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## U.S. BUSINESS NEWS

# Pension Rulings Roil Hundreds of Businesses

## Companies Seek U.S. Role In Cash-Balance Plans

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Two landmark court rulings against companies that sought to profit by revising employees' pension plans have unsettled hundreds of companies that have adopted similar programs and are likely to force Congress and the Treasury Department to decide how to regulate so-called cash-balance pension plans.

The separate rulings, against **International Business Machines Corp.** and **Xerox Corp.**, sliced through the arcana of pension rules to conclude that cash-balance plans discriminate against older workers, cut older workers' benefits and serve to lower the costs and bolster the profits of employers that use them.

In the rulings, a federal court decided Thursday that IBM discriminated against older workers when it changed to a cash-balance plan in 1999, a decision that potentially could require IBM to recalculate benefits for 130,000 employees and retirees. On Friday, an appeals court found that Xerox had miscalculated pension payouts in its cash-balance plan, and the company will have to pay more than \$270 million to 13,000 former employees whose employment ended between 1990 and 2000.

Cash-balance pension plans have been substituted for traditional pension plans at hundreds of U.S. companies, which benefit in several ways.

First, rather than paying a pension based on a worker's years of service and final salary, which provides a pension that increases rapidly in value in the later years on the job, cash-balance plans use a formula that has the appearance of a retirement account. They give each worker a hypothetical "account," into which the company places credits of, say, 2% to 5% of salary a year, plus interest. One effect of the shift in plans was to immediately lower pensions for people in their 40s and older who have many years at a company.

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Another benefit to companies was to give a lift to their earnings. Because the amount the companies faced in future pension liabilities would drop, their current costs also would fall and the pension plans would send pension "income" to the bottom line.

The judges in both of last week's cases refuted a key defense of employers, that cash-balance plans aren't pension plans that should be subject to the usual pension regulations because they are "hybrids" that are modeled on 401(k) plans controlled by employees. No dice, said Judge Richard Posner, one of the three-member panel in the Seventh Circuit Court of Appeals that decided against Xerox: "For 'hybrid,' " he wrote, "read 'unlawful.' "

Xerox says it will ask for a rehearing. IBM says it will appeal, and in a news release, J. Randall MacDonald, IBM's senior vice president of human resources, said, "This is a situation where a few have spoiled it for millions of U.S. workers."

The Erisa Industry Committee, an employer group that lobbies on pension issues, derided the decision, as did benefits-consulting firm Watson Wyatt Worldwide. "This is the sad result of a tort system that allows plaintiffs to jurisdiction-shop," noted Eric Lofgren, global director of the benefits consulting group, in a press release. The statement doesn't disclose that Watson Wyatt is IBM's actuary, and has designed and implemented cash-balance and other hybrid plans for many companies, including IBM.

Employers have reason to be uneasy. Xerox is the third appeals-court decision involving lump-sum payouts from cash-balance plans to be decided in favor of employees. Xerox lost in the U.S. District Court for the Southern District of Illinois, and lost again on appeal in the Seventh Circuit, based in Chicago, last week. In 2000, **Georgia-Pacific Corp.**, which won in the district court in Atlanta, lost on appeal in the 11th Circuit in Atlanta, while Bank of Boston, now part of **FleetBoston Financial Corp.**, which won in the lower court in Vermont, lost on appeal in the Second Circuit, in New York.

Also troubling to employers is that IBM's appeal will be heard in the Seventh Circuit, where it may be decided by one or more of the judges who just ruled against Xerox on appeal. These include Judge Posner, a highly regarded judge whose opinions have been cited by the Supreme Court, and a prolific writer of Erisa decisions that have had substantial impact. Erisa is the Employee Retirement Income Security Act, a 1974 law designed to protect employee benefits.

Now that the courts are looking more iffy for employers, companies are pressuring the Treasury to issue final regulations on cash-balance plans that say cash-balance plans aren't inherently age discriminatory, a position that would support their positions in court cases. In December, the Treasury indicated in its proposed regulations that it didn't think cash-balance plans were inherently discriminatory.

With the courts going one way, and the Treasury possibly going another, some say that the only way that the cash-balance controversy will be resolved is if Congress steps in and lays down some new laws.

