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*NOT ADMITTED IN THE DISTRICT OF COLUMBIA

OCTOBER 30, 2003

Re*: *Cash Balance Plan Alert

Cash balance plans suffered a major setback in *IBM v. Cooper*, which held that the IBM plan violates federal age discrimination laws. If upheld and adopted by other courts, the *IBM* decision makes most cash balance plans illegal

The publicity firestorm ignited by *IBM* has totally changed the politics of cash balance plans — for the much, much worse.

The Treasury Department has now cancelled all efforts to write pro-cash balance regulations. Congress has turned openly hostile to cash balance plans — both the House and Senate have voted to ban Treasury guidance that might undo the *IBM* case. With little hope of help from Treasury or Congress, and an *IBM* appellate decision maybe two years away, every cash balance plan faces the real possibility of an *IBM*-like challenge. A ***successful IBM-like suit*** against a typical cash balance plan could ***multiply its benefit obligations by a factor of four or more.***

What should a cash balance plan sponsor do? While the enclosed memo makes these points more fully, here is a summary of steps you can take:

I. Self-Help

Sponsors of cash balance plans should consider at least some of the following plan changes that can be put in place immediately:

- Hold off adopting new cash balance plans until the legal landscape clears.

- Freeze existing cash balance plans to stop damages from growing.

- Ban attorneys' fees from class action awards. A *major* incentive to ERISA class action lawsuits is the 33% contingency fee that plaintiffs' attorneys rake off the top of multi-hundred million dollar settlements. Amending your plan to limit plaintiffs' attorneys' fees to the vastly smaller "statutory" fee provided by ERISA will help make your plan the last target on plaintiffs' attorneys' hit list.

- Add a statute of limitations on benefit claims. Courts have upheld plan provisions that limit past benefit claims to as little as *one year*.

- Add venue restrictions to your plan, so that ERISA suits stay out of the Southern District of Illinois and other plaintiff-friendly jurisdictions.

- Amend the definition of the "accrued benefit." If your plan provides lump sum distributions, redefine the plan's "accrued benefit" as the cash balance account, rather than as the age-65 annuity.

- Amend the definition of "normal retirement date" so that it is expressed as five years of service, rather than age 65 or another specified age.

- Get participant waivers. Relief from Congress and Treasury — if any– might be prospective only. Waivers of past liabilities are not perfect from an employee relations perspective, nor air-tight from a legal one, but are an additional level of protection against past claims.

II. Lobbying Congress

Opponents of cash balance plans have been vigorously making their case to the press and Congress for years. Opponents have defined the issue. To make the pro-cash balance case, employers must recover much lost ground. This is not a fight over a technical issue that a highly regarded organization like ERIC or ABC can win on its own. This issue has become hotly political, the kind that can be won only by individual companies making their own case to lawmakers. The total defeat of cash balance plans in recent House and Senate votes shows this case has not yet been made.

Bottom line: Self-help solutions are a good band-aid. But the cure is regulations and legislation clarifying that cash balance plans are legal. Treasury has announced it will do nothing until Congress acts. Congress has shown that it will act only on behalf of the cash balance opposition, unless companies better make their case.

If you want more information on any of these points, please call Kevin O'Brien or Rosina Barker at 202 393 7600.

October 30, 2003

Cash Balance Plan Alert

Cash balance plans suffered a major setback in *IBM v. Cooper*, which held that the IBM plan violates federal age discrimination laws. If upheld and adopted by other courts, the *IBM* decision invalidates most cash balance plans as illegally age-discriminatory.

In the path of the political firestorm ignited by *IBM*, employers can expect little help from the government's other two branches. The Treasury Department has cancelled all efforts to write pro-cash balance guidance. Congress is now overtly hostile to cash balance plans. Both the House and Senate have voted to ban future guidance — at least through October 2004 — that might undo the *IBM* case. With no hope of help from Treasury, little from Congress, and with the IBM decision unlikely to be heard on appeal for one or two years, every cash balance plan faces the real possibility of an *IBM*-like challenge that, if successful, could multiply ***its liabilities by a factor of four or more.***

Faced with a substantial, costly and growing exposure, what should cash balance sponsors do? This memo is an attempt to describe the current situation and to suggest some steps plan sponsors should consider.

