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Re: New Cash Balance Plan Developments

Dear Clients and Other Friends:

Two new legal developments bode well for cash balance pension plans, pension equity plans and other "hybrid" retirement plans. First, the new Pension Protection Act ("PPA") provides that cash balance and other hybrid plans are not inherently age discriminatory if they meet certain statutory requirements. Prior to the PPA, there was little statutory guidance regarding these hybrid plans.

The second favorable development is the recent Seventh Circuit Court of Appeals decision in Cooper v. IBM Personal Pension Plan. Cooper reversed a 2003 lower court ruling that cash balance plans are inherently age discriminatory. Cooper provides comfort for employers that have sponsored cash balance plans prior to the PPA.

This is good news for cash balance and other hybrid plan sponsors because the Pension Protection Act provides prospective guidance and relief, while the Cooper case appears to provide retroactive relief. The following will discuss this good news in more detail:

Pension Protection Act Relief

Under the PPA, cash balance and other hybrid plans are explicitly permissible, subject to the following:

- **Vesting:** Cash balance and hybrid plans must provide for at least three year cliff vesting. This is required for plan years beginning in 2008. Employers can, however, elect to adopt the quicker vesting sooner.
- **Whipsaw:** The PPA provides prospective relief from the "whipsaw" problem. A "whipsaw" occurs when the applicable discount rate under Code §417(e) is lower than the rate of interest credited to the hypothetical account balance under a cash balance plan. (Hybrid plan designs with no interest credits do not have this problem.) Before PPA, the hypothetical account balance at age 65 was supposed to be discounted using the Code §417(e) rate to determine the lump sum amount payable at

the actual distribution date. If the discount rate was lower than the interest rate credited by the plan, the value of the lump sum would exceed the hypothetical account balance, resulting in a larger benefit than was intended. The PPA eliminates future whipsaw problems by explicitly providing that a lump sum distribution from a cash balance plan can equal the hypothetical account balance (or the accumulated percentage of final pay under a pension equity plan) without any further adjustments.

- **Age Discrimination:** The PPA clarifies that cash balance and other hybrid plans are not inherently age discriminatory. The plan must, however, provide for at least three year cliff vesting. In addition, any interest credits cannot exceed a market rate of return. Finally, an older participant's accrued benefit, determined at any date, must be at least the same as the accrued benefit of any other similarly situated younger employee. In other words, there is no age discrimination if the annual benefit credit is at least as large for older workers as for younger workers.

"Similarly situated" means that the workers are hypothetically identical in every respect except for age. The accrued benefit can be tested in several different ways including (i) hypothetical account balance, (ii) current value of the accumulated percentages of the employee's final average pay or (iii) the annuity amount payable at normal retirement age. Early retirement subsidies are disregarded.

Corresponding amendments have been made to the Age Discrimination in Employment Act (ADEA). This resolves the age discrimination issue, at least on a prospective basis, for typical cash balance and other hybrid plans.

- **Cash Balance Conversions:** Conversions from traditional pension plans to cash balance or other hybrid plans after June 29, 2005 cannot use the "wear away" approach with respect to the old accrued benefit under the traditional pension plan. This means that the accrued benefit under the traditional plan must be preserved, and future accruals under the cash balance or hybrid plan must be added to that amount.

Cooper Relief

The application of the PPA is prospective only and does not fully resolve age discrimination, whipsaw and conversion issues under prior law. The Cooper case, however, appears to resolve the age discrimination issue retroactively.

Cooper involved an appeal from a lower court decision that found cash balance plans to be age discriminatory. The plan in Cooper provided for hypothetical accounts that were credited with hypothetical contributions ("pay credits"), which in turn were credited with hypothetical interest. The lower court held that, because younger workers could earn interest credits on the annual pay credits over a longer period of time, the younger employees had a higher benefit accrual rate than the older workers. Thus, the lower court seemed to view the compounding of interest, or time value of money, as discriminating against older workers.

The appellate court rejected this concept of age discrimination observing that “treating the time value of money as a form of discrimination is not sensible”. The Cooper court held that the IBM benefit formula was age-neutral and noted that employers are free to change pension benefit formulas, so long as vested interests are not diminished. Finally, the court observed that, following the Cooper litigation, IBM eliminated new workers from its cash balance pension plan altogether, noting, “it is possible ... for litigation about pension plans to make everyone worse off.”

The Cooper decision appears to give retroactive age discrimination relief to cash balance plans (and other hybrid plans) at least for the time being. It is possible that other appellate courts will reach different conclusions, or that the Supreme Court will agree to decide pre-PPA cash balance plan claims. In other words, it is possible there could be different rules for cash balance plans before and after the PPA.

In that regard, the Seventh Circuit recently refused the Cooper plaintiffs’ request to rehear the appeal. Reportedly, the Cooper plaintiffs plan an appeal to the U.S. Supreme Court. It is far from certain, however, that the Supreme Court will hear the case, especially since there is no split among the appellate courts on this issue.

Even more recently, in Laurent v. PricewaterhouseCoopers, decided on September 5, 2006, the federal court for the Southern District of New York agreed that a cash balance plan is not age discriminatory. The Laurent court suggested, however, that the “whipsaw” rule may apply to pre-PPA distributions from cash balance plans.

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In any event, it is clear that there is more guidance and comfort for a cash balance and other hybrid plan sponsors following the enactment of the PPA and the Cooper decision. If you have any questions regarding the PPA, the Cooper decision, or any other employee benefit plan matters, please contact one of us.

Very truly yours,

Anthony R. Battles

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