

## FEDERAL COURT RULES CASH BALANCE PLANS UNLAWFUL

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The United States District Court for the Southern District of Illinois has ruled that IBM discriminated against older workers in violation of the Employee Retirement Income Security Act ("ERISA") when it changed its pension plan to a cash balance plan in 1999. *Cooper v. IBM Personal Pension Plan*, No. CIV. 99-829-GPM, 2003 WL 217667853 (S.D. Ill. July 31, 2003). The *Cooper* decision, affecting an estimated 140,000 IBM current and former employees, calls into question the legality of similar cash balance plans that have become increasingly common in recent years and have been implemented by many employers.

### IBM'S CASH BALANCE PLAN

In July of 1999, IBM amended its pension plan and put in place a cash balance formula for accruing benefits. Under the IBM cash balance plan, a participant's accrued benefit is determined by reference to a hypothetical account. Each year, benefits accrue by the addition of "pay credits" and "interest credits" to the hypothetical account. Pay credits are based on the employee's compensation (5% of base salary); interest credits are measured by reference to an external benchmark (one percentage point higher than the rate of return on a one-year Treasury security). Upon termination of employment, the participant may take a distribution of the participant's benefit, or the participant may defer distribution to a later date; in either case, the distribution may be taken in the form of a lump sum or a life annuity. Following termination of employment, interest credits (but not pay credits) continue to accumulate until the participant's benefit is withdrawn or converted to a life annuity.

### PLAINTIFFS CHALLENGE THE CASH BALANCE PLAN

IBM employees filed a class action against IBM, claiming that its cash balance plan violates ERISA's prohibition on age discrimination in pension plans because, under the plan's

method of crediting hypothetical accounts, “the rate of an employee’s benefit accrual is reduced, because of the attainment of any age.” 29 U.S.C. § 1054(b)(1)(H)(i).<sup>1</sup>

Plaintiffs based their age discrimination claim on the following: unlike individual account “defined contribution” plans (such as 401(k) plans), where contributions to an employee’s account, plus or minus investment experience, equal the amount of benefits distributed at retirement, cash balance pension plans are “defined benefit” plans. As such, plaintiffs claimed, ERISA requires that a participant’s accrued benefit – regardless of the participant’s age – must be expressed in the form of an annual benefit commencing at normal retirement age and must include interest credits, projected forward and expressed as an annuity commencing at normal retirement age (typically, age sixty-five). Hence, plaintiffs argued, IBM’s cash balance plan is age discriminatory because, although pay and interest credits to a participant’s hypothetical account are not *directly* related to age, the same credits to a younger employee, when projected forward and valued as an annuity commencing at normal retirement age, will result in a greater accrued benefit and a greater rate of benefit accrual than the same credits to an older employee with the same years of service and salary. This result, plaintiffs assert, is in direct violation of ERISA § 204(b)(1)(H).<sup>2</sup>

### **SUMMARY JUDGMENT GRANTED IN FAVOR OF PLAINTIFF EMPLOYEES**

The court agreed with the plaintiffs and granted summary judgment against IBM on the question of liability; the court did not address damages.<sup>3</sup>

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<sup>1</sup> ERISA § 204(b) sets forth detailed benefit accrual requirements for defined benefit pension plans subject to ERISA, which include cash balance pension plans such as the IBM plan. Among those requirements, ERISA § 204(b)(1)(H) provides that the benefit accrual requirements of ERISA are not satisfied if, under the plan, an employee’s benefit accrual ceases, or the rate of the employee’s benefit accrual is reduced, because of the attainment of any age. *See* 29 U.S.C. § 1054(b)(1)(H).