I. What Employers Should Know

1. Case law. The *IBM* decision held that the IBM cash balance plan violates federal age discrimination law. Only one other court has decided on cash balance plans under age discrimination law, with opposite results. *Eaton v. Onan Corporation.* So for now, the judicial score is evenly split — one for, one against cash balance plans. Some commentaries have cited other cases as pro-cash balance — but this scoring is optimistic. Two courts (in cases involving Bank of Boston and AT&T Corporation) have suggested favorable cash balance views, but only in non-binding dicta. The *Onan* and the *IBM* courts are the only courts to have decided the question.

Several pending lawsuits challenge cash balance plans under federal age discrimination law. Given the notoriety — and success — of the *IBM* case, the number of legal challenges can be expected to grow rapidly.

2. Help is not on the way. Some employers hope the *IBM* decision will be rapidly reversed on appeal. But the Seventh Circuit might not hear the *IBM* decision for one or two years. This delay is caused by the Appeals court's refusal to hear the age discrimination piece of the case until the lower court has decided other related issues.

The Treasury Department has virtually announced it will issue no cash balance guidance in the foreseeable future, dashing any hope for imminent regulations invalidating *IBM.* Pam Olson, Assistant Secretary for Tax Policy, said at a conference

October 10th that Treasury will issue no further cash balance plan regulations, but rather will seek legislation protecting cash balance plans. This is bad news. At best, we see no clear Congressional consensus on cash balance plans, and recent votes (discussed below) demonstrate downright Congressional hostility. Treasury's decision to abandon regulation writing in favor of seeking a legislative solution means plan sponsors at best face an indefinite period of uncertainty.

3. Age-Discrimination Remedy — Liabilities Multiplied by Four? Until the *IBM* loss, employers may not have focused on the cost of losing an age discrimination suit. But they should, because of the magnitude of the possible windfall gains to older participants. Here's why: If a cash balance plan loses an age discrimination suit, the court must decide how it will rewrite the plan to satisfy ERISA's requirement that the "rate of benefit accrual" for older people not be less than that for younger people. One possible and troubling solution is to "top up" accrual rates for older people.

To illustrate the enormous windfall cost of a top-up solution, consider a 5% pay credit for three participants: an 18-year-old, a 40-year-old, and a 55-year-old. When the annual pay credit of each is converted to an age-65 annuity — as the *IBM* court said it must be, for purposes of testing for age discrimination — we see the size of the problem: The 18-year-old has an age-65 accrual rate of 6% of pay, the 40-year-old, 2% of pay, and the 55-year-old, about 1% of pay. If the benefits of the 40-year-old and 55-year-old are topped up to equal the accrual rate of the 18 year old, ***the benefit of the 40-year-old triples, and that of the 55-year-old grows by a factor of 6.*** That is, the top-up remedy for older participants is many multiples of their benefit under the plan — and vastly exceeds any benefit they could reasonably have expected from an alternative plan formula, like a final average pay or career average plan. Our illustration assumes an interest rate of 5%. Higher interest rates (which give the younger participant a bigger age-65 rate of accrual) produce larger windfall gains for older participants. Actuaries informally say that a top-up cure for successful age discrimination claims would ***multiply total plan liabilities by between four and ten times.***

The plan, of course, would argue for a more rational plan redesign to solve the age discrimination problem, perhaps arguing for some kind of a career average benefit formula. But we want to stress the very hostile light in which some district courts — the courts where plaintiffs are likely to sue — hold cash balance plans. There is no reason for optimism that a court would impose a "reasonableness" limit on windfall damages, merely because participants got everything the plan promised.

4. "Better-of" plans and elective formulas The magnitude of possible damages for winning plaintiffs in an age discrimination suit means that the *IBM* holding could affect all cash balance plan designs. A plan might not escape just because it gives participants the "better of" a cash balance formula and some other formula. A "better of" formula did not save the Xerox cash balance plan from having to provide costly benefit adjustments to retired participants in a recent case. Some cash balance plans offer

participants an election between a cash balance formula and some other formula. These plans too may be at risk. If the cash balance formula is massively rewritten to incorporate a top-up formula, the court could well decide that participants' "elections" were invalid, and provide costly remedies to all plan participants — including those who chose the non-cash balance plan design.

5. Congressional Action. Congress has grown increasingly hostile to cash balance plans. Three weeks ago, the House overwhelmingly adopted an appropriations measure prohibiting the use of Treasury Department funds to intervene in the *IBM* case. Last week, the Senate adopted a similar measure, which would prohibit the Treasury from writing any age-discrimination regulations affecting cash balance plans.

