Order Code RL33004

CRS Report for Congress
Received through the CRS Web

# Cash Balance Pension Plans and Claims of Age Discrimination

Updated December 5, 2005

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## Summary

The issue of whether cash balance pension plans violate federal laws that prohibit age discrimination has recently been examined by the federal courts, the Treasury Department, and Congress. The relevant age discrimination provisions are found in the Employee Retirement Income Security Act (ERISA), the Internal Revenue Code (IRC), and the Age Discrimination in Employment Act (ADEA). There are two distinct claims that are usually made: (1) that cash balance plans inherently violate the age discrimination provisions because the rate of benefit accrual is decreased on account of age and (2) that the conversion of traditional defined benefit plans to cash balance plans violates the ADEA because of the negative impact on older workers.

In the past few years, several courts have looked at these issues. In a case that has received significant attention, *Cooper v. IBM Pers. Pension Plan*, 274 F. Supp. 2d 1010 (S.D. Ill. 2003), a district court held that IBM's cash balance plan was discriminatory. It appears the court's reasoning would hold that cash balance plans inherently violate the age discrimination provisions. Other courts have held that the plans are not discriminatory or have dismissed the claims for procedural reasons.

In 1999, in response to the growing controversy about whether the plans are discriminatory, the Treasury Department issued a moratorium on approving cash balance plans as qualified pension plans. In 2002, the Treasury Department proposed regulations that addressed the requirements a cash balance plan or conversion would have to meet in order to not violate the age discrimination provisions. These regulations were withdrawn in 2004. Also in 2004, the Treasury Department released a legislative proposal concerning the age discrimination issue, which has been included in the Administration's budget proposals for fiscal years 2005 and 2006.

Since 2001, several measures have been introduced in Congress to address the age discrimination issue. In 2003, Congress attached a rider to the Treasury appropriations bill for FY2004 that prevented the Treasury Department from finalizing the proposed regulations. The House approved a similar measure the next year, but it was not included in the final appropriations bill. In the 109th Congress, two pension measures that address the age discrimination issue are expected to be considered shortly: the Pension Protection Act of 2005 (H.R. 2830) and the Pension Security and Transparency Act of 2005 (S. 1783).

This report describes cash balance plans, discusses the arguments that cash balance plans do and do not violate the age discrimination prohibitions, provides an overview of the court cases, and addresses the activity by the Treasury Department and Congress. It will be updated as events warrant.

## Contents

# Cash Balance Pension Plans and Claims of Age Discrimination

This report examines the issue of whether a type of defined benefit pension plan, the cash balance plan, violates federal laws that prohibit age discrimination. The discrimination provisions are found in the Employee Retirement Income Security Act (ERISA), the Internal Revenue Code (IRC), and the Age Discrimination in Employment Act (ADEA).[1] While employer participation in the private pension system is voluntary, any offered plan must satisfy the legal requirements. The failure to do so may result in civil and criminal liability and the loss of favorable tax treatment for plan contributions and disbursements. Furthermore, ERISA and the ADEA create substantive rights for plan participants that they can seek to have judicially enforced.

This report will briefly describe a typical cash balance plan,[2] and then discuss the federal laws that prohibit age discrimination and the arguments that the plans are or are not discriminatory. The report will next look at several court decisions dealing with the issue of whether cash balance plans or the conversion to such plans violate the age discrimination provisions. It ends with a discussion of recent activity by the Treasury Department and Congress, including a summary of legislation that is expected to be considered shortly in the 109th Congress.

## Types of Pension Plans

### Defined Benefit and Defined Contribution Plans

There are two categories of pension plans under federal law: defined benefit plans and defined contribution plans. In a defined benefit plan, an employee is promised a specified future benefit that traditionally is an annuity beginning at retirement. The amount of the annuity is generally determined by a formula that factors in the employee's years of employment and the average salary of the employee's highest salaried years. Other factors, such as age, may be included. To fund the plan, the employer makes contributions to the common pension fund that are actuarially expected to grow through investment to cover the promised benefits. The employer bears the risk that the investments will not provide adequate funds and is responsible for any shortfalls. If the plan is terminated, the benefits are partially

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[1] ERISA was enacted in 1974, P.L. 93-406, and is codified in Title 29 of the United States Code, starting at section 1001. The Internal Revenue Code is found in Title 26. The ADEA was enacted in 1968, P.L. 90-202, and is codified in Title 29, starting at section 621.

[2] For more information on cash balance plans, see CRS Report RL30196, *Pension Issues: Cash-Balance Plans*, by Patrick J. Purcell.

insured by the Pension Benefit Guaranty Corporation. An employee who terminates employment before retirement will generally receive any vested benefits as an annuity at normal retirement age.

In a defined contribution plan, the employee is promised that the employer will currently make a specified contribution to the employee's pension account. The contribution is commonly a percentage of the employee's salary. Due to the risk of investment, the value of the account at the time of retirement is unknown. The employee bears the investment risk and the benefits are not insured by the Pension Benefit Guaranty Corporation. An employee who terminates employment before retirement may generally receive any vested benefits as a lump-sum payment at the time of termination.

In the past several decades, plans have been developed that modify the traditional defined benefit plan. These plans are referred to as hybrid plans because they are defined benefit plans that conceptualize the benefits in a manner similar to defined contribution plans. One type of hybrid plan is the cash balance plan.

## Cash Balance Plans

Cash balance plans are defined benefit plans that look like defined contribution plans because the employee's promised future benefits are stated as the individual's account balance. The account is hypothetical (i.e., each employee does not actually have an account), but is used to conceptualize the amount of benefits the employee has accrued. The account reflects contributions that are a percentage of annual compensation (called pay credits) and interest earned on those contributions (called interest credits). The interest rate may be fixed or tied to an index rate and is specified in the plan. The plan may use other factors in its benefit formula, such as age and length of service.

The employer currently contributes to the general pension fund. The employer bears the risk that the fund's investments will provide the promised benefits. In the event of plan termination, the benefits are partially insured by the Pension Benefit Guaranty Corporation. An employee who terminates employment before retirement may generally receive the current value of any vested benefits as a lump-sum payment at the time of termination.

