Cash Balance and Pension Equity Plans

Pension Protection Act of 2006 and Decision in Cooper v. IBM

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Agenda

- Background: A Long And Winding Road
  - How Did We Get Here?
- Pension Protection Act Hybrid Related Provisions
  - Is It Better or Worse Than No Legislation?
- August 7 Decision in Cooper v. IBM
  - How Happy Should Employers Be?
- Where Do We Go From Here
  - Can Hybrid Plans Help Revive Defined Benefit Plans?
  - Will Legal Uncertainties Linger?

Background: CB Plans Gain Popularity 1985-1997

- Cash balance plans were adopted 1985-1998 with little fanfare
  - Routine IRS approval
  - Limited and generally positive media coverage
- Limited regulatory guidance
  - Despite considerable input from practitioners
- 1991 safe-harbor in non-discrimination regulations
  - Interest credits do not cause age discrimination
  - Introduction of lump sum "whipsaw" theory – account may not be enough
    - Project account to normal retirement age based on plan's interest crediting rate
    - Convert to normal retirement annuity based on plan conversion interest / mortality
    - Reconvert annuity to current lump sum using statutory lump sum interest rates
- Notice 96-8 dealing with minimum lump sums
  - Confirms whipsaw theory
  - Safe harbor interest credits
  - Preliminary but no regulations ever proposed
- Final average pay variations developed – notably PEPs

Background: Problems Begin 1998 – 1999

- Lack of regulatory guidance set table for legal attacks
- Negative media coverage
  - First WSJ article in December 1998
  - Myths proliferated that conversions generally hurt older workers
- Congressional hearing in mid-1999 focused on IBM conversion
  - Spurred by plaintiffs attorneys and Pension Rights Center
  - Sen. Jeffords and Rep. Sanders took the issue on
  - IRS agreed to freeze determination letters on conversions
  - Treasury agreed to study age discrimination and other issues
- Lawsuits began to proliferate 1999 and after
  - Early cases mostly on whipsaw – plaintiffs scored wins
  - Age discrimination has dominated recent cases

Background: Treasury Acts Then Retreats 2000-2003

- Treasury finally issued proposed regulations on age discrimination in 2002
  - Had some problems but certainly would have helped employers
  - Critics viewed them as pro-business
  - Plaintiffs' attorneys threatened by them
- A few members of Congress managed to kill the regulations
  - Through Appropriations bills
  - The Bush Administration did not resist
- Became clear that Congress and the Courts would have to decide the fate of hybrid designs

Bush Offers Proposed Legislation 2004

- CB plans deemed not age discriminatory in the future
- Extensive new mandates that would stifle conversions and set precedents for other defined benefit amendments
    - Elimination of wearaway
    - Mandatory choice to stay in prior plan
    - 5-year hold harmless
- Viewed very negatively by employers and rather favorably by retiree advocates
- Raised entitlement bar so high it created problems for both Republicans and Democrats to retreat very much
- Never pushed by Administration but quietly reintroduced in 2005 pension reform proposals

Congress Develops Its Proposals 2005

- Critics pointed to Cooper v. IBM district court decision
  - "Proof" that these plans were bad and required tough legislation
  - Cash balance controversy used to promote expansion of entitlements
- Employers argued for "comprehensive" solution
  - Need clarification that these designs are and have been legal
  - Avoid new mandates – will do more damage to voluntary system
  - Any age discrimination test should be design neutral
- Four Committees with pension jurisdiction developed hybrid legislation during 2005 as part of pension reform
  - House version more employer friendly – no new benefit mandates
  - Senate version more closely resembled Bush proposals
  - Neither bill dealt with legal status for prior years
- Final bill more closely resembles House version but with some provisions from the Senate bill
  - Rep. Boehner was instrumental in achieving this result

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Pension Protection Act Hybrid Plan Provisions

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Hybrid Legal Issues Clarified

- Language included in Title VII of PPA
  - Sections 701 and 702
- Two major issues clarified (Section 701)
  - Age discrimination
  - Minimum vesting and lump sums
- But effective prospectively only
  - Past practices remain in limbo

Age Discrimination

- New rules apply to all DB plans
  - New test based on total “accrued benefits”
  - Generally effective June 29, 2005
- Additional rules for hybrid plans
  - Maximum / minimum interest credits
  - Conversion restrictions – no wearaway
  - Plan termination provisions

