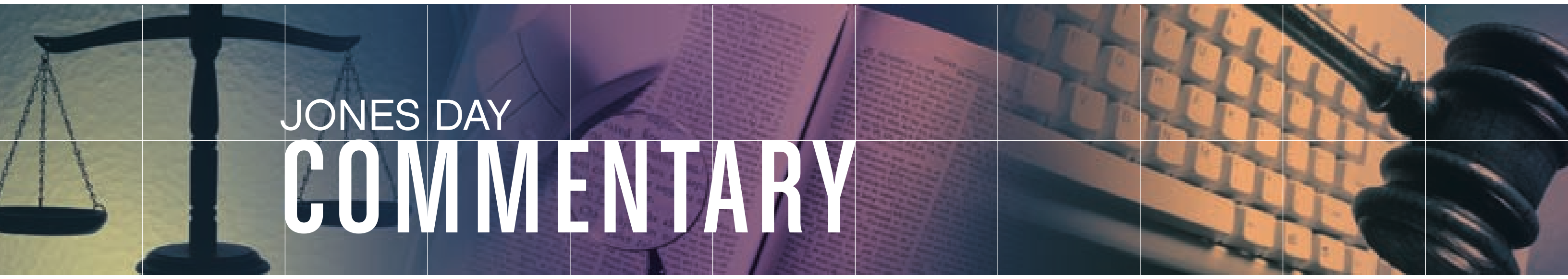
AUGUST 2007



FUTURE IMPERFECT? CASH BALANCE PLANS IN THE NEW MILLENNIUM

As the French like to say, *plus ça change, plus c'est la même chose* ("the more things change, the more they stay the same"). 2006 was that kind of year for cash balance plans. There are two ways to make a pension promise. You can specify how much you are going to contribute (a defined-contribution plan), or you can specify the amount the employee will be paid at retirement (a defined-benefit plan). A "cash balance" plan is a variation on the defined-benefit-plan theme. It combines the transparency of knowing to the dollar what is in your 401(k) account with the requirement that the employer fund this retirement benefit as if it were a traditional pension. Put simply, a cash balance plan is funded like a defined-benefit plan but looks to most participants like a 401(k) plan.

A cash balance plan typically provides participants with a hypothetical account balance that is credited each year with a percentage of the employee's pay and interest. Younger workers are favored by cash balance plans because these plans normally have a portability feature allowing employees to take their cash balance benefits with them as they move from job to job. Upon termination of employment or retirement, an employee can choose to receive his or her cash balance account as a lump sum or annuity. Unlike a traditional defined-contribution account, the cash balance plan provides a participant with a defined and determinable benefit regardless of the performance of the stock market. Thus, the risk and possible reward of stock market performance remain with the employer, much like a traditional defined-benefit plan. The benefits provided under the cash balance plan are also insured by the Pension Benefit Guaranty Corporation. Because of these "hybrid" attributes, cash balance plans gained popularity during the 1990s and were, for the most part, established by "converting" a traditional defined-benefit plan.

Recent attacks on cash balance plans are based on the idea that these plans discriminate against older workers. Plaintiffs allege that the design of a cash balance plan is inherently age-discriminatory because equal pay credits for younger workers have a much longer period of time to earn interest and accrue benefits before retirement. In other words, the "Economics 101" concept of compounding interest to employee accounts, due to the time value of money, is discriminatory because older workers will work fewer years than younger workers. Defendants reply that this age-discrimination logic is inconsistent with every other pension plan design and would even make 401(k) plans and Social Security benefits automatically age-discriminatory. The simple fact that an employee aged 55 years receives his pension benefit before an employee who is 25 years old should not make the pension plan age-discriminatory.

BEGINNING OF THE END?