## Plan Conversions

During the past two decades, numerous employers have either converted or considered converting their traditional defined benefit plans to cash balance plans. A conversion to a cash balance plan involves amending the original plan and is not treated as a plan termination.

**Anti-cutback Rule.** The conversion is subject to the rules that apply to any plan amendment. An important rule is that once a benefit is accrued, it may only be decreased in limited circumstances and with prior approval by the Treasury

Secretary.[3] An amendment may not eliminate or reduce an early retirement subsidy with regard to service that has already been performed.[4]

While a plan amendment may not decrease benefits that are already accrued, it may reduce future benefit accruals since these benefits have not yet been earned. This reduction may include ceasing benefit accrual for a period of time. Any amendment that significantly reduces the rate of future benefit accrual requires clearly-written notice to affected participants.[5]

## Claims of Age Discrimination

There have been claims that cash balance plans and/or the conversion to such plans violate the laws prohibiting age discrimination. The age discrimination provisions are found in ERISA, the IRC and the ADEA, although plan participants are only able to bring legal actions under ERISA and the ADEA. All three provisions were added by the Omnibus Budget Reconciliation Act of 1986 (OBRA).[6] They are:

ERISA § 204(b)(1)(H) [29 U.S.C. § 1054(b)(1)(H)] and IRC § 411(b)(1)(H):

> [A] defined benefit plan shall be treated as not satisfying the requirements of this paragraph [relating to benefit accrual] if, under the plan, an employee's benefit accrual is ceased, or the rate of an employee's benefit accrual is reduced, because of the attainment of any age.

ADEA § 4(j)(1) [29 U.S.C. § 623(i)(1)]:

> [I]t shall be unlawful for an employer, an employment agency, a labor organization, or any combination thereof to establish or maintain an employee pension benefit plan which requires or permits-
> (A) in the case of a defined benefit plan, the cessation of an employee's benefit accrual or the reduction of the rate of an employee's benefit accrual, because of age.

For purposes of this report, these sections will be collectively referred to as "the OBRA language." While their language differs slightly, they are intended to be interpreted in the same manner.[7]

Two distinct claims are usually made that cash balance plans or the conversions to such plans violate the law. The first claim is that the plans violate the OBRA language because the rate of an employee's benefit accrual is reduced on account of age. The second claim is that the conversions to the plans violate the ADEA because older workers are treated unfavorably in comparison to younger workers. Both claims are discussed below.

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[3] ERISA § 204(g)(1), 29 U.S.C. § 1054(g)(1); ERISA § 302(c)(8), 29 U.S.C. § 1082(c)(8); IRC § 411(d)(6); IRC § 412(c)(8).

[4] ERISA § 204(g)(2), 29 U.S.C. § 1054(g)(2); IRC § 411(d)(6).

[5] ERISA § 204(h)(1), 29 U.S.C. § 1054(h)(1).

[6] P.L. 99-509.

[7] *See* House Report 99-727 at 378-79; P.L. 99-509, § 9204(d).

Before continuing, it should be noted that this report only addresses the issue of whether cash balance plans or the conversions to such plans are inherently discriminatory. While not addressed in this report, it is clear that specific cash balance plan designs or conversions could violate the age discrimination rules for reasons unique to that plan or conversion. Furthermore, the design of a cash balance plan could violate other ERISA or IRC provisions not related to age discrimination, such as the anti-cutback rules that were discussed above.

## Violation of the OBRA Language

The OBRA language prohibits an employee's rate of benefit accrual from being decreased on account of age.[8] In order to determine whether cash balance plans violate this prohibition, two basic issues must be decided: (1) how to interpret the phrase "rate of benefit accrual" and (2) whether the language applies to employees who are younger than normal retirement age.

**Rate of Benefit Accrual.** There is disagreement on how to determine the employee's "rate of benefit accrual" under a cash balance plan. Those who claim the plans are discriminatory argue that it is defined with reference to an annuity that begins at normal retirement age. This will be referred to as an "age 65 annuity." The argument is based on the fact that cash balance plans are a type of defined benefit plan, the "accrued benefit" of a defined benefit plan is defined in ERISA as being "in the form of an annual benefit commencing at normal retirement age,"[9] and an accrued benefit that is defined under a plan in a different form must be converted into such an annuity.[10] The proponents of the discrimination claims argue that this framework requires that the benefits in a cash balance plan, which are conceptualized as an account balance, be converted into an age 65 annuity in order to test for age discrimination. Under this argument, when the benefits are expressed as an age 65 annuity, the cash balance formula violates the OBRA language because the rate of benefit accrual decreases as the employee's age increases.

If the argument that "rate of benefit accrual" must be determined with reference to an age 65 annuity is correct, then the rate under the typical cash balance formula does appear to decrease as the employee's age increases. This is because of the interest credit and the effect of compounding interest. Specifically, as an employee approaches age 65, the contributions made in each subsequent year have a decreasing impact on the amount of the age 65 annuity because they have less time to earn interest. Thus, as the employee's age increases, the rate of benefit accrual, calculated using an age 65 annuity, decreases.

Those who claim that the plans are not discriminatory respond that there is nothing that requires an age 65 annuity be used to test for age discrimination since

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[8] The rate of benefit accrual that is being tested is the rate in the cash balance plan. The rate of benefit accrual under the traditional plan is not being compared with the rate of benefit accrual under the cash balance plan.

[9] ERISA § 3(23)(A), 29 U.S.C. § 1002(23)(A); IRC § 411(a)(7)(A)(i).

[10] *See* IRC § 411(c)(2)(B); 26 CFR § 1.411(a)-7(a)(1)(ii).

the phrase "rate of benefit accrual" is not defined in the statutes and the term "accrued benefit" has various usages in ERISA and the IRC. They argue that instead of using an age 65 annuity, the rate should be tested using the amount that is in the employee's hypothetical account since this is how benefits are expressed in cash balance plans. Thus, under this argument, the "rate of benefit accrual" refers to the rate at which the contributions are made to that account.[11] Additionally, the opponents of the discrimination claims argue that the effect noted by the proponents is not a result of "the attainment of any age," but rather the economic effect of the time value of money.

