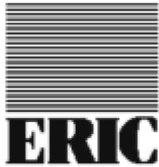

The ERISA Industry Committee

Representing the Employee Benefits Interests of America's Largest Employers

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EXECUTIVE SUMMARY

HYBRID PENSION PLANS DO NOT DISCRIMINATE AGAINST OLDER WORKERS

On July 31, a federal district court in Southern Illinois adopted a test for age discrimination that would outlaw all hybrid pension plans.

- The decision in *Cooper v. The IBM Personal Pension Plan* ignores the policy behind the age discrimination rules, the wording of the statute, the views of the IRS and Treasury Department, the considered opinions of other federal courts, and plain common sense in order to embrace a test that others had rejected as untenable and absurd.

- Under the reasoning of the *Cooper* decision, 401(k) plans and even the Social Security system would be age discriminatory. The *Cooper* decision would outlaw contributory pension plans and many other traditional defined benefit plans as well as hybrid pension plans.

- Hybrid pension plans accumulate pay credits and interest credits in each employee's account. Whether workers are 25 or 85, they earn the same pay credits and interest credits each year.

- The *Cooper* decision concludes that hybrid pension plans are age discriminatory because younger employees have more time to accumulate interest credits before they retire. This view is mistaken. Interest credits merely compensate employees for the time value of money while they wait to receive their benefits, ensuring that workers of all ages receive benefits of equal value.

- More than 400 major companies have adopted cash balance plans and other hybrid pension plans. These plans cover millions of employees and hold 40% of all defined benefit plan assets invested in the U.S. economy. If hybrid pension plans are outlawed, workers will be the biggest losers.

- Employers adopt hybrid pension plans because these plans better serve their business needs and are more appealing to the employees they want to attract and retain. Hybrid plans combine some of the best features of 401(k) plans and defined benefit plans. For example, they
    - provide understandable, portable benefits;
    - are especially valuable to women and other mobile workers;
    - deliver benefits evenly throughout an employee's career;
    - place all of the investment risk on the employer;
    - offer annuity options and surviving spouse protection.

- The *Cooper* decision calls into question plan features that have been in operation for many years and that have been approved repeatedly by federal regulators. It encourages costly and unpredictable litigation between employers and their employees. It raises the specter of huge retroactive liabilities, and it demands absurd prospective remedies.

- Employers will have no choice but to abandon hybrid pension plans if this decision becomes law. Their exodus from the defined benefit system will have a devastating effect on the economy and on society as a whole.

HYBRID PENSION PLANS DO NOT DISCRIMINATE AGAINST OLDER WORKERS

On July 31, a federal district court in Southern Illinois held that IBM's pension plan violated the provisions of ERISA prohibiting age discrimination in retirement benefits.[1] The *Cooper* decision ignores the policy behind the age discrimination rules, the wording of the statute, the views of the IRS and Treasury Department, the considered opinions of other federal courts, and plain common sense in order to embrace a test others had rejected as untenable and absurd.

THE *COOPER* DECISION WOULD OUTLAW ALL HYBRID PENSION PLANS

More than 400 major companies have adopted hybrid pension plans. Millions of workers—more than a quarter of all workers who are still covered by defined benefit plans—participate in hybrid pension plans. Hybrid pension plans also hold more than 40% of all defined benefit assets invested in the U.S. economy. If the *Cooper* decision stands, it will outlaw all of these plans.

Much of the controversy over hybrid plans has focused on the transition issues that arise when an employer converts from a traditional pension formula to a hybrid plan formula. But the *Cooper* decision does not address transition issues. Instead, it holds that hybrid plans are inherently age discriminatory, merely because they credit interest to reflect the time value of deferred payments.