The issue providing the most mileage for the ERISA plaintiffs' bar has been the metaphysical question of what the rate of benefit accrual means for cash balance plans. ERISA prohibits age discrimination in benefit accruals under defined-benefit pension plans by providing that "the rate of an employee's benefit accrual may not be reduced, because of the attainment of any age." 29 U.S.C. § 1054(b)(1)(H), ERISA § 204(b)(1)(H). The district court decision in *Cooper v. The IBM Personal Pension Plan and IBM Corp.*, 274 F. Supp. 2d 1010 (S.D. Ill. 2003) (which gave credence to this theory), involved older participants in the IBM cash balance plan. As participants nearing retirement age, they alleged that the homogenized interest rate for all benefit accruals violated ERISA § 204(b)(1)(H)'s anti-age-discrimination provision. *Id.* This ERISA provision states that a defined-benefit plan may neither cease an employee's benefit accrual nor reduce the rate of an employee's accrual of benefits because the employee has reached a particular age. While finding that all of the IBM Pension Plan terms were age-neutral and provided the same credits per annum to all covered employees, the district court nonetheless ruled that since younger employees receive more interest over time than similarly situated older employees due to compounding interest and the time value of money, the Plan terms discriminated against older employees. *Id.* at 638. The district court arrived at this conclusion by interpreting the phrase "rate of an employee's benefit accrual" found in § 204(b)(1)(H) to mean "what the employee takes out [of his plan] on retirement," not what he puts into his plan. *Id.* at 638. Under the logic of the district court decision in *Cooper*, all cash balance plans violate ERISA.

It turns out that the district court's age-discrimination theory in the *Cooper* case was wrong. The Seventh Circuit ruled in *Cooper v. IBM*, 457 F.3d 636, 643 (7th Cir. 2006):

> The phrase "benefit accrual" reads most naturally as a reference to what the employer puts in (either in absolute terms or as a rate of change), while the defined phrase "accrued benefit" refers to outputs after compounding. That's where this litigation went off the rails: a phrase dealing with inputs was misunderstood to refer to outputs.

Id. at 639. Judge Easterbrook explained:

> Here, as so often, it is essential to separate age *discrimination* from other characteristics that may be correlated with age. That was the Supreme Court's point in *Hazen Paper*: wages rise with seniority (and thus with age) at many employers, but distinctions based on wage levels (in order to reduce a payroll) do not "discriminate" by age. . . . [A] plaintiff alleging age discrimination must demonstrate that the complained-of effect is *actually* on account of age. One need only look at IBM's formula to rule out a violation. It is age-neutral. . . .
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> . . . Like a defined-contribution plan, a cash-balance plan removes the back-loading of the pension formula . . . .

The *Cooper* court determined that the anti-age-discrimination provisions in both ERISA § 204(b)(1)(H)(i), dealing with defined-benefit plans, and 204(b)(2)(A), dealing with defined-contribution plans, both say the same thing—they prohibit an employer from stopping allocations or accruals to the plan or changes in their rate on account of age. The common-sense rules described in these statutory provisions are centered on how allocations are made to an employee's account, rather than the annual rate of withdrawal at retirement. *Id.* at 639. To hold otherwise "treats the time-value of money as age discrimination." *Id* at 638. "Nothing in the language or background of § 204(b)(1)(H) suggests that Congress set out to legislate against the fact that younger workers have (statistically) more time left before retirement, and thus a greater opportunity to earn interest on each year's retirement savings." *Id.* at 639. Applying this interpretation, the court held that the IBM Plan terms are age-neutral, reversed the district court decision, and entered judgment in favor of IBM. *Id.* at 642–43.

The Seventh Circuit recognized that older workers may ultimately receive less benefits under the IBM cash balance plan than they would have under a traditional defined-benefit plan, but it refused to hold that a change in older workers' expectations amounted to age discrimination:

> [O]lder workers accurately perceive that they are worse off under a cash-balance approach than under a traditional years-of-service-times-final-salary plan. But removing a feature that gave extra benefits to the old differs from discriminating against them. Replacing a plan that discriminates against the young with one that is age-neutral does not discriminate against the old. . . . That the change disappointed expectations is not material. An employer is free to move from one legal plan to another legal plan, provided that it does not diminish vested interests. . . .

Id. at 642; *citing Lockheed Corp. v. Spink*, 517 U.S. 882 (1996). On January 16, 2007, the U.S. Supreme Court denied cert in the *Cooper* case. _____ U.S. _____, 75 US&W 3365 (2007).