If this argument is correct and the "rate of benefit accrual" is determined with reference to the rate at which contributions are made to the employee's hypothetical account, then it appears that cash balance plans do not inherently violate the OBRA language. This is because the rate under the cash balance formula at which contributions are made to the account over the employee's years of service is generally constant or increases if the plan is weighted for age.

**Application of the OBRA Language.** There is also disagreement about whether the OBRA language applies to plan participants who are younger than normal retirement age. Opponents of the discrimination claims argue that the legislative history shows that Congress only intended for the OBRA language to require benefit accrual for employees who continued working past normal retirement age. This argument is based on the language of the OBRA conference report,[12] the floor statements of legislators,[13] and the heading to IRC § 411(b)(1)(H) that reads "Continued Accrual Beyond Normal Retirement Age."

In response, the proponents of the age discrimination claims point out that the plain language of the OBRA statutes does not limit the provisions to those employees older than normal retirement age.[14] The proponents further note that the intent of the ADEA is to prohibit age discrimination and it applies to everyone who is at least

[11] This argument would treat cash balance plans similar to defined contributions plans, which also express the benefits as an individual's account. *See* ERISA § 3(23)(B), 29 U.S.C. § 1002(23)(B). Defined contribution plans do not violate the age discrimination provisions so long as "allocations to the employee's account are not ceased, and the rate at which amounts are allocated to the employee's account is not reduced, because of the attainment of any age." ERISA § 204(b)(2)(A), 29 U.S.C. § 1054(b)(2)(A); IRC § 411(b)(2)(A); ADEA § 4(j)(1)(B), 29 U.S.C. § 623(i)(1)(B).

[12] House Report 99-727.

[13] *See* 131 Cong. Rec. 18868 (July 11, 1985) [statement by Senator Grassley]; 132 Cong. Rec. 32963 and 32975 (Oct. 17, 1986) [statements by Representative Jeffords, Roukema, Clay, and Hawkins].

[14] The Treasury Department adopted this view in its explanation of regulations that were proposed in 2002. *See* 67 Fed. Reg. 76123, 76124 (Dec. 11, 2002). These regulations have been withdrawn, as discussed in the "Treasury Department" section of this report.

40,[15] and that ERISA gives standing to any plan participant, without reference to age.[16]

## Claims that Conversions Violate the ADEA

Courts have also considered whether conversions to cash balance plans violate the ADEA. Under ADEA § 4(a)(1), it is illegal for an employer to "discriminate against any individual with respect to his compensation, terms, conditions, or privileges of employment, because of such individual's age."[17] Here, the argument is that older workers fare poorly when plans convert to cash balance plans in comparison to younger workers.[18]

Under the ADEA, two types of age discrimination claims can be made: disparate treatment claims and disparate impact claims. A disparate treatment claim requires an employee to show that the employer intentionally discriminated against the employee on the basis of age. With a disparate impact claim, an employee must show that the employer's actions, while neutral on their face, actually had a disproportionate adverse impact on older workers. Disparate impact claims arise more often because of the difficulty of proving intentional discrimination by the employer in the adoption of or conversion to a cash balance plan.

**Disparate Treatment Claims.** Proponents of the discrimination claims argue that the conversion to a cash balance plan that the employer knows will treat older workers less favorably than younger workers is evidence of intentional discrimination.[19] Opponents respond that the fact employers may know that older employees will be treated less favorably under the cash balance plan is not evidence of individualized discrimination.[20] Further, opponents note that employers may refute the claim by showing there was a reasonable basis for the conversion other

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[15] ADEA § 12, 29 U.S.C. § 631.

[16] ERISA § 502, 29 U.S.C. § 1132.

[17] ADEA § 4(a)(1), 29 U.S.C. § 623(a)(1). In the context of a defined benefit plan, ADEA provides that "it shall be unlawful for an employer . . . to establish or maintain an employee pension benefit plan which requires or permits . . . in the case of a defined benefit plan, the cessation of an employee's benefit accrual, or the reduction of the rate of an employee's benefit accrual, because of age . . . ." ADEA § 4(j), 29 U.S.C. § 623(i).

[18] Not all conversions face this issue. Some plan designs avoid these problems by, for example, giving older workers the choice between continuing under the traditional defined benefit plan or switching to the cash balance plan.

[19] It is generally not debatable that employers would be and are aware of the effects of a plan conversion on older workers. In addition to the fact that the effect on older workers is commonly known, it would be expected that most employers engage in analysis of what the conversion would mean to the pension fund, the company, and the employees. Thus, it is not unexpected that employees could prove the employer knew of the conversion's effects on older employees. The issue is whether this is evidence of intentional discrimination.

[20] *See* Goldman v. First Nat'l. Bank of Boston, 985 F.2d 1113, 1119-20 (1st Cir. 1993) (holding that no inference of age bias exists based on an employer's decision to convert to a cash-balance pension plan).

than age and that there are numerous reasons for an employer to convert to a cash balance plan, including attractiveness to employees and decreased costs of administering the plan.[21]

**Disparate Impact Claims.** Proponents of the discrimination claims argue that while the conversion to a cash balance plan may be facially neutral, it has a disproportionate adverse impact on older workers. There are two primary claims. First is that older employees lose the expected benefits of the traditional plan without gaining the benefits from the new cash balance plan. The formula under a traditional defined benefit plan is weighted towards longer-serving employees so that employees accrue significant benefits in their later years of employment. Thus, older employees may have worked for years under the traditional plan with the expectation that they would accrue significant benefits in their final years. However, since benefits under a cash balance plan are accrued at a more constant rate over the employee's years of service, these employees lose the opportunity for the increased accrual. At the same time, because the older workers are near retirement, they are unable to take advantage of the compounding interest feature of the cash balance plan.