THE *COOPER* DECISION IS CONTRARY TO LAW AND PRODUCES ABSURD RESULTS

Hybrid pension plans—the IBM plan included—treat older workers at least as well as younger workers, and sometimes treat them more favorably. If a 25-year-old and a 60-year-old enter a hybrid plan on the same day, earn the same pay, and withdraw their accounts after the same number of years, they will both withdraw *exactly* the same amount—regardless of age. No rational test would call these plans age discriminatory.

The *Cooper* decision adopts a test for age discrimination that by the court's own admission leads to "startling anomalies and absurdities." It is a test no 401(k) plan could pass, and one that many traditional defined benefit plans would fail. It is a test under which the Social Security system itself would prove age discriminatory. It is inconceivable that Congress intended such a result when it wrote a statute whose stated purpose was simply to ensure that employees who worked past age 65 would continue to earn pension benefits.

HYBRID PENSION PLANS SHOULD BE ENCOURAGED, NOT OUTLAWED

Hybrid pension plans combine some of the best features of 401(k) plans and defined benefit plans. Under a cash balance plan, each employee receives a "pay credit" equal to a percentage of his or her annual compensation and an annual "interest credit" equal to a percentage of the balance in his or her

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[1] *Cooper et al. v. The IBM Personal Pension Plan,* Civ. No. 99-829-GPM (S.D. Ill. July 31, 2003).

account. Pension equity plans are similar, except that the pay credits are based on average compensation and the interest credits apply after the participant's employment terminates. These credits accumulate in each employee's account and are usually available in a lump sum when the employee retires or changes jobs.

Hybrid pension plans are popular with workers because they provide understandable, portable benefits that accumulate evenly over an employee's career. Unlike 401(k) plans, however, hybrid pension plans place all of the investment risk on the employer. A hybrid pension plan provides a predictable benefit when the employee retires, no matter what the stock market does in the meantime. Hybrid pension plans also offer annuity payment options and provide surviving spouse protection.

THE *COOPER* DECISION PUTS THE DEFINED BENEFIT SYSTEM IN PERIL

Employers are struggling to keep their defined benefit retirement programs alive in the face of severe economic pressures as well as intense competition from companies that offer less expensive plans. The combination of unprecedented low interest rates and a long decline in the stock market has magnified pension liabilities, and the cash to fund those liabilities is scarce in a soft economy. Large employers have continued to provide defined benefit plans in the face of these pressures because they believe the plans are critical to employees' retirement security needs. The value of defined benefit programs has never been more apparent than it is now, after a declining stock market has slashed workers' 401(k) accounts.

Employers adopt hybrid pension plans because these plans better serve their business needs and are more appealing to the employees they want to attract and retain. The more portable benefits provided by hybrid plans are a better choice for employees who change jobs frequently, for employees who move in and out of the work force (for example, to raise a family), and for businesses that are bought and sold. Employers do not adopt hybrid plans to save money: they can reduce costs more easily by amending traditional benefit formulas to reduce future pension accruals.

But this is a voluntary retirement system. Make defined benefit plans too expensive or impractical to maintain—layer on too many costly and irrational rules—destroy too many sensible design options—and the system will collapse.

The *Cooper* decision calls into question plan features that have been in operation for many years and that have been approved repeatedly by federal regulators. It encourages costly and unpredictable litigation between employers and their employees. It raises the specter of huge retroactive liabilities, and it demands absurd prospective remedies. For example, it has been estimated that a 65-year-old would have to earn pay and interest credits more than ten times greater than those earned by a 21-year-old with the same salary in order to satisfy the *Cooper* test. Employers will have no choice but to abandon hybrid and traditional pension plans if this decision becomes law.

If employers replace their pension plans at all, it will be with 401(k) plans. Their exodus from the defined benefit system will have a devastating effect on the economy and on society as a whole. As financially sound companies and plans leave the defined benefit system, the PBGC will be left to prop up the weaker companies and the less well-funded plans with a drastically reduced premium base. Ultimately, taxpayers will foot the bill.