New Age Discrimination Test

- Accrued benefit at any time must be equal or greater than that for any similarly situated younger employee
  - Similarly Situated: same service, pay history, position, etc.
  - Accrued Benefit: defined by plan and can be normal retirement annuity, account (cash balance) or percent of final average pay (PEP)
- Can disregard certain plan features
  - Early retirement subsidies
  - Permitted disparity (Social Security integration)
  - Offsets (e.g., in floor offset arrangements)
  - Indexing that does not reduce unadjusted amount
    - Except variable annuity plans can have negative returns
- How Do Hybrid plans pass this test?
  - Account balances
  - Plan formula
  - Normal retirement annuity – disregard indexing

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Additional Hybrid Plan Rules
Maximum Interest Credits

- Interest credits cannot exceed market rate of return in any year
  - Subject to Treasury regulations
  - Can provide reasonable fixed rate
  - Can provide greater of market variable rate and reasonable fixed rate
- Presumably Notice 96-8 rates will be starting (but not ending) point
- PEPs should satisfy this rule
  - Zero interest credits during employment
  - Fixed or variable rate after termination

Additional Hybrid Plan Rules
Minimum Interest Credits

- If plan's interest credits could be negative in any year, account cannot be less than any opening balance plus pay credits
  - Affects CB plans with equity return credits
- Effective for plan years starting in 2008

Additional Hybrid Plan Rules
Interest Rates After Plan Termination

- When CB or PEP is terminated variable bases must be converted to fixed bases
  - Interest credits
  - Bases to convert accounts to annuities
- Use average of variable basis over last five years
- Should help PBGC in distress terminations
- Should facilitate annuity purchases in standard terminations

Additional Hybrid Plan Rules
Conversion Restrictions

- Wearaway of benefits must be precluded
  - On both normal and early retirement benefits
- Minimum on "A+B" basis
  - Part A: accrued benefit at conversion with right to grow into early retirement subsidies
  - Part B: cash balance with no opening balance
- Not clear if opening balance approach can be used in lieu of A+B approach with sufficient (or contingent) early retirement subsidies
- Effective for conversions adopted and effective after June 29, 2005

Minimum Vesting and Lump Sum Rules

- Cash balance and PEPs subject to 3-year vesting
  - Effective for 2008 plan years
- Lump sum equal to cash balance or PEP account is adequate – no whipsaw calculations needed
  - Applies to distributions after enactment date
  - Broader than had it applied to benefits accruing after enactment date

Other Notable Provisions

- Age discrimination provisions amend Code, ERISA and ADEA
- No inference language regarding prior years
  - Will not help and might hurt employers in litigation
  - Some of the legislative history may help
- Hopefully Treasury guidance on market rates and other open issues will be reasonable and timely
- Section 702 requires Treasury to issue regulations within a year on conversions resulting from mergers and acquisitions

Initial Reactions

- For future conversions and adoptions mostly positive
  - Age discrimination and whipsaw clarified
  - Conversion restrictions relatively modest
- Existing plans a mixed bag
  - Negative: prior years not addressed
  - Positive: potential liability limited to prior years and exposure on conversion approach might be limited to wearaway issue

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About the Cooper v. IBM Decision

- **Background**
  - Main issue: do guaranteed interest credits violate age rules?
  - Prior guidance from Treasury and other district courts said no
  - Cooper district court disagreed, sending shock waves through system
- **Appeal to 7th Circuit**
  - IBM narrowed issues through settlement
  - To main age issue and one closely related conversion issue
- **7th Circuit Reverses District Court**
  - Reflecting “time value of money” is not age discrimination
  - Moving from age-weighted plan to age-neutral plan isn’t either
  - Comments on adverse effects of litigation
- **Likely Future Developments**
  - Petitions for rehearing by 7th Circuit and for Supreme Court review
  - Decisions expected from 2nd and 9th Circuits within next year

Where Do We Go From Here?

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Can Hybrid Plans Help Revive the DB System?

- Many factors have affected the shift away from DB plans
- Hard to isolate impact of uncertain legal environment
- How important are lingering legal uncertainties?
- Any prospect for second round of legislation?
  - Helpful or harmful?

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Thank You For Attending/Question & Answers

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