House and Senate action show that the political outlook for cash balance plans has grown bleaker in the last year. Four years ago, even cash balance plan opponents agreed that cash balance plans were not bad *per se*. Only cash balance conversions, they agreed, needed regulation. Now the House and Senate have both voted against any rulemaking that might clarify the legality of cash balance plans *per se*. Even more ominously, during Floor debate on the House bill, supporters of cash balance plans were unable to muster enough speakers to fill up the 30 minutes allotted to their side of the debate. In Parliamentary terms, supporters "gave up the balance" of their time. In plain English, members of Congress were too afraid of the cash balance issue to even talk about their support — let alone vote for it.

6. FASB Involvement. The Financial Accounting Standards Board has reopened a cash balance plan project, portending new and unfavorable accounting rules for cash balance plans. Earlier this year, a FASB Task Force recommended that cash balance plan liabilities be measured by using Treasury bill rates, whereas other types of defined benefit plan liabilities are measured by means of a high quality, long-term corporate bond rate index. It was estimated that the FASB proposal could increase cash balance pension liabilities ***by 20-40%.*** FASB backed off its Spring 2003 proposal, and it is not certain that a new proposal will pick up on the earlier idea. Nonetheless, the FASB initiative represents yet another attack on cash balance plans, at a time when the legal and legislative challenges promise to command full attention. FASB wants to have cash balance plan guidance in effect by the end of 2004.

II. What Employers Can Do

It is doubtful that the age discrimination issue will be resolved soon. Most of the cash balance plan cases have been instigated by a handful of lawyers, but copycat lawsuits are likely to proliferate in light of the magnitude of the possible recoveries. In light of these expected challenges, what can employers do?

A. Self-help

The only real solution is regulations and legislation clarifying that cash balance plans are not age-discriminatory. But that help may be a long time in coming. In the meantime, here are measures an employer should consider adopting immediately.

- Hold off adopting new cash balance plans. Treasury guidance — if any— will be delayed until after 2004. Any reversal of the *IBM* decision will occur no sooner. A company considering the possibility of converting to or adopting a new cash balance plan, should consider delaying until the law is clarified.

- Freeze existing cash balance plans. An employer who already sponsors a cash balance plan might consider freezing the formula. A benefit freeze will not protect against a legal challenge to prior benefit accruals, but would reduce the scope of any potential liability.

  A benefit freeze requires advance notification to participants under ERISA § 204(h), and raises obvious participant morale questions. It also raises tax and accounting issues, including questions of whether it is a "partial termination" for vesting purposes, and a "curtailment" for accounting purposes. Under case law, the partial termination issue is less likely to be a problem if the plan is underfunded, so the freeze solution may be relatively attractive in the current climate of depressed financial asset values.

- Cap attorneys' fees. A major incentive to class action ERISA lawsuits is the lure of contingent attorneys' fees paid out of any plaintiffs' award. For example, consider a $300 million award to winning plaintiffs. Attorneys paid a 33% contingency fee — *routinely* approved by judges in ERISA class action settlements — take $100 million off the top; participants get the other $200 million.

  A sponsor can amend its plans to stop the availability of these huge contingency fees, making its plan a less attractive target. Here's how:

  There are two alternative ways that plaintiffs' lawyers get paid if they win: (1) contingency fee awards taken out of plaintiffs' awards (as in the above example); or (2) hourly based fee awards under ERISA section 502(g), which are paid in addition to plaintiffs' award. ERISA section 502(g) fees are much, much smaller. Let's say plaintiffs' attorneys in the above example worked a total of 20,000 hours, at an average rate of $300 per hour. Attorneys' fees under ERISA section 502(g) would be $6 million — a long shot from the $100 million contingency fee.

Sponsors should consider amending their plan to forbid payment of contingency fees out of class action awards, and to limit plan-paid fees to those under ERISA section 502(g). There is one catch: The section 502(g) fee is paid on top of the award, while the contingency fee is paid out of the award. But it offers a big advantage: It will make the plan much less attractive to plaintiffs' lawyers.

- Add a statute of limitations on benefit claims. ERISA does not have a statute of limitations on benefit claims. Courts have thus upheld plans' own internal statute of limitations. For example, courts have upheld plan provisions that limit claims to ***one year***. Employers should consider amending their plans to include a specific statute of limitations on benefit claims to one year.