IF HYBRID PLANS ARE OUTLAWED, WORKERS WILL BE THE BIGGEST LOSERS

Researchers at the Federal Reserve Board[2] and the Urban Institute[3] have documented the fact that hybrid plans improve retirement security for the modern workforce by distributing pension wealth more equally across all ages. If hybrid plans are outlawed, millions of workers will lose the understandable, portable, secure retirement benefits they enjoy today.

Women, who are more threatened by impoverishment in old age, will be among the biggest losers. They will lose the greater spousal protection that defined benefit plans provide, and they will lose the family-friendly benefits that hybrid plans provide to workers who leave the work force or work part-time while they raise families.

THE *COOPER* DECISION ADOPTS THE WRONG TEST

Put $1,000 in a 401(k) account when you're 25, let it grow at 5% interest, and you can withdraw $7,040 when you're 65. Put the same $1,000 in a 401(k) account when you're 60, let it grow at the same rate of interest, and you will have $1,276 when you're 65. The money you invest when you're 25 earns more interest because it is invested longer. That's just common sense.

But that's exactly what the court saw as age discrimination in *Cooper*. *Cooper* concludes that when you test a hybrid pension plan for age discrimination, you can't just look at the pay and interest credits that are added to an employee's account each year (which are exactly the same for employees of all ages). Instead, according to *Cooper,* you must look at all the interest the employee will earn on this year's pay credit until he reaches normal retirement age at 65. Under this test, the pay credit an employee earns at 25 is much more valuable than the equal pay credit he earns at 60, because the pay credit at 25 includes 40 years of interest, and the pay credit at 60 includes only 5 years of interest.

In reaching the decision to project interest credits to age 65, the court mistakenly relied on (and then incorrectly applied) the reasoning in informal IRS guidance from 1996 that addresses an entirely different issue.[4] Not even the IRS thinks this reasoning applies to age discrimination.

THE *COOPER* DECISION MISINTERPRETS THE STATUTE

The statutory age discrimination test is straightforward: if a plan applies a less favorable formula once an employee reaches a given age, the plan violates the statute. Conversely, if the plan uses the same

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[2] "The earlier accrual and portability of [cash balance] benefits will better facilitate the accumulation of wealth for a more mobile labor force." Phillip C. Copeland & Julia Lynn Coronado, *Cash Balance Pension Plan Conversions and the New Economy* at 22 (April 2002). Federal Reserve Board of Governors, Washington, D.C.

[3] Cash balance plans "would increase median lifetime pension wealth in the total covered population." Richard W. Johnson & Cori E. Uccello, *Can Cash Balance Pension Plans Improve Retirement Security for Today's Workers?* at 6 (Nov. 2002). The Urban Institute, Washington, D.C.

[4] The court relied on the reasoning in IRS Notice 96-8, 1996-1 C.B. 359, which proposes an interpretation of the rules governing "backloading" and lump-sum calculations. There is substantial reason to doubt that this notice is a valid interpretation of the backloading rules. In a letter to Senator Grassley on June 6, 2003, Treasury Assistant Secretary for Tax Policy Pamela Olson stated that Treasury "is fundamentally reconsidering all aspects of Notice 96-8." In any event, Notice 96-8 has never been the law even for backloading, let alone for age discrimination (which the notice does not address). The notice stated that it was issued as "proposed guidance" to elicit public comment in advance of issuing proposed regulations. More than seven years after the notice was published, the Treasury Department still has not issued the proposed regulations.

benefit formula at all ages, and allows employees to accrue benefits in exactly the same way at all ages, the plan complies with the age discrimination rule.

The cash balance formula in the IBM plan treats all employees in exactly the same way at all ages. Whether an employee is 25 or 85, he always earns the same pay credit and the same interest credits. The United States Court of Appeal for the Seventh Circuit—the court that would hear an appeal from the *Cooper* decision—has refused to find a facially neutral pension formula age discriminatory.[5]

THE *COOPER* DECISION IGNORES ECONOMIC REALITY

The interest credits under hybrid pension plans serve a simple purpose: they compensate employees for the time value of money while they wait to receive their benefits. A participant who waits forty years to receive his benefits, and who receives additional interest credits while he waits, does not have an economic advantage over an older employee who receives his benefits earlier. Instead, the interest credits offset the economic disadvantage of the delay in payment, which otherwise would erode the value of the younger employee's pay credit.