### **Crafting a Middle Ground**

"There is a rational middle ground, and it's time for Congress to stake it out," says J. Mark Iwry, a senior fellow at the Brookings Institution and a former benefits tax counsel at the Treasury. "Congress can craft a balanced solution that permits cash-balance plans on condition that they reasonably protect older workers in the conversion" to cash-balance from traditional pensions, he says. "The solution should give employers

reasonable flexibility to choose how, but not whether, to provide fair protection."

Employers and benefits consultants want Congress to validate cash-balance plans just the way they are. If it doesn't, they say, employers will pull the plug and "offer their employees only a 401(k) plan," as Watson Wyatt warned.

That isn't likely, however, because pension plans are so valuable to employers. That may sound unlikely, especially at a time when there is so much discussion about underfunded pension plans, but except for the sickest kittens in the steel and auto industries, pension programs are valuable to companies, even if they are underfunded. Accounting rules allow employers to use hypothetical asset returns to smooth earnings, and companies have used the plans to shed older workers less expensively, among other things.

Indeed, last week's decision in the IBM case illustrated how valuable pension plans can be. Although employers for years have insisted that cash balance plans don't save them money, that assertion was skewered by Judge C. Patrick Murphy, the district court judge who noted, "Astonishingly, plan income was over \$1 billion in 2001, and this accounted for 13% of IBM's overall net income."

### **Age-Discrimination Issues**

The IBM decision also made it clear that the savings come from cutting benefits for older workers. Judge Murphy noted that the 1999 pension change reduced future benefits for older IBM employees by as much as 47%. And in another example, he noted that an employee at IBM working from age 35 to age 50, earning \$60,000, would end up with an annual benefit of \$15,111, while an employee with the same salary, but working from age 50 to 65, would end up with a benefit of only \$13,189.

"IBM was aware of the age-discrimination issues that would come with the new" cash-balance formula ... and "IBM, like many other corporate plan sponsors, proceeded with open eyes and was fully informed of the consequences of the litigation that was sure to come," Judge Murphy noted.

Employers have always known that cash-balance plans violate age-discrimination rules in pension law, but have been comforted by the fact that the Internal Revenue Service has never issued final regulations on cash-balance plans that decide, one way or another, whether these plans are exempt from the rules.

### **Incentive to Cut Pensions**

Throughout the 1990s, companies adopted cash-balance plans because they were a valuable way to boost earnings. With the aid of consulting firms, employers increasingly understood that pension accounting rules reward companies that cut pensions. That is because when the return on pension assets is greater than the annual cost of the benefits, the excess is reported as income, almost as though it were profit from goods and services. Thus, companies had an incentive to cut pension benefits, even though their pension plans were robustly overfunded.

While any kind of pension cut can achieve this result, cash-balance plans were one of the most popular ways to cut pensions, because benefits and costs could be reduced, beyond the simple cost of future payouts being lower.

After a conversion, for instance, older workers often stop building benefits for months or years, a

phenomenon called "wearaway," because employers established "opening account balances" that were of lower value than what the employees had earned. If someone's pension were valued at \$100,000 had it been converted to an immediate cash payment, for example, a company might establish an opening balance at \$80,000. The employee then would have to wait until his annual pay credits and interest built back up to \$100,000 until he actually began building a new benefit. In contrast, a new or young worker would begin to build a balance right away.

Another reason employers liked cash-balance plans was that employees could rarely tell that their pensions were being cut. That changed in 1999 when IBM employees noticed, and sued.

In recent testimony to the House committee on education and work force, Mr. Iwry, the Brookings fellow, responded to congressional questions about a possible legislative solution. He suggested that, in addition to prohibiting "wearaway," employers converting to cash balance be given the option of choosing among several additional means of protecting older workers, including providing them with higher pay credits or additional opening balances, giving certain groups the greater of the old and new plan formulas, and "grandfathering" people close to retirement, or for a period of years.

While none of these solutions would prevent employers from reducing the benefits of older workers, when the dust settles, it is likely that employers still will be allowed to switch to cash-balance plans, but will have to take greater steps to protect older workers when they make these pension changes, and as a result won't save as much money.

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