The second argument concerns the issue of "wear-away," which proponents of the discrimination claims argue disproportionately impacts older workers. Wear-away occurs when the value of the employee's accrued benefits under the traditional plan exceeds the starting balance of the hypothetical account, which is provided in the terms of the plan conversion. The employee is guaranteed the benefits that he or she accrued under the old plan. The employee will not accrue any additional benefits until he or she earns enough benefits under the cash balance plan so that the value of the hypothetical account exceeds the value of the benefits earned under the traditional plan. Thus, the level of the employee's benefits is basically frozen until that point is reached. The proponents argue that this "wear-away" hits older employees the hardest because they are more likely to have high starting balances.

There have been two primary arguments made against disparate impact claims under the ADEA, both in general and in the context of cash balance plans. First, opponents have argued that in individual cases, plaintiffs had failed to exhaust the administrative remedies, specifically, by failing to file a timely complaint with the Equal Employment Opportunity Commission (EEOC). Second, opponents have argued that the claims should be dismissed because under the ADEA it is not illegal for an employer "to take any action otherwise prohibited . . . where the differentiation is based on reasonable factors other than age . . . ."[22] In other words, the argument is that disparate impact claims cannot be brought under the ADEA. This argument was supported by the fact that, in cases not dealing with cash balance plans, the

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[21] *See* Hazen Paper Co. v. Biggins, 507 U.S. 604, 610-11 (1993) ("In a disparate treatment case, liability depends on whether the protected trait (under the ADEA, age) actually motivated the employer's decision . . . Whatever the employer's decision making process, a disparate treatment claim cannot succeed unless the employee's protected trait actually played a role in that process and had a determinative influence on the outcome . . . .").

[22] ADEA § 4(f), 29 U.S.C. § 623(f).

majority of the federal circuits that considered the issue had not recognized disparate impact claims under the ADEA.[23]

As seen in the cases discussed below, this second argument, that disparate impact claims against cash balance plans should be dismissed because such claims are not recognized under the ADEA, has been successful. However, there has been a major change in the law. In 2005, the Supreme Court held that disparate impact claims are allowed under the ADEA.[24] In *Smith v. City of Jackson*, the Court found that a salary plan which provided proportionately higher raises for employees with less work experience (who were typically younger in age) than for more experienced employees did not violate the ADEA. While the Court found that the ADEA claim failed in this instance, the Court made clear that plaintiffs are not barred under the ADEA from bringing claims under a disparate impact theory of liability. Since the *Smith* case, no case has dealt with whether a cash balance plan violates the ADEA.

# Court Cases

Several courts have considered the issue of whether cash balance plans violate the age discrimination provisions. In a case that received significant attention, *Cooper v. IBM*, a U.S. district court held that the IBM plan was discriminatory. While the court only looked at the IBM plan, it would appear that cash balance plans are inherently discriminatory under the court's reasoning. Other courts have held that cash balance plans do not violate the age discrimination provisions or have dismissed the cases on procedural grounds.

## Cooper v. IBM Pers. Pension Plan

In 1999, IBM amended its pension plan to convert it to a cash balance plan. Under the new plan, each employee's hypothetical account was credited with a pay credit equal to 5% of salary and an interest credit equal to 1% higher than the rate of return on one-year treasury securities.

In 2003, the U.S. District Court for the Southern District of Illinois held that IBM's cash balance plan violated ERISA § 204(b)(1)(H).[25] First, the court determined that "rate of benefit accrual" had to be determined with reference to an age 65 annuity. The court noted that while ERISA did not explicitly address whether an age 65 annuity should be used, the term "accrued benefit" was expressed for defined benefit plans as an age 65 annuity under ERISA § 3(23).[26] The court concluded that since a cash balance plan was a type of defined benefit plan, an age

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[23] Disparate impact claims under the ADEA were not recognized in the First, Third, Sixth, Seventh, and Eleventh Circuits, but had been recognized in the Second, Eighth, and Ninth Circuits. *See* Smith v. City of Jackson, 125 S. Ct. 1536, n.9 (2005).

[24] Smith v. City of Jackson, 125 S. Ct. 1536 (2005).

[25] Cooper v. IBM Pers. Pension Plan, 274 F. Supp. 2d 1010 (S.D. Ill. 2003).

[26] *Id*. at 1016.

65 annuity must be used to express its benefits.[27] The court, while noting that the terms "accrued benefit" in ERISA § 3(23) and "benefit accrual" in ERISA § 204(b)(1)(H) were not identical, reasoned that since the term "accrued benefit" was used in the subsection immediately prior to ERISA § 204(b)(1)(H) [ERISA § 204(b)(1)(G)],[28] "[t]he best interpretation of 'rate of benefit accrual' is that it also refers to an employer's age 65 annual benefit and the rate at which that age 65 annual benefit accrues."[29] The court stated that the use of the different terms "accrued benefit" and "benefit accrual" reflected grammatical usage — i.e., that it was grammatically correct to say "rate of benefit accrual" as opposed to "rate of accrued benefit."[30]

The court found that when the age 65 annuity was used to determine whether the rate of benefit accrual decreased on account of age, the plan violated ERISA because of the interest credit component.[31] This was because the interest credit would be more valuable to younger employees than older employees.[32] The court explained:

> IBM's own age discrimination analysis illustrates the problem: a 49 year old employee with 20 years of service accrues an age 65 annuity of $ 8,093 in the year 2000. The following year, he accrues an additional $ 622, and by 2010, his additional annual accrual is only $ 282. This 49 year old employee's benefit accrual has been reduced for each year he has aged, and this reduction violates ERISA § 204(b)(1)(H).[33]

IBM has appealed the decision to the Seventh Circuit Court of Appeals, but has also reached a partial settlement with the employees. The settlement requires IBM to pay $320 million in payments to current and former IBM employees for claims concerning retirement benefits.[34] These payments will be distributed to employees through their retirement plan as additional pension benefits. The settlement did not resolve two of the employee's claims, including the issue of whether cash balance plans are inherently age discriminatory. If the appeals court finds that IBM's plan does violate the age discrimination provisions, the settlement calls for a $1.4 billion

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[27] *Id*. at 1021.