The *Cooper* decision recognized that this was a "good argument" from an economic perspective. The court acknowledged that "a dollar today is worth more than the promise of a dollar a year from now." Having acknowledged that the older employee's "dollar today" was worth more, however, the court veered off into a grammatical argument rather than follow its own logic to the inevitable conclusion—that interest credits under a hybrid pension plan do not discriminate based on age.

THE *COOPER* DECISION IGNORES THE DECISIONS OF OTHER FEDERAL COURTS

This was not the first court to face the question whether hybrid pension plans are inherently age discriminatory. Another federal court thoroughly considered the same issue three years ago and rejected the analysis that the court adopted in *Cooper*.[6] The court held that a cash balance plan could be tested by reference to the rate of growth in an employee's account balance—a test that hybrid pension plans easily satisfy. More recently, a federal district court in New Jersey concluded that the age discrimination rules do not apply at all to cash balance benefits accruing before age 65, a conclusion that makes the notion of projecting interest credits to age 65 irrelevant.[7] The *Cooper* opinion flatly ignored these decisions.

THE *COOPER* DECISION IGNORES THE VIEWS OF FEDERAL REGULATORS

Cash balance plans have been around since 1985. The Treasury Department and the IRS, which are charged with administering the age discrimination rules, have had eighteen years in which to study the design of cash balance plans and other hybrid pension plans. If the federal regulators believed that the accumulation of interest credits over time was somehow age discriminatory, they would have said so before now.

In fact, the Treasury Department and the IRS have consistently said just the opposite. Many hybrid pension plans have received determination letters from the IRS confirming that their design complies with applicable law, including the age discrimination rules. The Treasury Department has published

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[5] *Lunn v. Montgomery Ward,* 166 F.3d 880 (7th Cir. 1999).

[6] *Eaton v. Onan Corp.,* 117 F. Supp. 2d 812 (S.D. Ind. 2000).

[7] *Engers v. AT&T Corp.,* No. 98-3660 (D.N.J. June 6, 2001).

several statements confirming that cash balance plans do not violate the age discrimination rules solely because interest credits accrue when the employee earns the related pay credit. Treasury's most recent proposed age discrimination regulations create an explicit safe harbor for cash balance plans.

THE *COOPER* DECISION WOULD OUTLAW MANY OTHER LONGSTANDING PLAN DESIGNS

Catastrophic as the effect of the *Cooper* decision would be on hybrid pension plans, its destructive potential is not limited to those plans. If the decision stands, it will outlaw many traditional pension plan designs that were commonly used and widely accepted long before the age discrimination rule was enacted. Congress could not possibly have intended this result.

Perhaps the most startling victim of the sweeping decision is the contributory pension plan. These defined benefit plans are required by statute to credit employee contributions with interest in precisely the same way that a hybrid pension plan does, and they would fail the *Cooper* test for the same reason hybrid plans fail.

Other defined benefit plans that index benefits between an employee's termination date and the date when an employee begins receiving benefits also would fail the *Cooper* test. Indeed, if the federal Social Security program were subjected to this test, the Social Security system would be found to be age discriminatory: Social Security benefits are indexed by the growth in the national wage base, and the indexing period is longer for younger workers.

The *Cooper* decision does not withstand scrutiny. It turns age discrimination law on its head, and it does not benefit older workers (apart from the few who might enjoy an unexpected windfall as plaintiffs in the case). The age discrimination test in *Cooper* never was, and never should be, the law.

August 21, 2003
THE ERISA INDUSTRY COMMITTEE