

August 5, 2003

Two Setbacks for Cash Balance and Pension Equity Plans

In two unrelated ERISA decisions last week, federal courts dealt significant blows to cash balance and pension equity plans. In one decision, a federal district court ruled that IBM Corporation's cash balance plan unlawfully discriminated against older workers under ERISA. On the following day, a federal court of appeals upheld a judgment against the Xerox Corporation cash balance plan awarding participants additional lump sum benefits based on a so-called "whipsaw" claim.

If the *IBM* decision stands, virtually all cash balance and pension equity plans will be outlawed. Because of the importance of the *IBM* and *Xerox* cases for the future of these plans, the Seyfarth Shaw Employee Benefits Practice Group is hosting a teleconference client briefing on the cases on Wednesday, August 6, at 1:00 p.m. Central time. Instructions on participating in the conference call accompany this Management Alert.

IBM Plan Held Discriminatory Against Older Employees

Cooper v. IBM Personal Pension Plan was decided by the United States District Court for the Southern District of Illinois. The IBM plan was originally converted from a traditional pension plan to a pension equity plan ("PEP"), and then converted again into a cash balance plan. Both cash balance and PEP plans are designed to provide employees with a lump sum benefit similar to that provided by an individual account plan such as a profit-sharing plan. In a cash balance plan, a dollar amount (usually a percentage of compensation) is credited to each employee's hypothetical "account" each year. The hypothetical account is also credited with a specified rate of interest at least annually. A PEP similarly expresses the employee's retirement benefit as a hypothetical lump sum. In a typical PEP, the employee is credited with a specific percentage of final average pay each year, which is converted to lump sum benefit when the employee terminates.

The *IBM* court held that whether a plan violates the anti-age discrimination provisions of ERISA is determined by analyzing the employee's expected annuity benefit at age 65. The court

found that the IBM plan, and apparently any other cash balance plan or PEP, is illegal because the same dollar amount credited to two participants' accounts in any year is inherently less valuable to an older employee than to a younger employee because an older employee will accrue less interest before reaching age 65 than a younger worker. In reaching its conclusion, the court ignored at least one other district court case holding that a cash balance plan is not discriminatory if the same amount is credited to the hypothetical accounts of employees with similar service, regardless of age. The court also ignored IRS guidelines and recently proposed regulations that imply that cash balance plans are not inherently discriminatory.

IBM has already announced that it will appeal the decision, and it is certainly possible that it will be reversed on appeal. Nevertheless, the court's analysis, while simplistic, is one possible interpretation of the law, and plan sponsors should be aware of the possibility that the *IBM* decision will be adopted by other courts. Another wild card to consider is the effect of the decision on the pending IRS regulations regarding cash balance and PEP plans. Employers need to monitor this situation very carefully.

Xerox Plan Caught in the Whipsaw

Berger v. Xerox Corporation Retirement Income Guarantee Plan was decided by the United States Court of Appeals for the Seventh Circuit, which will also hear the appeal from the *IBM* case. The *Xerox* case deals with a technical problem known as interest rate "whipsaw," which results from the difference between the interest rate credited to retirement accounts under the plan and the interest rate that must be used under the Internal Revenue Code to value lump sum distributions — currently the 30-year Treasury bill rate (although Congress is considering changing it). If a cash balance plan provides for interest credits at a higher interest rate, the plan may be required to pay out a lump sum calculated by crediting interest to age 65 at the higher rate, and discounting the age 65 benefit back to its present value using the 30-year Treasury rate. In other words,

the lump sum benefit may exceed the employee's hypothetical plan account balance. This is what happened to Xerox.

It appears that Xerox chose not to follow IRS guidance specifying certain "safe harbor" interest rates that can be used by a cash balance plan to avoid whipsaw, electing instead to challenge the whipsaw theory. Thus, the primary lesson of the *Xerox* case is that the whipsaw analysis has been clearly accepted by the courts, and plan sponsors who wish to limit employees' lump sum termination benefits to their retirement account balance will need to stick closely to the safe harbor guidelines provided by the IRS.

One alternative way of dealing with the whipsaw effect is for a plan to provide each employee with the greater of the retirement account balance or the actuarial value of his or her hypothetical future pension. In calculating the amount that participants should have received, Xerox attempted to use a preretirement mortality assumption to take into account the statistical possibility that an employee will not survive to age 65. This method was summarily rejected by the Court of Appeals. If the Court's holding were extended to plans providing the greater of the two benefits, it would have the effect of significantly increasing benefit costs.

Details regarding the August 6th conference call can be found on our website at www.seyfarth.com/events. If you wish to discuss these issues, or any other issue related to cash balance and pension equity plans, please contact the Seyfarth Shaw Employee Benefits Practice Group attorney with whom you work, or any employee benefits attorney listed on the website at www.seyfarth.com.

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