[28] ERISA § 204(b)(1)(G) also prohibits discrimination on the basis of age. It reads, in part, "a defined benefit plan shall be treated as not satisfying the requirements . . . if the participant's accrued benefit is reduced on account of any increase in his age or service."

[29] Cooper, 274 F. Supp. 2d at 1016.

[30] *Id*. at 1016, 1022.

[31] *Id.* at 1021.

[32] *Id*.

[33] *Id.* at 1021-22.

[34] *See* David Cay Johnson, *IBM Employees Get $320 Million in Pension Suit*, N.Y. Times, Sept. 30, 2004, at A6.

cap on damages.[35] IBM has closed its cash balance plan to new hires and now offers them a 401(k) plan that matches 100% of contributions up to 6% of salary.[36] The employees who remain in the cash balance plan continue to accrue benefits at a rate of 5% of pay plus the interest credit.[37]

## Other Cases

While the district court in *Cooper v. IBM* held that the cash balance plan discriminated on the basis of age, several other courts have either held that the plans are not discriminatory or dismissed the claims for procedural reasons. While the *Cooper* case only addressed whether the plan violated the OBRA language (i.e., decreased the participant's "rate of benefit accrual" on account of age), these other cases have also examined whether the OBRA language is applicable to participants under age 65 and whether participants may bring disparate treatment or impact claims under the ADEA. The following cases are arranged chronologically.

It is important to note that these cases were all decided before the Supreme Court's recent ruling in *Smith v. City of Jackson*. To the extent that these cases are decided based on the idea that a disparate impact claim is not available under the ADEA, this reasoning is inconsistent with the *Smith* decision.

**Engers v. AT&T.** In 1997, AT&T converted its traditional defined benefits plan to a cash balance plan. Under the new plan, employees were credited with a percentage of their pay and an interest credit. Employees were assigned an initial account that in some cases was worth less than the value of the accumulated benefits under the old plan, thus creating a situation with "wear-away." Because of the change in benefit formula and the wear-away issue, the plaintiffs alleged the converted plan violated ERISA and the ADEA.

In *Engers v. AT&T*, the U.S. District Court for the District of New Jersey dismissed the plaintiffs' disparate treatment claim but allowed the claim dealing with the "rate of benefit accrual" issue to proceed.[38] First, the court dismissed the plaintiffs' claim that the conversion to the cash balance plan violated the ADEA under a disparate treatment theory. The court noted that it had dismissed the plaintiffs' disparate impact claim in their original complaint (this was the plaintiffs' amended complain) because such claims were not allowed under the ADEA.[39] The

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[35] *Id.*

[36] Tom Anderson, *IBM, SBC Retirement Plans May Give Glimpse of Future,* Employee Benefit News (2005), available at [http://www.benefitnews.com/retire/detail.cfm?id=7312] as visited on June 27, 2005.

[37] *Id.*

[38] Engers v. AT&T Corp., 2000 U.S. Dist. LEXIS 10937 (N.J. 2000).

[39] *Id.* at 17.

court then dismissed the disparate treatment claim because the plaintiffs had not alleged any factual claims of deliberate discrimination.[40]

Second, the court refused to dismiss the plaintiffs' claim that the cash balance plan violated ERISA and the ADEA because it reduced the rate of benefit accrual on account of age. The court did not rule on the substantive issue of whether the plan violated the statutory language, but rather found that the plaintiffs' claim had alleged sufficient facts to survive the motion to dismiss.[41]

**Eaton v. Onan.** The Onan Corporation had a defined benefit pension plan which it converted to a cash balance plan.[42] The cash balance formula adopted by Onan provided annual pay-based credits for each year of employment and interest credits. Pay based credits were calculated as 2.5% of an employee's eligible compensation up to the Social Security wage base, and 4.5% of compensation above the wage base. Interest credits were based on whether the employee was currently employed by Onan. Former employees received interest credits at the same rate as the average of the one-year Treasury bill and the 30-year U.S. government bond yields for the preceding fiscal year. Active employees received an interest credit rate 2.5% higher than the rate for former employees.

In an attempt to protect the rights and expectations of employees who participated in the defined benefit plan, Onan had a provision in its plan document which stated that prior accrued benefits were protected under the amended cash balance plan. Also, the cash balance plan provided optional annuities which would keep benefit amounts comparable to what employees would have been entitled to under the former defined benefit plan. Plaintiffs, employees of the Onan Corporation, claimed that the cash balance plan was age discriminatory because the cash balance plan reduced the rate of benefit accrual because of the participant's age.

The U.S. District Court for the Southern District of Indiana held that the cash balance plan did not violate the age discrimination provisions for two reasons. First, legislative history indicated that the age discrimination provisions were not intended to protect workers until after they reached normal retirement age.[43] Looking at the legislative background of OBRA, the court concluded that Congress intended the provisions "to ensure that employees who decided to work beyond normal retirement age would continue to accrue additional retirement benefits from such service."[44] Second, the court found that if the age discrimination provisions were applied to cash balance plans, the rate of benefit accrual would not depend on age.[45] The court explained that the phrase "rate of an employee's benefit accrual" did not clearly indicate that the benefit had to be measured in terms of an annual benefit beginning

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[40] *Id*. at 17-18.

[41] *Id.* at 27.

[42] Eaton v. Onan Corporation, 117 F. Supp. 2d 812 (S.D. Ind. 2000).

[43] *Id*. at 815.

[44] *Id*. at 827.

[45] *Id*. at 815-16.

at normal retirement age.[46] The court found no statutory or public policy reason for interpreting the rate of benefit accrual in terms of the value of the annuity, and after considering the legislative history of the age discrimination provisions, along with the practical effects of defining rate of benefit accrual in terms of the value of annuity at normal retirement age, the court indicated that the age discrimination provisions may permit, but do not require this standard.[47] The court also asserted that the rate of benefit accrual in the context of cash balance plans "should be the employee's cash balance account from one year to the next."[48]

**Campbell v. BankBoston.** In 1989, BankBoston converted its defined benefit plan to a cash balance plan.[49] Under the terms of the new plan, future retirement benefits would accrue under a cash balance formula, while prior accruals would remain based on the older annuity-based formula. The plan also contained a "Benefit Safeguard Minimum Benefit" provision which guaranteed long-term employees that the benefits they would receive under the new plan would be no less than the benefits they would have received under the defined benefit plan. Several years later, BankBoston switched entirely to a cash balance system and removed the benefit safeguard provision. Employees then maintained opening account balances based on the present value of their accrued benefits at the time of the switch. Campbell, an employee of BankBoston and its predecessors, claimed that BankBoston's conversion from a traditional defined benefit plan to a cash balance plan violated age discrimination provisions of both ERISA and ADEA.