<sup>2</sup> Pursuant to the same act that amended ERISA to include the anti-discrimination provision, the Omnibus Budget Reconciliation Act of 1986, an analogous age discrimination provision was included in the Age Discrimination in Employment Act (“ADEA”). Section 4(i)(1)(A) of ADEA makes it unlawful for an employer to establish a defined benefit plan that requires or permits the “cessation of an employee’s benefit accrual, or the reduction of the rate of an employee’s benefit accrual, because of age.” 29 U.S.C. § 623(i)(1)(A). Thus, age discrimination challenges to pension plans can and have been brought under ADEA. *See Campbell v. BankBoston, N.A.*, 327 F.3d 1 (1<sup>st</sup> Cir. 2003); *Amara v. Cigna Corp.*, No. CIV.3:01CV2361(DJS), 2002 WL 31993224 (D. Conn. Dec. 20, 2002). However, ADEA’s strict procedural requirements, time limitations, issues of intent, and the age of the class protected under ADEA, may play a role in plaintiffs’ decisions whether to bring these cases under ERISA, ADEA or both.

<sup>3</sup> The court also found that the IBM pension plan violated ERISA’s age discrimination proscription prior to the 1999 amendment, based on the plan’s design as a “pension equity plan” and its “pension credit formula”

The court's analysis begins with the observation that IBM's cash balance plan — although "it looks like a defined contribution plan" — is in fact a defined benefit plan and, thus, is held to the same statutory requirements regarding vesting and accrual of benefits as any defined benefit plan.<sup>4</sup> The court then largely adopted the plaintiffs' reasoning, concluding that the IBM cash balance plan fails to comport with the statutory requirements of a defined benefit plan, because the method under which IBM calculates participants' interest credits "runs afoul of ERISA's age discrimination proscription" and violates § 204(b)(1)(H).<sup>5</sup> Under this court's broad interpretation, virtually all cash balance plans would fail to satisfy the statute's anti-discrimination provision.

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The district court in Illinois is the first district court to rule that a cash balance plan violates ERISA's age discrimination provisions. Indeed, the one other district court to consider the issue ruled that it did not. *See Eaton v. Onan Corp.*, 117 F. Supp. 2d 812 (S.D. In. 2000). While no appellate court has yet ruled on this issue, IBM has announced that it will appeal the *Cooper* decision to the Seventh Circuit. However, a decision by the Seventh Circuit, which would be binding only in that jurisdiction, is unlikely to quell the uncertainty surrounding cash balance plans and the final word on these plans may require a decision by the United States Supreme Court or congressional action. Meanwhile, employers with existing cash balance plans, and employers considering implementation of such plans, will continue to face considerable uncertainty regarding the legality of such plans.

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that, like the cash balance formula, resulted in a lower rate of benefit accruals and smaller accrued benefits for older employees. The court's analysis concerning the pension credit formula is not addressed in this memorandum.

<sup>4</sup> The IBM court relied on earlier court of appeals decisions establishing that cash balance plans must comply with ERISA's strict requirements governing defined benefit plans notwithstanding their comparability, in certain features, to a defined contribution plan. *Berger v. Xerox*, NO. 02-3674, 2003 WL 21770803 (7<sup>th</sup> Cir. August 1, 2003) (rejecting Xerox's argument that its cash balance plan is a "hybrid," and holding that cash balance plans must satisfy ERISA's requirement that, in a defined benefit plan, a lump-sum distribution of pension benefits must equal the value of the benefits if the employee decided to wait until normal retirement age); *Esden v. Bank of Boston*, 229 F.3d 154 (2d Cir. 2000) (same).

<sup>5</sup> Significantly, this court did not even consider the regulations proposed last year by the Internal Revenue Service ("IRS") which addressed, among other issues, the proper definition of the rate of benefit accrual for cash balance plans for purposes of IRS approval of the plan, under which certain cash balance plans would satisfy the age discrimination provisions. *See Reductions of Accruals and Allocations because of the Attainment of any Age: Application of Nondiscrimination Cross-Testing Rules to Cash Balance Plans*, 67 Fed. Reg. 76,123 (proposed Dec. 11, 2002). It is possible, however, that should these proposed regulations become final, they may have an impact upon future court decisions.

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