Just when we thought it was safe to go back into the cash balance water, the Southern District of New York rekindled the age-discrimination debate. On October 30, 2006, a New York court declined to follow the Seventh Circuit's decision in *Cooper,* observing that New York was not Illinois. *In re JP Morgan Chase Cash Balance Litig.*, 460 F. Supp. 2d 479 (S.D.N.Y. 2006). District court decisions in the Second Circuit have been divided as to whether the terms of cash balance plans violate ERISA's anti-age-discrimination provisions. The *JP Morgan* court ruled that cash balance plans discriminate on the basis of age. *Id.* Like other courts that had reviewed the issue, the *JP Morgan* court focused on the definition of the phrase "rate of an employee's benefit accrual" found in § 204(b)(1)(H)(i) and whether it "refers to the employer's contribution to the plan (inputs) or the employee's retirement benefit (outputs)." *Id.* The court stated that the "rate of an employee's benefit accrual" refers to the outputs from the Plan, which distinguishes defined-benefit plans from defined-contribution plans, where employees are promised an "input." It reasoned that the "binary regulatory framework" governing defined-benefit and defined-contribution plans "compels differing treatment for the two plans," and thus makes the phrase "unambiguous." In December, two other district courts within the Second Circuit followed the *JP Morgan Chase Cash Balance Litig*. decision. *In Re Citigroup Pension Plan ERISA Litigation*, _____ F. Supp. 2d _____, 2006 WL 3613691 (S.D.N.Y. December 12, 2006), and *Parsons v. AT&T Pension Benefit Plan*, 2006 WL 3826694, 39 UBC 2233 (D. Conn. December 26, 2006).

On January 30, 2007, the Third Circuit Court of Appeals weighed in on the side of Judge Easterbrook. *Register v. PNC Financial Services Group, Inc*., _____ F.3d _____, 2007 WL 222019 (3d Cir. 2007). PNC changed its traditional defined-benefit-plan formula on January 1, 1999, to a cash balance formula. Sandra Register and five other PNC pension plan participants filed suit during 2004, alleging that the change from a traditional defined-benefit-plan formula to a cash-balance-plan formula was age-discriminatory. She based her challenge on three basic theories: (1) the cash balance plan's formula for crediting benefits was alleged to be age-discriminatory; (2) the conversion from a traditional defined-benefit plan to a cash balance plan resulted in so-called "wear-away," that is, a time period when participants like Ms. Register would not receive any benefit increases, in purported violation of ERISA's backloading rules; and (3) the plan communications describing the conversion from the defined-benefit to a cash balance formula were inadequate. The federal district court granted PNC's motion to dismiss on all of these issues, and the Third Circuit Court of Appeals affirmed. The Third Circuit's decision, in large part, tracks Judge Easterbrook's opinion in the *Cooper v. IBM* case. According to the Third Circuit, it is clear that the accrual of benefits in ERISA § 204(b)(1)(H)(i)

> refers to the credits deposited into the participant's cash balance accounts, *i.e.,* the inputs. If we concluded otherwise we simply would ignore the characteristic of a cash balance plan distinguishing it from a traditional defined benefits plan . . . . Second, a comparison of the parallel defined benefit plan and defined contribution plan anti-discrimination provisions reinforces our interpretation. . . .

> The provisions are nearly identical and prohibit the same behavior, *i.e.,* "the employer can't stop making allocations (or accruals) to the plan or change their rate on account of age." *Cooper*, 457 F.3d at 638. . . . We do not find any support for appellants' argument that Congress wanted to prohibit such a consequence with respect to cash balance plans, but legitimize it for defined contribution plans.

NEW LEGISLATIVE PROTECTION

After six months of wrangling, Congress passed the Pension Protection Act of 2006, Pub. L. No. 109-280 (the "Act"), in August, which included provisions that confirmed the legitimacy of cash balance plans, on a prospective basis. Just one week before the Act was passed, the Seventh Circuit Court of Appeals issued the *Cooper* decision reversing the district court decision that helped create the firestorm of age-discrimination claims against cash balance plans. *Cooper,* 457 F.3d at 643. The Act addresses several of the nettlesome issues that have troubled sponsors of cash balance plans, including: (i) rate of benefit accrual, (ii) interest, (iii) conversions, (iv) the "whipsaw" effect, and (v) vesting. However, much to the dismay of beleaguered cash-balance-plan sponsors, the new law does not address cash balance plans implemented before June 29, 2005. This means that plans existing before June 29, 2005, are still in litigation "play."

