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AUGUST 2006

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Cash Balance Comeback - New Opportunities for Employers in Wake of Court Decision and New Legislation

By Steven J. Friedman

In recent years many employers that maintain traditional defined benefit pension plans have been searching for ways to transform their plans into other types of retirement vehicles. Traditional defined benefit pension plans generally provide a benefit to employees expressed as an annuity at retirement equal to a certain percentage of final average pay (which is usually arrived at by multiplying a participant's years of service by a specified percentage amount).

These traditional plans generally provide a disproportionate share of benefits to long-service workers and accordingly may not be particularly effective at attracting mid-career hires or younger workers who may not envision spending their entire career with one employer. The cost of benefits can also be quite high under traditional pension plans, especially in periods during which investment gains are lower than expected because it is the plan sponsor who, by virtue of promising a stated benefit, takes on the investment risk. Interest rates are also used to determine plan funding requirements, so periods of fluctuating rates can create further unpredictability in plan funding.

For these reasons, employers have been, in a fairly robust manner, converting their traditional pension plans to alternative plan designs, such as cash balance plans and pension equity plans. However, in 2003, a ruling out of the District Court for the Southern District of Illinois put a halt to this robust migration to cash balance plans. Specifically, the court held in *Cooper v. IBM* that the benefits provided under IBM's cash balance plan discriminated against older workers. The holding also implicated pension equity plans. This caused many employee benefits professionals to question whether cash balance (and pension equity) plans were legally viable alternatives to traditional plans.

Two very recent developments have now bolstered the legal viability of these types of plans.

IBM Decision Reversed

On August 7, 2006, the Court of Appeals for the Seventh Circuit reversed the district court's decision in *Cooper* holding that cash balance and similar plans do not discriminate against older workers. The district court's findings were grounded in the fact that because IBM's cash balance plan is a defined benefit plan, the benefits it provides must be measured like other defined benefit plan benefits - namely by evaluating the value of each year's benefit accrual as a portion of an "annual benefit commencing at normal retirement age."

The Internal Revenue Code ("the Code") and the Employee Retirement Income Security Act (ERISA) both provide that a plan is discriminatory if "the rate of an employee's benefit accrual is reduced because of the attainment of any age." Under IBM's plan (as would be typical under a cash balance plan), a uniform percentage of pay is provided to the plan account of each participant regardless of his or her age. This approach results in a 20-year-old participant being allocated a 2006 accrual that will likely grow to a much higher amount at age 65 than the 2006 accrual that is allocated to the account of a 60-year-old participant earning the same amount (because the account of the 20 year old will accrue plan earnings over 40 additional years.)

The district court held that because older workers might accrue less than younger workers at retirement in connection with a particular year's accrual (on account of the fact that their accrual would grow for a shorter period of time), the IBM plan was age discriminatory.

Employers feared that *Cooper* would spell the end of cash balance and pension equity plans when employers were seeking a means to provide alternatives to traditional pension plans. On appeal, however, the Court of Appeals for the Seventh Circuit reversed the district court and found that the structure of IBM's plan was not discriminatory. The court stated that the district court improperly treated the time value of money as age discrimination. The court held that benefit accruals under IBM's cash balance plan should be measured by looking at the amount of the employer's contributions (which were clearly age neutral) rather than the value of such contributions after they have accrued earnings from the date of the contribution through the plan's retirement date. Accordingly, as long as an employer provides credits which are uniform percentages of pay to all participants, the Code and ERISA prohibitions against not reducing accruals to a participant on account of his or her age would not be violated.

Pension Protection Act Also Boosts Cash Balance Plans

The Pension Protection Act, passed by Congress on August 3 and signed into law on August 17, 2006, provides that "hybrid" plans, which are account-based defined benefit plans, such as cash balance (and pension equity) plans are not discriminatory so long as participant's accrued benefit, determined as of any date, is greater than or equal to that accrued by a similarly situated, younger participant. Accordingly, this new legislation explicitly approves typical cash balance and pension equity plan designs.

Conclusion

Although there are some obstacles that still remain for employers to be cognizant of when establishing a cash balance or pension equity plan, the *Cooper* case and new legislation generally validate the legality of the basic design underlying these plans. It is expected that many employers who were sitting on the sidelines waiting for the legal uncertainty underlying these plans to clear, may now consider redesigning their pension plans.

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