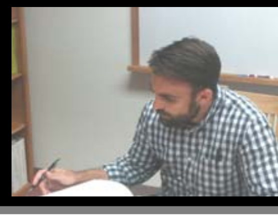
# The Forensic Economist

An Economic Newsletter for Lawyers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## Considerations for Valuing Retirement Benefits

### Introduction

The loss of an individual's pension benefits can be a significant element of economic damages in a personal injury, wrongful death, wrongful termination, or divorce case. Careful analysis and attention to detail is required to understand the nature of the pension benefits and their economic value. As many people can be expected to live approximately 20 or more years after retirement and some plans can produce earnings that approximate more than 60 percent of an individual's pre-retirement annual earnings, pension plans can be a significant asset and source of future economic losses. This article discusses some considerations for plaintiff and defense attorneys concerned with economic issues that include retirement benefits.

### Defined Benefit versus Defined Contribution

In simple terms, a retirement plan is an arrangement by which workers can continue to receive income after their separation from the workforce. The plan may contain provisions to pay benefits upon the employee's retirement, disability or death. Employee retirement plans may be broadly classified as either *defined benefit* or *defined contribution* plans. The traditional definition of a retirement plan has been that of a *defined benefit* pension plan. This type of pension plan can be described as a promise to pay a participant specified future benefits, based upon a formula, and usually for the remainder of the participant's life expectancy. This formula includes prerequisites the participant must meet. Such factors typically include age, years of service, and compensation.

The sponsor of a defined benefit plan generally guarantees the participant a level of benefits upon retirement, usually paid on a monthly basis over the remainder of the participant's life. Participants may also receive some form of health insurance, as well as cost of living adjustments. Plan terms typically include provisions for the continued payment to the participant's spouse upon death--referred to as a "survivor's benefit". When in place, a survivor's benefit usually results in the participant's monthly benefit being reduced by some percentage to insure that a specific level of funds will continue to be available to the surviving spouse.

Many employers have moved away from the traditional defined benefit plans toward *defined contribution* retirement plans. In these plans, the participant's future retirement benefit is not a specified amount. Rather the pension level is based on the pre-tax employee and employer contributions to a trust fund, and the fund's subsequent investment performance. Common defined contribution plans include 401k and 403b, Money Purchase, Profit-sharing and Employee Stock Ownership (ESOP).

Contributions to these plans are made with pre-tax dollars on a regular basis and are typically invested in mutual funds or money market accounts. The participants in such plans bear the risk of earnings performance.

In addition to the participant's contributions, the sponsoring employer will frequently also provide funds in the form of a "matching contribution." For instance in a 401k type plan, an employer may agree to match the participant's contributions up to 5% of the participant's wages. In a "Money Purchase" plan, the employer may make a direct contribution-- without requiring the participant to contribute--based on the payroll and the employee's annual earnings.

### Valuing the Retirement Benefit

When valuing a retirement plan, it is necessary to understand the type of plan involved as different issues are relevant in valuing a defined contribution versus a defined benefit retirement plan. In the case of defined benefit plans, the plan sponsor provides the majority of the funding and does not maintain individual participant accounts. If the plan is privately sponsored, then the participant's benefit is likely insured with the Pension Benefit Guarantee Corporation.

In many defined benefit plans, the participant is required to make regular contributions. However, it is important to note that in most such plans, these contributions represent only a small fraction of the funds that will eventually be required to fund the participant's benefit. Subsequently, when considered alone, these contributions typically do not provide a good measure of the future benefit. Typically, the plan sponsor does not allocate the funds necessary to support the benefit until sometime near the retirement date.

In the case of defined contribution plans such as a 401k, there is no prescribed future benefit or formula by which to project potential future benefits. However, there is an account balance which, generally speaking, can provide an approximate pre-tax value of the individual participant's retirement plan. All contributions, investment earnings, investment losses and loans are recorded in this individual account.

### Personal Injury, Wrongful Death, and Wrongful Termination

An individual's future retirement benefit may be adversely affected by a reduction in earnings due to an injury or death. For instance, the personal injury of an individual participating in a defined benefit retirement plan may result in a permanent reduction in that person's future earnings capacity. Depending on the specifics of the case, the economic value of lost retirement benefits may be measured by projecting the level of the contribution paid by the employer to the individual's retirement plan.

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Generally, industry survey data can be used as the basis for such projections. The cumulative difference between the employer's contribution level for the without-injury and with-injury earnings projections provides a measure of the economic loss. The analyst must be careful to properly account for any required contributions by the participant, when projecting future losses.

The injured participant's lost benefits may also be valued according to more specific calculations. In such a case, the analyst will prepare a projection of future pension benefits based on the plan's benefit formula and requirements. Under this approach, the economic losses associated with the retirement plan are described by the difference between the anticipated retirement benefits that result from the projected without-injury and with-injury future benefit streams. In most jurisdictions the calculations are reduced to present value.

The economic value of a defined contribution plan can be measured by projecting employer contributions over the subject's anticipated work life. Industry survey data also exists by which this value can be measured. Alternatively, if the subject has a history of contributing to some form of self-directed retirement plan or a pattern of retirement related savings, a projection of plan contributions and performance may be useful in estimating the subject's economic loss. Care must be taken to accurately analyze economic losses.

In certain circumstances, such as those that may exist with large employers and highly compensated individuals, retirement benefits may include supplemental benefits such as life insurance or deferred compensation arrangements. In these situations the analyst must understand the plan eligibility and benefit mechanisms and valuing retirement benefits may require additional calculations and analysis.

### ***Marital Dissolution***

In many jurisdictions, pension benefits accrued by the participant during the term of a marriage, are considered to be a divisible marital asset in the event of a divorce. Determining the retirement plan's economic value for purposes of marital dissolution will depend in part on whether the plan is a defined benefit or defined contribution plan.

The division of a defined benefit retirement plan may lead to confusion for those involved because it requires understanding the value of dollars that may not be realized until some future time period, and hence, carry some uncertainty. In comparison, other assets typically divided in divorce proceedings, such as a home, can be sold in the current time period and thus have an easily understood dollar value. The courts have typically ruled that such benefits, even though they may not occur until many years into the future, are divisible marital assets.

Most jurisdictions accept the comparison of these various assets and recognition of uncertainty may be included in the present value calculation. In general, the current account balance of a defined contribution plan is also the present economic value of the plan. Accordingly, the potential division of this asset in conjunction with other property of the marriage tends to be relatively straightforward.

The division of the pension benefit is typically based on a comparison of the time the couple was married and participating in the plan, relative to the participant's total time of participation in the plan. This may be expressed as a ratio in which the numerator corresponds to the number of months the couple was married and participated in the plan, and the denominator corresponds to the total number of months the participant was in the plan. This methodology is frequently referred to as a "coverture factor," but may also be referred to as the coverture period, marital portion, fixed percentage, or proportionate share.

Federal tax and pension law provides specific guidance for the division of future retirement plan benefits in a divorce proceeding, through the Qualified Domestic Relations Order (QDRO). The QDRO originated with the Retirement Equity Act of 1984. In general, a QDRO is a legal instrument used to facilitate the division of future retirement benefits between divorcing parties. It is intended to provide the retirement plan administrator with an understanding of how the retirement benefits are to be divided between the participant and his or her spouse.

### ***Summary***

As forms of deferred compensation, retirement plans may factor into estimates of economic loss for cases such as personal injuries, wrongful deaths, wrongful terminations, and divorces. Careful analysis and attention to detail is required to understand the nature of the pension benefits and their economic value. Pension plans can be a significant asset and source of future economic losses.

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