The Pension Protection Act of 2006 ("PPA"), for its part, follows the Seventh Circuit's decision in *Cooper*. It clarifies that after June 29, 2005, cash balance plans will not violate the age-discrimination provisions of ERISA or the parallel age-discrimination provisions found in the Internal Revenue Code and ADEA, provided a participant's "accrued benefit," as of any date, is equal to or greater than that of any similarly situated younger individual who is or could be a participant in the plan.

For companies considering whether to establish cash balance plans, the PPA offers some certainty. It states that companies that convert to cash balance plans after June 29, 2005, are not age-discriminatory as long as they pass certain tests. The tests are aimed at protecting older workers from the erosion of their pension benefits that occur when employers freeze more senior workers' pension accruals for a period of time when the new plan goes into effect.

In January 2007, the IRS issued Notice 2007-6, stating that it is beginning to process applications for cash-balance-plan determination letters. This Notice also provides interim guidance on changes the Pension Protection Act made to the age-discrimination rules for cash balance plans. The PPA added new Internal Revenue Code § 411(a)(13), which provides that certain cash balance plans (referred to as "statutory hybrid plans") do not violate the minimum vesting standards solely because they define the present value of any participant's accrued benefit as the balance in a hypothetical account or as an accumulated percentage of the participant's final average compensation. The PPA also added new IRC § 411(b)(5) to specify rules for applying the age-discrimination standards to defined-benefit plans in general and the statutory hybrid plans in particular. Notice 2007-6 provides safe-harbor guidelines for converting traditional defined-benefit plans to cash balance plans and indicates that the IRS expects to issue regulations concerning cash-balance-plan conversion amendments "not later than August 17, 2007."

A number of employers who have submitted applications for favorable determination letters have been surprised at the harsh IRS response to hybrid cash balance plans containing a "greater of" benefits provision. A "greater of" method is, in essence, a "most favored nations" clause, allowing longer-service workers to receive the better of plan benefits calculated under the old defined-benefit formula or the new cash balance formula. In reviewing determination letter requests for these hybrid cash balance plans, the IRS indicated during 2007 that a "greater of" approach violates the rules designed to prevent backloading of pension accruals because the increase in benefits at retirement is too large when the old defined-benefit formula dwarfs the benefits under the cash balance formula. On June 20, 2007, the American Benefits Council, the American Society of Pension Professionals and Actuaries, the U.S. Chamber of Commerce, the ERISA Industry Committee, and the Business Roundtable sent a letter urging the House Ways and Means Committee to correct the IRS's overly "formalistic" interpretation.

The backloading rules were designed to prevent large and disproportionate benefit accruals in an employee's later years of service. These rules were enacted to make sure employees' pension benefits vested over a reasonable five-year cliff vesting time period or a three- to seven-year graded vesting schedule and not during the employee's 30th year of service. But providing a "greater of" benefit to cash-balance-plan participants doesn't backload benefit accruals or change the vesting rules in the plan. More important, the "greater of" formula usually involves additional plan sponsor payments upfront to the plan, a pro-employee funding pattern that was blessed in the ERISA Conference Report. The irony of the IRS position is that employers that have already adopted these "greater of" formulas in an effort to protect the pensions of their longer-service employees are now discovering they may have to pay millions of dollars to avoid plan disqualification so as to cure this alleged backloading "problem."

Although the PPA is of great help to employers who plan to convert their defined-benefit plans to cash balance plans in the future, the law remains unchanged and unsettled for most cash balance plans. It is estimated that one-half of all U.S. defined-benefit pension plans are cash balance plans that converted before the PPA and remain subject to the old rules. For the thousands of cash balance plans that were converted before June 29, 2005, the more things change, the more they remain the same.

Heather Reinschmidt assisted in the preparation of this Commentary.

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