

Recent Cash Balance Decisions Pose Limited Threat to Governmental Cash Balance Plans

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In recent years, a number of state and local governmental employers have adopted cash balance plans, which are defined benefit plans that operate in a manner similar to defined contribution plans. The typical cash balance plan credits an employee with a percentage of pay each year, plus a percentage of interest on those pay credits at a rate set forth in the plan document. Unlike a defined contribution plan, however, the participant does not have an individual account with actual assets and earnings reflected in it, but rather the plan has a "pool" of funds to pay all participants, and its earnings may or may not equal the interest rate provided under the plan by the employer. The participant's benefit is equal to his or her cash balance account and the employer bears the funding investment risk. Cash balance plans have been controversial for years, and engendered much litigation. Two significant recent decisions in the tide of cash balance litigation – *Cooper v. The IBM Personal Pension Plan and IBM Corp.* in the Southern District of Illinois and *Berger v. Xerox Corporation Retirement Income Guaranty Plan* in the Seventh Circuit – raise significant issues involving the implementation and operation of many cash balance plans. These rulings primarily impact private sector plans, but also have some potential impact on governmental cash balance plans.

The IBM Case

The key issue in the *IBM* case was whether the IBM cash balance plan violated the age discrimination rule of Internal Revenue Code ("Code") section 411(b)(1)(H), which prohibits the cessation of an employee's benefit accrual or the reduction in the rate of an employee's benefit because of an employee's attainment of any age. The district court in the Southern District of Illinois held that, because of its structure, the IBM cash balance formula (and a predecessor "pension equity" formula) violated this age discrimination rule. If broadly applied, this decision would in effect treat all cash balance plans as illegal.

Although Code section 411(b)(1)(H) does not apply to governmental plans, the mirror provision in the Age Discrimination in Employment Act ("ADEA") section 4(i) (29 U.S.C. 623(i)) does. ADEA is applicable to both

private sector and governmental plans. It may be enforced by either Equal Opportunity Employment Commission (EEOC) action or, except as described below, by private lawsuits filed after putting the EEOC on notice of a potential claim. The EEOC has brought claims against governmental plans for age discrimination in the past.

With respect to potential EEOC action against a governmental cash balance plan, ADEA section 4(i)(7) provides that regulations issued by the Secretary of the Treasury shall govern ADEA issues under ADEA section 4(i) and Code section 411(b)(1)(H). As such, it appears likely that the EEOC will defer to the Internal Revenue Service on the enforcement of ADEA section 4(i). In light of the positive treatment of cash balance plans under Treasury's December, 2002, proposed Code section 411(b)(1)(H) regulations, it seems unlikely that a governmental cash balance plan would face an EEOC enforcement action at this time.

Governmental cash balance plans also face a limited risk of private ADEA section 4(i) claims. In 2000, in *Kimel v. Florida Board of Regents*, the Supreme Court concluded that there is no private ADEA cause of action against governmental plans because of a state's sovereign immunity under the Eleventh Amendment. Courts may, however, attempt to limit *Kimel's* protection to only certain state-related entities (See *e.g.*, *Narin v. Lower Merion School Dist*, a Third Circuit decision). As such, some local governmental cash balance plans may face a private litigation risk under ADEA.

Governmental cash balance plan sponsors should take this opportunity to review the operation of their cash balance plans (including any proposed conversions to cash balance plans) to consider their planning options in light of the litigation risk posed by *IBM* decision. However, because of the proposed and pending cash balance guidance from the Internal Revenue Service supporting the use of cash balance plans, other court decisions to the contrary on the age discrimination issue (*e.g.*, *Eaton v. Onan Corporation*, a case from the Southern District of Indiana), IBM's intention to appeal the *IBM* decision, and the limited shield provided by *Kimel*, a rush to abandon governmental cash balance plans is premature at this time.

The Xerox Case

The key issue in the *Xerox* case was how lump sum payments from the cash balance plan should be calculated. The Xerox plan had previously paid out lump sum distributions prior to normal retirement age as the value of a participant's account at distribution without adjustment for future interest

credits. The Seventh Circuit concluded that that lump sum payments from cash balance plans must be calculated by projecting the value of a participant's account to his or her normal retirement age using the plan's interest crediting rate and then discounting the normal retirement age benefit back to a current lump sum using the IRS-provided rate for calculating lump sum distributions. The Seventh Circuit then further concluded that because the plan's interest rate was greater than the IRS-provided rate, the lump sum distributions paid to participants were smaller than the distributions that should have actually been paid. This conclusion is also consistent with the Internal Revenue Service's conclusions in Notice 96-8.

The *Xerox* decision should be of little impact to governmental cash balance plans. Because governmental cash balance plans are not required to use the IRS-provided rate for determining lump sum payments, governmental cash balance plans may be able to avoid this issue by using the same interest rate for interest credits and determining the lump sum value of distributions. Significantly, however, the *Xerox* case serves as an additional reminder to those governmental plans that use different interest rate assumptions for interest credits and the calculation of lump sum benefits, that lump sum distributions should be calculated by using the plan's interest crediting rate to project a participant's benefits to normal retirement age and then discount that benefit to current value by using the plan's interest rate assumption for lump sums.

Governmental cash balance plans should review their current operations to ensure that they are calculating lump sums in a manner consistent with the *Xerox* holding.

Summary

Recent litigation attacking cash balance plans has, for the most part, involved issues that do not directly affect governmental plans. However, governmental plan sponsors should be aware that some age discrimination concerns have arisen because of the IBM case. And, certainly, the tarnished reputation of cash balance plans in general could spill over to governmental cash balance plans.