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Management Alert

Good News for Cash Balance Plans - They Are Not Discriminatory

Within a week's time span, there have been two developments that clarify the legality of cash balance plans. First, the Seventh Circuit Court of Appeals ruled that IBM's cash balance plan did not unlawfully discriminate against older workers. This highly anticipated ruling is the first of its kind by a Court of Appeals. Second, Congress passed the Pension Protection Act of 2006 (Act), which provides a safe harbor for hybrid plans - including cash balance plans - effective as of June 30, 2005. The Seventh Circuit's ruling in *IBM* and the Act both favor the continued use of cash balance plans as a way of providing retirement income.

Summary of Lower Court's Decision

In *Cooper v. IBM Personal Pension Plan*, the United States District Court for the Southern District of Illinois - in a groundbreaking decision - ruled that the pension equity and cash balance formulas under IBM's pension plan impermissibly provided lower benefits to older participants in violation of ERISA's anti-age discrimination provisions. Those provisions prohibit a defined benefit plan (like a cash balance plan) from stopping accruals or reducing accruals because of the attainment of any age. Although the IBM plan annually credited the account of each participant with the same flat percentage of compensation regardless of the participant's age, the court held that since the same dollar amount credited to a participant's account provides a smaller age 65 annuity amount to an older employee than a younger employee (simply because it would accrue hypothetical interest for a shorter period of time,) the plan was inherently discriminatory. Essentially, the court defined a participant's benefit accrual as the expected benefit at age 65, rather than the amount credited to the participant's account each year.

Although other district courts had concluded that cash balance plans were not inherently discriminatory, the IBM decision cast doubt on the legality of such plans and deterred many employers from adopting them.

Reversed by the Seventh Circuit

In reversing the lower court's decision concerning the cash balance formula, the Seventh Circuit took a very practical approach. In its analysis, the Court mainly focused on the use of the term "benefit accrual" under ERISA's anti-age discrimination provisions. The Court found that the term "benefit accrual" refers to the allocation of contributions or credits. As such, it held that as long as the formula for crediting amounts to a participant's account under a cash balance plan is age-neutral, there is no age discrimination.

This rationale differed from that of the lower Court, which defined the "benefit accrual" as the expected annuity payable at age 65 under the IBM cash balance plan, and ignored the plan's age-neutral crediting formula.

According to the Seventh Circuit, a major flaw in the lower court's decision was its determination that prohibited age discrimination resulted because an older worker's opportunity to earn interest was limited to a shorter period than that of a younger employee. Under this argument, if a 25 year old employee and a 60 year old employee both receive the same age neutral annual credit to their cash balance account based on their respective compensation, the fact that the 60 year old only has five years to earn interest on that credit, while the 25 year old has 40 years to earn interest, would result in prohibited discrimination. The Seventh Circuit completely rejected this argument.

IBM did not appeal the lower court's ruling that its pension equity formula also resulted in age discrimination, but instead chose to settle that portion of the case. As a result, the Court did not address this issue in its decision. The Seventh Circuit's decision, however, further supports the position that a pension equity plan does not inherently discriminate based on age. In a pension equity plan, the allocation of contributions or credits are age-neutral. Employees with the same salary and service receive the same credits.

Pension Protection Act

In addition to the favorable ruling by the Seventh Circuit, on August 3, 2006, Congress passed the Pension Protection Act, which included a number of provisions intended to clarify the legal status and requirements applicable to "hybrid" account-based defined benefit pension plans, including cash balance and pension equity plans.

The Act provides that a hybrid plan does not violate the age discrimination rules if a participant's accrued benefit would be equal to or greater than that of any similarly situated, younger participant. For this purpose, a participant's accrued benefit may be expressed as the balance of a hypothetical account, and "similarly situated" means that the participants are identical in every respect (i.e., period of service, compensation, position, date of hire, work history), except age. Although this provision is effective as of June 30, 2005, the Act specifically provides that no inference should be drawn from the Act's new rules as to the status of hybrid plans before that date. In other words, an employer could not use the Act to shield itself from age discrimination claims concerning operation of its hybrid plan before June 30, 2005, but neither can employees argue that the enactment of the Act implies that hybrid plans were previously illegal. The Seventh Circuit's decision in *Cooper v. IBM* lessens the importance of the Act's "no inference" provision.

In addition to the discrimination issues, the Act also addressed other issues regarding hybrid plans such as (i) whether the conversion from a traditional pension plan to a cash balance plan is age discriminatory and violates Internal Revenue Code rules regarding benefit accruals, and (ii) how lump-sum distributions are calculated (the so-called "whipsaw" issue).

If you have any questions concerning the IBM case, the new rules governing hybrid plans, or any other provision of the Pension Protection Act, please contact the Seyfarth Shaw LLP attorney with whom you work or any employee benefits attorney on the website at www.seyfarth.com. In addition, Seyfarth Shaw will sponsor a teleconference client briefing on the new Act on August 17, 2006. Visit www.seyfarth.com/events or contact Craig Maas at cmaas@seyfarth.com or 312-460-6422, to register.

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