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Client Alert

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Cash Balance Plans — The Debate Continues

The ongoing debate as to the ability of employers to utilize cash balance pension plans and pension equity plans (commonly known as "PEPs") burst into public view again at the beginning of August with two court decisions that made the front page of many newspapers. The two decisions, *Cooper et. al. v. The IBM Personal Pension Plan* ("*Cooper*") and *Berger et. al. v. Xerox Corporation Retirement Income Guarantee Plan* ("*Berger*"), add to the uncertainty surrounding these non-traditional defined benefit pension plans. *Cooper* was decided by Judge Murphy of the Southern District of Illinois, and the decision in *Berger* was issued by the Seventh Circuit Court of Appeals (on appeal from the Southern District of Illinois).

Simply described, cash balance plans and PEPs are variations of traditional defined benefit plans under which a participant is granted a hypothetical (as opposed to actual) account balance. For each year of service, a credit, either expressed in dollars or a percentage of pay, is made to this account on a participant's behalf. Further, each year, the hypothetical account is adjusted by an interest factor, even after employment ends. While this structure does take on characteristics of a defined contribution plan, in that participants' benefits are measured by reference to their account balances, these plans are treated as defined benefit plans for all other purposes under the law (such as funding, required forms of distributions and accrual).

The *Cooper* decision offers support to the positions advanced by the entities and individuals challenging these types of plans. For the last several years, there has been active debate as to whether aspects of these plans (especially when converted from a traditional defined benefit plan) are age discriminatory or violate various technical Internal Revenue Code and ERISA provisions. The debate has resulted in the publication of proposed Treasury regulations, an Internal Revenue Service moratorium on the issuance of rulings on these types of plans, Congressional hearings and, of course, the commencement of a number of litigations.

The *Cooper* and *Berger* decisions are probably only skirmishes in this battle, but could be viewed as important psychological and political victories for the critics of these plans. However, the holding in *Cooper* does not appear to be consistent with either prior jurisprudence, or perhaps, the basic findings of the Seventh Circuit in *Berger* (which held only that a specific methodology used by a cash balance plan was found to violate applicable law, but suggests a fundamental acceptance of cash balance plans). It is important to remember that *Cooper* is merely one decision issued by one district court. Therefore, while *Cooper* may not be binding precedent, it is an important decision because of the publicity it has received and the effect it could have on the consideration of the Treasury regulations.

Cooper

In *Cooper*, Judge Murphy concluded that IBM's pension plan (which included both cash balance and PEP components for certain periods) violated ERISA because the rate of benefit accrual, based on an age 65 annuity, of a hypothetical participant could be reduced as a result of increasing age. Under both components of IBM's plan (and similar to most "hybrid" defined benefit plans), employees received an annual adjustment to their hypothetical account balance, even after termination of employment. According to Judge Murphy, because a younger employee will earn these account balance adjustments for more years than an older employee, the amount credited to a younger participant's hypothetical account is larger than that credited to an older employee – even though the adjustment in any given year is exactly the same for a younger and older employee. While Judge Murphy acknowledged that these adjustments were only intended to protect the participants' hypothetical accounts from the effects of inflation, he nonetheless found these adjustments to be in violation of the ERISA's benefit accrual rules.

Particularly surprising was Judge Murphy's dismissal of the "time value of money" argument as to the growth in value of an accrual. Specifically, he rejected the argument that younger employees need to accrue interest credits for a longer period of time than older employees because they are further from retirement.

In his decision, Judge Murphy went further than anyone expected. Prior to *Cooper*, the debate focused predominantly on the conversion of traditional defined benefit plans to PEPs and/or cash balance plans and not on the creation of new PEPs or cash balance plans. Judge Murphy's decision went beyond converted plans, such as the IBM Plan, as he questioned the fundamental structure of PEPs and cash balance plans under ERISA's accrual rules. Judge Murphy, however, did specifically find that terminating a defined benefit plan and creating a new defined contribution plan was not discriminatory.

Judge Murphy's decision is, in many respects, inconsistent with prior guidance on hybrid plans. *Cooper* is the first Federal court decision to hold flatly that hybrid pension plans are illegal. In fact, at least two other Federal courts (the Southern District of Indiana and the First Circuit Court of Appeals*) have held that cash balance plans are not inherently age discriminatory, even where younger employees receive annual adjustments for a longer period of time than older employees. Further, the U.S. Treasury Department recently proposed regulations that specifically sanction cash balance plans, but not PEPs. In addition, the legislative history of ERISA and even recent Congressional hearings make it clear that the drafters of ERISA intended to afford plan sponsors great flexibility in establishing new types of pension arrangements. Outlawing hybrid pension plans would constrict such flexibility. It is noteworthy that Judge Murphy did not even mention any of this authority in reaching his conclusions. Instead, he relied exclusively on his technical reading of the language of one section of ERISA.

As noted above, we understand that IBM will be appealing Judge Murphy's decision to the Seventh Circuit Court of Appeals, the court that, almost immediately after the *Cooper* decision was issued, decided *Berger*.

Berger

In *Berger*, in an opinion written by Judge Posner (who has written a number of influential ERISA opinions), the Seventh Circuit found that Xerox's cash balance plan violated ERISA. Unlike *Cooper*, however, the Berger court did not determine that cash balance plans are inherently flawed. Instead, Judge Posner merely focused on the manner in which the Xerox plan calculated lump sum payments.

Like most cash balance plans, the Xerox plan provided that a participant's hypothetical account balance is augmented annually with interest adjustments until normal retirement age. However, unlike many cash balance plans, in calculating future projected benefits for participants electing lump sums, interest adjustments for the period between the lump sum distribution date and normal retirement age were calculated utilizing the PBGC lump sum actuarial rate and not the plan's interest rate. The result was a lump sum equal to the account value on the date of distribution that did not take into account the future interest rate that would have been used to calculate normal retirement benefits had the participant not retired early. The Court found this methodology to be flawed because the plan's interest rate was considered to be a part of the participants' accrued benefit and, as a result, the lump sum value distributed to participants was not the actuarial equivalent of the normal retirement benefit.

* *See Eaton v. Onan Corp.*, 117 F. Supp.2d 812 (S.D.Ind. 2000); *Goldman v. First Bank of Boston*, 985 F.2d 1113 (1st Cir. 1993).

The result in *Berger* is not as surprising as *Cooper* and will affect few plans. More interesting is the fact that the court, which will hear the *Cooper* appeal, did not express any inherent reluctance about the cash balance plan concept. *Berger* may provide some insight into how the Seventh Circuit will handle the appeal of *Cooper*.

Ramifications

Cooper and *Berger* have clearly complicated the cash balance/PEP debate and have, once again, engendered trepidations about their fundamental viability. There is no question that these cases have re-energized the political issues over these plans, with different constituents advocating their own positions. As mentioned above, the Internal Revenue Service has proposed regulations and received detailed comments on these regulations. It is unclear whether *Cooper* will impact the content or issuance of the final regulations or whether Congress will intervene. It is expected that most employers maintaining existing PEP or cash balance plans will not take precipitous action, but undoubtedly will take a wait and see approach, recognizing that *Cooper* is only the decision of one district court, will be appealed, and is contrary to other court decisions. Uncertainty in this area, however, may negatively affect the creation of new hybrid pension plans.

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