BankBoston argued that Campbell's ADEA claim failed both procedurally and on the merits.[50] According to BankBoston, Campbell's claim was an adverse impact claim under the ADEA and these claims were not actionable in the First Circuit.[51] Campbell argued that there was no basis for barring his claim for procedural reasons, and that the claim should be characterized as a disparate treatment claim, since BankBoston had specifically targeted older employees when changing the benefits system.[52]

The U.S. District Court for the District of Massachusetts agreed with BankBoston that Campbell's claim was procedurally defective.[53] Even though the court did not have to continue its analysis of the case because of the procedural defects, the court chose to explain that the claim also failed on the merits.[54] The court found that no disparate impact claim was permissible based solely on the fact

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[46] *Id.* at 825.

[47] *Id*. at 827-30.

[48] *Id*. at 832-33.

[49] Campbell v. BankBoston, 206 F. Supp. 2d 70 (Mass. Dist. Ct.)(2002).

[50] *See id.* at 77.

[51] *Id*.

[52] *Id*.

[53] *Id*. at 78.

[54] *Id*.

that older workers would have less time to accrue interest on their retirement accounts than younger workers.[55] Campbell's disparate treatment claim, the court opined, failed due to the insufficiency of the evidence.[56]

The First Circuit Court of Appeals affirmed the *Campbell* decision and held that the ADEA claim was barred on procedural grounds.[57] The Court of Appeals found the claim that the cash balance plan violated the age discrimination provision of ERISA was waived since Campbell did not raise this argument before the district court.[58] Still, the Court of Appeals acknowledged that the issue would likely be adjudicated in the future and discussed the controversy.[59] The court mentioned that it was uncertain whether the age discrimination provision of ERISA applied to workers younger than normal retirement age.[60] Assuming that the provision did apply, the court brought up the opinion of critics who argued that it was unclear whether comparing the amount of the annuity workers of different ages received when they reached retirement age was the only permissible way to determine benefit accrual.[61] The court concluded that none of these issues had to be addressed in the case since the question was first raised on appeal.[62]

**Godinez v. CBS.** In 1999, CBS converted its traditional defined benefit plan to a cash balance plan. Employees who were closest to retirement were kept in the old plan, employees under the age of 41 were put in the cash balance plan, and employees who were in between the two groups were put in the cash balance plan and received transitional pay credits. Employees in this middle group sued, alleging, among other things, that the conversion had a disparate impact on them under the ADEA.

In *Godinez v. CBS Corp.*,[63] the U.S. District Court for the Central District of California found that the plaintiffs had not produced evidence to show a prima facie case of age discrimination and granted the defendants' motion for summary judgment.[64] Specifically, the court stated that the plaintiffs had not provided evidence to show the plan's negative impact on older employees or statistical

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[55] *Id*. at 78.

[56] *Id*.

[57] Campbell v. BankBoston, 327 F.3d 1 (1st Cir. 2003).

[58] *Id*. at 9.

[59] *Id*.

[60] *Id.* at 10.

[61] *Id*.

[62] *Id*.

[63] Godinez v. CBS Corp., 2002 U.S. Dist. LEXIS 27161 (C.D. Cal. 2002), *aff'd by* 81 Fed. Apx. 949 (9th Cir. 2003).

[64] *Id*. at 8-9.

evidence to show that any negative impact was due to the employee's age.[65] The court noted that, in fact, it appeared the plaintiffs were receiving better treatment than younger employees under the cash balance plan because of the transitional pay credits.[66]

The plaintiffs appealed the decision to the U.S. Court of Appeals for the Ninth Circuit. In an unpublished decision, the court affirmed the district court's decision.[67]

**Tootle v. ARINC.** In 1999, ARINC converted its traditional defined benefit plan to a cash balance plan. Under the plan, the pay credit increased according to the employee's age (e.g., employees under age 25 received a 3% pay credit while those over age 60 received a 16% pay credit). Employees were credited with a lump sum representing the value of their accrued benefits under the old plan. Additionally, employees were credited with transition credits that were structured to be more favorable to older employees. Employees who had vested in the prior plan and were either at least 55 years old or had 25 years of service in the plan were allowed to choose whether to continue under the traditional plan or switch to the cash balance. All other employees were required to switch to the cash balance plan.

Tootle qualified to choose between plans and chose to switch to the cash balance plan. He was terminated in 2002 and took a lump-sum distribution of his accrued benefits. This amount was approximately $14,000 more than his benefits would have been if he had remained under the old plan. Most of this increase was due to the transition credit.

After his termination, Tootle sued, alleging various claims of age discrimination. In *Tootle v. ARINC, Inc*., he sought class certification for several claims, including the claim that the conversion to the cash balance plan was discriminatory because it favored younger workers.[68] It appears he had originally made this claim under the ADEA, and it had been dismissed because he had not filed a complaint with the EEOC.[69] He then amended his complaint to make the claim under ERISA. This case considered the amended complaint.

The U.S. District Court for the District of Maryland denied the motion for class certification and dismissed the amended complaint for failure to state a claim upon which relief can be granted. The court began by looking at the different conclusions that the courts in *Cooper*, *Eaton*, and *Campbell* had reached on whether cash balance plans caused a decrease in the "rate of benefit accrual" and said that it agreed with the *Eaton* analysis.[70] First, the court agreed with the *Eaton* court that the ERISA

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[65] *Id*. at 7.

[66] *Id*. at 7-8.

[67] Godinez v. CBS Corp., 81 Fed. Appx. 949 (9th Cir. 2003).

