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# Plan Sponsor Forced to Restore Plan Benefits Due to Intentionally Misleading Communications to Employees

On September 29, 2015, the U.S. District Court for the Southern District of New York issued a decision that emphasizes the importance of accurate communications to employees regarding changes in qualified retirement plan benefits. In Osberg v. Foot Locker, Inc., the plaintiffs in the class action consisted of nearly 16,000 participants in a defined benefit pension plan sponsored by Foot Locker. Prior to 1996, Foot Locker sponsored a traditional defined benefit pension plan in which benefits were defined as an annual life annuity commencing at age 65. Like most traditional defined benefit pension plans, the plan also provided early retirement subsidies, which allowed participants to retire as early as age 55 with subsidized reduction factors (i.e. more valuable than actuarial reduction factors) applied to their age 65 benefit. Other than the small sum cashout exception, participants did not have the option of taking their pension plan benefit as a lump sum.

Foot Locker amended the pension plan effective January 1, 1996 to become a cash balance plan by converting the accrued benefit as of December 31, 1995 into an initial account balance. This initial account balance was determined by 1) calculating a lump sum value of a participant's age 65 benefits, and then 2) discounting this value to the participant's actual age as of January 1, 1996. Both of these calculations were done using a 9% discount rate, which produced a smaller value than would result from using a lower interest rate. This value was then reduced further by applying a mortality discount. However, participants who had at least 15 years of service and were at least age 50 received an enhancement to their opening account balance. Following this conversion, participants' account balances were credited with pay credits as well as interest credits at a fixed annual rate of 6%. Participants were allowed to elect a lump sum under the new structure, but if paid prior to normal retirement would not include the early retirement subsidy that applied if an early retirement annuity was elected.

ERISA and the tax code contain an anti-cutback rule, which requires that a participant's accrued benefit, once earned, may never be reduced by a plan amendment. However, future accruals may be reduced or eliminated completely. Because of the steep discount rate used to arrive at the initial account balance (that is, the use of a 9% discount rate when the ERISA rate used to convert annuities into lump sums was around 6% at the time), the cash balance formula resulted in an accrued benefit that was less than the December 31, 1995 benefit in almost every case. Thus, in order to comply with ERISA's anti-cutback rule, the new plan calculated benefits based on a "greater of" approach, in which the benefit payable was actually the greater of the December 31, 1995 accrued benefit (the "A" Benefit) and the accrued benefit determined by the cash balance formula (the "B" Benefit) applying the pay and interest credits to the initial cash balance account. Until a participant's cash balance account grew enough to produce an accrued benefit greater than the December 31, 1995 benefit, he would not earn any additional benefits despite continued service. This concept is known as a "wear-away", and essentially resulted in an accrued benefit freeze for a number of years for virtually all of the active participants. Not only did Foot Locker management understand that a wear-away would occur, but they also chose the initial conversion rates which resulted in lower opening balances as a means of cost savings.

The communications to participants about the change were numerous and included an announcement letter to participants, a highlights summary of the changes, personalized booklets that provided "total compensation" statements and initial cash balance account, and a summary plan description ("SPD"). All of the communications failed to describe the wear-away and the resulting freeze in benefits for a period of time. Further, the communications did not clearly discuss the reasons for the difference in the accrued benefit on December 31, 1995 and the cash balance after conversion. In fact, all the communications mislead the participants who thought that continued service with the company would increase their benefit. Although participants received statements showing their account balances growing, they did not realize that even the growing accounts did not yet equal their accrued benefit as of December 31, 1995.

ERISA imposes strict standards of conduct for fiduciaries of qualified retirement plans if they have any discretionary authority or responsibility in the administration of the plan, including the duty to disclose and explain an amendment's impact on benefits. Moreover, the U.S. Supreme Court has held that when "reasonable employees . . . could have thought that [their employer] was communicating with them [about the contents of the plan] both in its capacity as employer and in its capacity as plan administrator," the employer is acting as a fiduciary under ERISA. The District Court found that the communications to the participants were made in a fiduciary capacity and held that by knowingly issuing false and misleading communications that failed to detail the effect of wear-away under the new benefit structure, Foot Locker breached its fiduciary duties under ERISA. The District Court found that the breach constituted equitable fraud and the remedy was equitable reformation. Therefore, the District Court ordered Foot Locker to retroactively reform the benefit structure to calculate the initial cash balance account based on a 6% (rather than 9%) discount rate and actually provide the "A plus B" benefit to which the participants reasonably believed they were entitled. In addition, any participant who had already retired will not only receive the difference between the "A plus B" benefit and the benefit actually received, but will also receive interest at an annual rate of 6% from the date of their underpayment.

It is interesting to note that the problem here did not lie with Foot Locker's redesign of the plan, as the wear-away effect was allowed in defined benefit to cash balance conversions in 1996 (although PPA changed this to require the "A plus B" approach). The problem was simply that Foot Locker fiduciaries intentionally hid the wear-away effect from participants, allowing them to believe they were accruing additional benefits during a time when they were not. Because of this intentional misleading of participants, the original amendment was not valid and Foot Locker was forced to give participants the benefits which the communications led them to believe they were earning.