

# Employee Benefits Briefing

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A bulletin designed to keep clients and other friends informed on employee benefits law matters

August 2006

## Seventh Circuit Reverses IBM Cash Balance Plan Ruling

The growing trend of converting traditional pension plans to cash balance or other hybrid designs suffered a drastic setback in 2003, when the United States District Court for the Southern District of Illinois held that IBM's cash balance pension plan violated the age discrimination provisions of ERISA. The District Court's rationale in *Cooper v. IBM Personal Pension Plan* cast doubt on the lawfulness of most—and perhaps all—cash balance and hybrid plans.

IBM appealed the District Court's decision to the United States Court of Appeals for the Seventh Circuit. The stakes were high: IBM agreed to settle the age discrimination claims for \$1.4 billion (yes, billion) if the District Court's decision was affirmed on appeal. The District Court decision also prompted class action litigation against other cash balance plan sponsors, attracted widespread media coverage of cash balance plan conversions, and provided ammunition for members of Congress, who succeeded in enacting riders to appropriation bills that blocked the IRS from finalizing its proposed regulations on cash balance plans.

On August 7, 2006, the Court of Appeals issued its long-awaited decision on IBM's appeal and reversed the District Court's decision. The Court of Appeals ruled that the IBM plan did not violate ERISA's age discrimination rules. In doing so, the Court observed that the "terms of IBM's plan are age neutral. Every covered employee receives the same 5% pay credit and the same interest credit per annum." That age-neutral design, the Appeals Court concluded, does not constitute unlawful "age discrimination."

In the course of its decision, the Court of Appeals flatly rejected the District Court's rationale, pointing out that the District Court had confused the phrase "rate of benefit accrual" in ERISA's age discrimination rules with the definition of "accrued benefit," used in another section of the statute. The concept of "benefit accrual" refers, the Court of Appeals said, not to what the employee takes out of the plan but to what the employer puts in or credits to the employee. Since the "rate of an employee's benefit accrual" under the IBM plan remained constant at five percent of pay annually, plus interest, regardless of age, the Court reasoned, the plan did not unlawfully reduce the benefit accrual of any employee because of age. The difference in the ultimate benefit at age 65 (the "accrued benefit") for a younger participant compared to an older participant was strictly a function of the time value of money and was not prohibited age discrimination.

The Court of Appeals acknowledged that the traditional formula used prior to IBM's change to a cash balance approach favored older workers, as opposed to those whose employment terminated earlier. This is because benefit accruals under the traditional final average pay approach were "backloaded" (which means that accruals are small in the earlier years of an employee's career and increase significantly as pay increases in an employee's final years of employment). "But removing a feature that gave extra benefits to the old differs from discriminating against them," the Court of Appeals explained. "Replacing a plan that discriminates against the young with one that is age-neutral does not discriminate against the old."

This is not the end of the controversy. The IBM plaintiffs may appeal to the U.S. Supreme Court. Other District Courts have split on the age discrimination issue, and appeals of several of those decisions are pending in other Circuits. The new pension legislation—the Pension Protection Act of 2006—blesses cash balance conversions prospectively, subject to certain conditions, but does not address the status of the prior conversions. Nevertheless, the Seventh Circuit Court of Appeals decision in the *IBM* case is a welcome statement of common sense and should provide some reassurance to plan sponsors of cash balance and other hybrid pension plans.

If you have questions about the *IBM* decision or cash balance plans generally, please call Paul Russell (312/609-7740), Tom Hancuch (312/609-7824) or any other Vedder Price attorney with whom you have worked.

*Employee Benefits Briefing* is published by the law firm of Vedder, Price, Kaufman & Kammholz, P.C. It is intended to keep our clients and interested parties generally informed of legal developments in employee benefits. It is not a substitute for professional advice.

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