[68] Tootle v. ARINC Inc., 222 F.R.D. 88 (D. Md. 2004).

[69] *Id*. at 91.

[70] *Id*. at 93.

provision was not applicable to individuals younger than normal retirement age.[71] For support, the court noted that the "beyond normal retirement age" statutory headings in the IRC and the OBRA language's legislative history.[72] The court went on to say that even if the provision did apply, it did not make sense to use an age 65 annuity for determining the rate of benefit accrual for cash balance plans because this did not take into account the way that the plans are structured.[73] The court noted that doing so could lead to illogical results, such as in this case where the plan was actually structured to favor older workers.[74] Instead, the court stated it made more sense to look at how defined contribution plans were tested for age discrimination and then use a similar testing method for cash balance plans.[75] The court looked at the rate that amounts were allocated to the cash balance account and how the account balance changed over time.[76] Using that method, the court found that the ARINC plan did not violate the age discrimination provisions.[77]

**Register v. PNC Financial Services Group.** In January 1999, PNC Financial Services Group converted its traditional defined benefit plan to a cash balance plan. Under the cash balance formula, employees' accounts were credited with pay credits that were weighted towards age and length of service and interest credits based on the 30-year Treasury rate. Some employees also received transitional earning credits. At the conversion, some employees, depending on the value of their opening account balances, were subject to "wear-away." Employees filed suit against PNC in which they alleged, among other things, that the conversion violated the age discrimination provision in ERISA § 204(b)(1)(H).

In November 2005, the U.S. District Court for the Eastern District of Pennsylvania granted the defendants' motion to dismiss for failure to state a claim.[78] The court looked at the *Eaton*, *Campbell*, *Cooper*, and *Tootle* cases, and decided it agreed with part of the *Eaton's* court analysis.[79] Specifically, the court found that ERISA did not require the phrase "rate of employee's benefit accrual" be defined in terms of an age 65 annuity.[80] The court then reasoned that since traditional defined benefit plans are defined in terms of an age 65 annuity and the rate of benefit accrual for those plans is the change in the annuity, it made sense for the rate of benefit accrual in a cash balance plan to be the change in the account balance since cash

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[71] *Id*.

[72] *Id*.

[73] *Id*. at 93-94.

[74] *Id*. at 94.

[75] *Id*. at 93-94.

[76] *Id*. at 94.

[77] *Id*.

[78] Register v. PNC Financial Services Group, Inc., 2005 U.S. Dist. LEXIS 29678 (E.D. Pa. 2005).

[79] *Id*. at 21.

[80] *Id*.

balance plans are defined in terms of the cash balance account[81] The court found support for its interpretation in the OBRA conference report, which used the word "accrued" to mean "earned," and in statements by the Treasury Department, including the preamble to the 2002 regulations and recent revenue proposals (both are discussed below in the "Treasury Department" section), that the plans are not inherently age discriminatory.[82] Using this analysis, the court found that the PNC plan was not discriminatory.[83]

## Treasury Department

**Moratorium.** In 1999, the Department of the Treasury responded to the growing controversy over cash balance plans by placing a moratorium on approving the plans as meeting ERISA and IRC requirements. It is still in effect.

**Treasury Regulations.** In December 2002, the Treasury Department proposed regulations that would, among other things, address the age discrimination issue.[84] Under the proposed regulations, cash balance plans would not have been discriminatory so long the pay credits for older workers were at least equal to those for younger workers. Additionally, a conversion to a cash balance plan would not have been discriminatory so long as the conversion either did not result in wear-away (i.e., the employee's benefit under the plan was not less than the sum of his or her accrued benefits under the traditional plan plus the cash balance account) or the employee's opening account balance was not less than the actuarial present value of his or her accrued benefit under the traditional plan, using reasonable actuarial assumptions. In 2004, the Treasury Department withdrew the regulations in response to congressional activity, which is discussed below in the "Legislation" section.[85]

**Treasury Proposal.** Also in 2004, the Treasury Department announced a legislative proposal that addresses the issue of cash balance plans.[86] For purposes of this report, the proposal does two things. First, it would clarify that a cash balance plan does not violate the age discrimination provisions if the pay credits for older employees are at least equal to those for younger employees.

Second, it would address some of the reasons why conversions are said to disproportionately harm older workers. First, it would create a five year "hold harmless" period. This means that for the first five years after a conversion, the benefits earned under the cash balance plan would have to at least equal the benefits that would have been earned under the old plan. Second, the proposal would prohibit wear-away of normal or early retirement benefits, either during or after the five year

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[81] *Id*. at 22-23.

[82] *Id*. at 23-26.

[83] *Id*. at 26.

[84] 67 Fed. Reg. 76123 (Dec. 11, 2002).

[85] IRS Announcement 2004-57 (June 15, 2004).

[86] Treasury Department Press Release JS-1132 (Feb. 2, 2004), which is available at [http://www.treas.gov/press/releases/js1132.htm].

"hold harmless" period. A plan that violated either provision would be subject to a penalty tax that would equal 100% of the difference between the benefits required under the proposal and the benefits actually provided. The tax would be limited to the greater of the plan's surplus assets at the conversion or the plan sponsor's taxable income. There would be no penalty if participants were given a choice between the two plans or if current participants were grandfathered under the old plan's formula.

The proposal would apply prospectively and would not be intended to create an inference as to the status of cash balance plans or conversions under current law.

The proposal has been included in the revenue provisions of the Administration's budget proposals for fiscal years 2005 and 2006.[87] For FY2006, it is estimated that the changes would increase revenue by $1,096,000 between 2006 and 2015.

# Summary of Current Law

Currently, the question of whether cash balance plans are inherently age discriminatory remains unanswered. While a few courts have found cash balance plans not to violate the age discrimination provisions of ERISA, the IRC, and the ADEA, one district court has concluded to the contrary. Proposed regulations concerning cash balance plans were introduced but have been withdrawn, and the Department of Treasury's moratorium on approving cash balance plans remains in effect.