- Add a restrictive venue provision. Many cash balance cases are brought in the notoriously defendant-unfriendly U.S. District Court for the Southern District of Illinois. Some cash balance plan sponsors have added a venue provision to their plans intended to prevent any legal challenge from being brought before that District Court. No authority specifically upholds such provisions under ERISA, but they are routinely upheld in contract cases. Case law favoring plans' internal statutes of limitations suggests that courts would look favorably on venue limitations as well.

- Redefine the "accrued benefit" under the plan. For technical reasons, any supposed age discrimination problems arise only when the participant's "rate of benefit accrual" is measured in terms of the age-65 annuity, rather than the account balance. Many cash balance plans define the "accrued benefit" as the age-65 annuity that is the actuarial equivalent of the account balance. This age-65 definition makes it easier for plaintiffs to argue that the "rate of benefit accrual" is age discriminatory.

  If your plan makes the cash balance account available as a lump sum, you should consider redefining the "accrued benefit" as the account balance rather than the age-65 annuity. While this approach has not been tested by case law, the amended definition of "accrued benefit" is supported by Code section 411(c)(3), ERISA section 204(c)(3), and regulations thereunder, which allow the plan to define the accrued benefit in any way it chooses.

  Plans have not adopted this approach because IRS agents typically insist that a plan define the "accrued benefit" as the age-65 annuity as a condition of receiving a determination letter. But IRS seems to have informally suspended issuance of all cash balance determination letters. Treasury's recent announcement that it will issue no cash balance guidance until Congress acts shows that the logjam will not be broken soon. Since

Treasury has taken itself out of the picture, plans need worry only about plaintiffs and federal courts for the foreseeable future.

- Redefine normal retirement date as five years of service. A plan sponsor might consider protecting future plan accruals by changing the plan's definition of "normal retirement date" from age 65 to the age of completion of five years of service. Under this amended definition, it can be argued that any supposed reduction in the accrual rate stems from the employee's years of service — which under statute is not age discriminatory — and not because of the participant's increasing age. The IRS has informally indicated it might attempt to outlaw this approach. But the IRS has taken no such action yet. Indeed, the IRS has issued favorable determination letters on plans containing such provisions.

  This approach has been adopted by several employers, but it has a number of disadvantages, including significantly increased plan costs.

- Obtain waivers from participants. Before canceling its guidance-writing altogether, Treasury signaled that any future regulatory relief would not be retroactive. Given the possible absence of retroactive relief, one radical solution is to impose a general freeze on the cash balance plan — but to allow additional accruals for employees who agree to waive any claims for past years against the plan. The waiver solution has some obvious drawbacks in terms of participant communications. It is also not water-tight as a legal solution. In the current environment, however, it may be preferred to keeping past liabilities exposed indefinitely.

B. Lobbying Congress

What cash balance plans really need is assurance that they are legal. This assurance should have come from Treasury, but didn't. Treasury has now said it will not act until told what to do by Congress.

We have said that the Congressional situation is dire — but it is not hopeless. Lawmakers have heard only one side of the case. Cash balance opponents — including AARP, plaintiffs, and plaintiffs' attorneys — have lobbied actively for years. The press, including the *Wall Street Journal*, has reported only the opponents' side, presumably because it has heard only one side.

The results speak for themselves. So far, when Congress votes, cash balance plans lose. Employers can reverse this situation, but it will take lobbying.

In our view, this is not an issue that sponsors can expect a large employer organization, even an active and well regarded one such as the American Benefits Council (ABC) or the ERISA Industry Committee (ERIC), to win on its own. Cash

balance sponsors are asking lawmakers to support a position that, thanks to the vociferous and unflagging efforts of cash balance opponents, may well be unpopular with constituents, particularly the older ones most likely to vote. In our experience — which comes both from the Washington lobbying, and the Hill staff perspective — legislators don't take risks for employers not willing to come forward and take the risk themselves.

On this issue, employers have not come forward. The results are telling. In recent House and Senate votes, Congressional supporters of cash balance plans were nearly invisible. Cash balance plans lost decisively.

If you want to keep your cash balance legal, you might strongly consider deploying your Washington office to start making up the ground lost to the cash balance plan opposition.

In the meantime, you might consider adopting the measures we have outlined above.

If you have any questions on this memo, please don't hesitate to contact any of us: Kevin O'Brien, Mike Huffstetler, Laurie Keenan, Rosina Barker, Will Sollee, Jodi Epstein, Dean Morley, Eric Chason or Robin Solomon, at 202 393 7600, or in our California office, Steve Witmer at 310 598 2057.