plan sponsor.

In each of these three cases, notice must be provided as soon as reasonably possible under the circumstances, unless notice before the end of the blackout period is impracticable.

Updated Notice Required. If the beginning or ending date of a blackout period changes after the original blackout notice is sent, the plan administrator must send an updated notice to participants and beneficiaries and to the issuers of employer securities. The updated notice must include a description of: (1) the new beginning and/or ending date of the blackout period; (2) the reason(s) for the change; and (3) all other material changes from the prior notice. This updated notice must be furnished as soon as practicable, unless updating the notice before the blackout termination date is impracticable.

Civil Penalties. The regulations clarify that there is a $100 civil penalty for each failure to provide the required advance notice. The penalty is imposed upon the plan administrator and cannot be paid from the plan assets. The penalty is imposed for each day, beginning with the first day on which the 30-day advance notice was not timely provided and ending on the last day of the blackout period, for each participant or beneficiary who did not receive a timely notice. For */ continued page 6*

1902–2002
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Employee Plans — New Law Action Checklist

✓ **QUALIFIED RETIREMENT PLANS — CERTAIN EGTRRA AMENDMENTS MUST BE ADOPTED BY 12/31/02.**

The Economic Growth and Tax Relief Reconciliation Act of 2001 made sweeping changes to pension legislation by significantly increasing plan contribution and benefit limits. Almost all of the EGTRRA amendments are effective for plan years beginning after December 31, 2001. Some of the amendments are mandatory, while others are optional. The Internal Revenue Service has indicated that the remedial amendment period for qualified plans is the last day of the first plan year *beginning on and after January 1, 2005*. However, if plans wish to take advantage of some of these more generous benefit limitations, they will need to implement "good faith amendments" based upon the model amendments issued by the IRS for many of the EGTRRA changes in the years in which the amendments are to be effective. *Good faith amendments for any year must be adopted no later than the end of the plan year for which such amendment is to be effective.* For example, if a 401(k) plan wishes to take advantage of the EGTRRA amendment which permits catch-up contributions (increased elective deferrals for those participants who have attained at least age 50 during the plan year) beginning in 2002 and later years, the 401(k) plan must have adopted a "good faith" EGTRRA amendment by the end of 2002 to allow catch-up contributions in 2002.

✓ **401(k) PLANS — BLACKOUT PERIOD RESTRICTIONS**

The Department of Labor recently issued guidance on blackout restrictions under individual account plans, such as 401(k) plans. These restrictions apply to both public and private companies and take effect January 16, 2003. These regulations are described in this month's newsletter (see pages 3 through 6).

✓ **HEALTH PLANS — HIPAA PRIVACY RULES**

Beginning April 14, 2003, new privacy rules under the Health Insurance Portability and Accountability Act of 1996 take effect for most health plans. The new HIPAA privacy rules are designed to protect individuals against disclosure of personal health information to unnecessary parties. Sponsors of health plans subject to the new privacy rules must take action to insure that the privacy rights of participants are protected. These actions include, for example, (1) updating contracts with "business associates" (such as claims processors, attorneys and recordkeepers) to insure that participant privacy is protected, (2) providing notice to health plan participants of their privacy rights under HIPAA, (3) preparing written participant authorization forms to allow necessary disclosures of private information to certain parties, (4) amending plan documents, (5) providing certifications to plans and insurers, (6) training employees and (7) providing records and compliance reports to the Secretary of Health and Human Services. Many of these actions are time consuming and must be taken in advance of April 14, 2003, to ensure compliance with HIPAA regulations.

If your company has not already done so, now would be a good time to review your company's plans to ensure compliance with EGTRRA, blackout restrictions and HIPAA.

Blackout Periods

continued from page 5

example, if a plan administrator is one day late in providing the 30-day advance notice for a blackout period which will last 10 days, and the plan covers 1,000 participants, the total penalties would be $4,000,000 ($100 x 40 days x 1,000 participants).

Practice Pointer. Because the penalties are so onerous for missing the advance notice deadline, if an employer misses the deadline, the employer should consider moving the blackout period to a later time to avoid the penalties.

Benefits practitioners have commented to the Department of Labor that these penalty calculation rules should be revised because of their potential significant financial impact.

Effective Date. The regulations are effective for blackout periods beginning on or after January 26, 2003. For the period January 26, 2003 through February 25, 2003, plan administrators must furnish the required notice as soon as reasonably possible.

Coordination with Insider Trading Blackout Restrictions. Sarbanes-Oxley also prohibits transactions in employer equity securities by directors and executive officers outside an individual account plan during blackout periods, if the director or executive officer acquired the equity securities in connection with his or her service or employment. Unlike the blackout period notice requirements, the insider trading blackout restrictions apply only to public companies and private companies that have filed a registration statement under the Securities Act of 1933. Please see *Client Alert: Sarbanes-Oxley Act of 2002 Amends Securities Law to Crack Down on Corporate Fraud, July 2002,* on our website **www.chadbourne.com/publications/sub_Publications.html** for further details.

Action Required. Plan administrators of individual account plans should monitor carefully any future restrictions on investments, loans, distributions and transactions, consult with qualified advisors on the blackout notice requirements and provide the appropriate blackout notices when required.

Please contact us if you would like more information regarding the blackout notice requirements or a copy of the model form of blackout notice.

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Employee Benefits & Executive Compensation: Legal Perspectives
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