# Legislation

## Prior Congresses

In the 107th and 108th Congresses, several measures were introduced that addressed the issue of cash balance plans and age discrimination. This section will discuss only those provisions that passed the House and/or Senate.

**107th Congress.** In 2001, the House passed the Comprehensive Retirement Security and Pension Reform Act of 2001 (H.R. 10) that included a provision that would have required the Treasury Department to prepare a report that examined the effects of conversions of traditional defined benefit plans to hybrid plans, including the effects on older employees. The bill passed by a vote of 407 to 24 (Roll Call 96, 107th Cong. 1st Sess.). The Senate passed a version of H.R. 10 that was markedly different from the House version and did not include the cash balance provision.

In 2002, Representative Sanders introduced an amendment to the Treasury and General Government Appropriations Act, 2003 (H.R. 5120, 107th Congress) that said:

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[87] The proposal for FY2006, found in the *General Explanations of the Administration's Fiscal Year 2006 Revenue Proposals* on pages 81-84, is available at [http://www.treas.gov/offices/tax-policy/library/bluebk05.pdf].

> None of the funds appropriated by any Act may be used by the Internal Revenue Service for any activity that is in contravention of Internal Revenue Service Notice 96-8 issued on January 18, 1996, section 411(b)(1)(H)(i) or section 411(d)(6) of the Internal Revenue Code of 1986, section 204(b)(1)(G) or 204(b)(1)(H)(i) of the Employee Retirement Income Security Act of 1974, or section 4(i)(1)(A) of the Age Discrimination in Employment Act of 1967.

The amendment was approved by a vote of 308-121 (Roll Call 339, 107th Cong. 1st Sess.). The provision was not included in the final appropriations bill.

**108th Congress.** In 2003, shortly after the *Cooper v. IBM* decision, Representative Sanders introduced an amendment to the Transportation, Treasury, and Independent Agencies Appropriations Act, 2004 (H.R. 2989, 108th Congress) that said:

> None of the funds appropriated by this Act may be used to assist in overturning the judicial ruling contained in the Memorandum and Order of the United States District Court for the Southern District of Illinois entered on July 31, 2003, in the action entitled Kathi Cooper, Beth Harrington, and Matthew Hillesheim, Individually and on Behalf of All Those Similarly Situated vs. IBM Personal Pension Plan and IBM Corporation (Civil No. 99-829-GPM).

The amendment was approved by a vote of 258 to 160 (Roll Call 485, 108th Cong. 1st Sess.). The Senate later approved a similar amendment to its version of H.R. 2989 by voice vote. That amendment was introduced by Senator Harkin and it said:

> None of the funds made available in this Act may be used by the Secretary of the Treasury or his delegate to issue any rule or regulation which implements the proposed amendments to Internal Revenue Service regulations set forth in REG-209500-86 and REG-164464-02, filed December 10, 2002, or any amendments reaching results similar to such proposed amendments.

In conference, the amendment was changed to:

> Within one hundred and eighty days of enactment, the Secretary of the Treasury shall present to the Congress a proposal for legislation which would provide transition relief for older and longer-service participants affected by conversions of their employers' traditional pension plans to cash balance pension plans: Provided, That none of the funds made available in this Act may be used by the Secretary of the Treasury, or his designee, to issue any rule or regulation which implements the proposed amendments to Internal Revenue Service regulations set forth in REG-209500-86 and REG-164464-02, or any amendments reaching results similar to such proposed amendments.

H.R. 2989 was then incorporated into the Consolidated Appropriations bill, H.R. 2673 (108th Congress). The House approved H.R. 2673 by a vote of 242 to 176 (Roll Call 676, 108th Cong. 1st Sess.) and the Senate approved it by a vote of 65-28 (Roll Call 3, 108th Cong. 2nd Sess.).

In 2004, Representative Sanders introduced an amendment to the Treasury appropriations bill (H.R. 5025, 108th Congress) that related to cash balance plans and the *Cooper* decision. It read:

> None of the funds appropriated by this Act may be used to assist in overturning the judicial ruling contained in the Memorandum and Order of the United States District Court for the Southern District of Illinois entered on July 31, 2003, in the action entitled Kathi Cooper, Beth Harrington, and Matthew Hillesheim, Individually and on Behalf of All Those Similarly Situated vs. IBM Personal Pension Plan and IBM Corporation (Civil No. 99-829-GPM).

The amendment was approved by a vote of 237-162 (Roll Call 458, 108th Cong., 2nd Sess.). The provision was not included in the final appropriations bill.

## 109th Congress: Selected Bills

**H.R. 2830.** The Pension Protection Act of 2005 was approved by the House Education and the Workforce Committee on June 30, 2005.[88] The act would establish an age discrimination standard for defined benefit plans and revise the existing age discrimination provisions of ERISA and the IRC. More specifically, the act states that a plan would not be considered age discriminatory if a participant's entire accrued benefit, as determined under the plan's formula, was at least equal to that of any similarly situated, younger individual. The act would define "similarly situated" to mean an individual that is identical to the participant in every respect, including length of service, compensation, position and work history, except for age. The act also includes a provision which states that a plan would still comply with the age discrimination standard even if it allowed for pre-retirement indexing of accrued benefits (pre-retirement indexing provides for adjustments in accrued benefit based on an index or methodology which protects the value of benefits against inflation). The provisions would apply prospectively.

**S. 1783.** The Pension Security and Transparency Act of 2005 was introduced on September 28, 2005, as a compromise between the bills approved by the Senate Finance Committee (S. 219, National Employee Savings and Trust Equity Guarantee Act of 2005) and the Senate Health, Education, Labor and Pensions Committee (the Defined Benefit Security Act, number unavailable).[89] Under the bill, a cash balance plan would not be discriminatory so long as the rate of pay or interest credits did not decrease because of the participant's attainment of any age. The provision would be effective for periods after July 31, 2005.

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[88] For a general description of the act, see CRS Report RS22179, *H.R. 2830: The Pension Protection Act of 2005*, by Patrick Purcell.

[89] For a general discussion of the act, see CRS Report RS22221, *S. 1783: The Pension Security and Transparency Act of 2005*, by Patrick Purcell.