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JUNE 2008

The U.S. Supreme Court in *Kentucky Retirement Income Systems v. EEOC*, found that a pension plan designed to increase disabled public safety workers' pensions to the level they would have attained at normal retirement age, even though it meant that workers who became disabled after reaching retirement age would not receive any pension increase, did not violate the ADEA.

## Supreme Court Charts New Course in Pension Plan Case Interpreting ADEA

By Susan Katz Hoffman

In *Kentucky Retirement Income Systems v. Equal Employment Opportunity Commission*, No. 06-1037 (June 19, 2008), the United States Supreme Court interpreted the Age Discrimination in Employment Act (ADEA) to permit Kentucky to increase disabled public safety workers' pensions to the level they would have attained at normal retirement age, even though that meant workers who became disabled *after* reaching retirement age would not receive any pension increase. In a 5-4 decision,<sup>1</sup> the Court rejected the position of the EEOC that the pension design discriminated on account of age unless the state could show an equal-cost justification for the difference in benefits received by two employees with equal pay and service but different ages.

### Application of the OWBPA and ADEA to Pension Plan

The case presented the Court with its first opportunity to address the impact of the Older Workers Benefit Protection Act (OWBPA) amendments to the ADEA on pension plan design. The OWBPA amendments had been adopted after the Court had held that the ADEA did not prohibit discrimination in the provision of employee benefit plans so long as the plans were not a "subterfuge" adopted for the purpose of evading the ADEA. The OWBPA amendments eliminated the "subterfuge" test, substituting a provision that discrimination in employee benefits violates the ADEA unless the discrimination is justified by equal cost or equal benefits (language used by prior EEOC regulations). The OWBPA amendments also provided various safe harbors and alternatives (such as certain voluntary retirement incentive programs) that were not at issue in this case. But the Court sidestepped this opportunity, holding instead that the EEOC had failed

to prove that the pension design produced a distinction in benefits "on account of age" rather than on account of retirement eligibility, and therefore, failed a threshold test necessary before any of the specific OWBPA benefit provisions would be relevant.

The Kentucky plan for public safety workers, like many state plans, provides for normal retirement benefits to begin at any time after the worker attains either age 55 or 20 years of service. If the worker becomes disabled before attaining eligibility, the pension will be calculated by adding enough years to reach eligibility (but not more than the accrued years of service).<sup>2</sup> The EEOC took the position that this design would be lawful only if cost-justified, based on a provision in its compliance manual that benefits are not equal if the plan reduces or eliminates benefits based on a criterion that is explicitly defined (in whole or in part) by age. The manual also specifically stated that basing disability retirement benefits on years remaining to normal retirement age gives more constructive service to younger employees, and therefore, violates the ADEA.

The Court refused to grant full deference to the EEOC's position in its compliance manual, because it did not carry the weight of a regulation. Rather, the Court relied on an earlier case, *Hazen Paper Co. v. Biggins*, 507 U.S. 604 (1993), in which the Court held that an employer did not violate the ADEA by firing an employee shortly before vesting in his pension, because discrimination based on pension status is not necessarily discrimination based on age. In that case, the Court stated that the plaintiff would have to show that age "actually motivated the employer's decision." Because the alleged discrimination was based on years of service, the plaintiff had no case under ADEA, unless

he could show that pension status served as a proxy for age. Applying this principle to Kentucky's pension plan design, the Court found that because pension eligibility also arose after 20 years of service (as well as attainment of age 55 with 5 years of service), pension eligibility was not a proxy for age (particularly where the ADEA specifically permits pension eligibility to be based on age). The Court also considered various circumstances that led it to the conclusion that the differences in pension benefits were not "actually motivated" by age:

- An employee working past normal retirement age does not receive a pension until he retires - so the receipt of the pension is not based on age but on retirement status.
- The ADEA treats pensions "more flexibly and leniently in respect to age."
- The Social Security system and a former federal pension system similarly impute years of service only to younger disabled workers.
- The imputed service rules clearly track the normal retirement rules, so that the purpose is to treat all disabled employees as if they became disabled after, not before, they were eligible for retirement benefits, rather than with regard to their ages at disablement.
- In some cases, a younger worker with more service would receive fewer imputed years than an older worker, because of the 20-year eligibility rule.
- The system does not rely on any stereotypical assumptions about the work capacity of older workers relative to younger workers, even though it assumes that all disabled workers would have worked until (but not beyond) the point they become eligible for a pension.

Finally, the Court found relevant that if the EEOC's position were to be upheld, the resolution would not be to increase benefits for disabled older workers, but more likely to cut back benefits for disabled younger workers.

## What Are the Implications of this Decision for the Average Employer's Pension Plan?

Most private sector pension plans approach disability benefits in one of two ways. Where the employer does not otherwise provide long-term disability benefits, the plan may provide an immediately-payable, often unreduced, benefit. Although this benefit has a greater value for employees who are younger at the age of disability onset, this design generally will satisfy one of the ADEA safe harbors (the difference with the Kentucky plan is that Kentucky also enhanced the benefit amount by the years remaining to retirement age). Where the employer does provide long-term disability benefits, the plan may provide for continued accrual of vesting service and/or pension service until actual retirement. This latter design is similar to the Kentucky design, but will generally not lead to the same EEOC challenge because pension onset is delayed until actual retirement (in Kentucky, the pension was payable immediately upon disability). Thus, neither private pension design is likely to give rise to similar concerns.

Where private sector benefit plans do begin to resemble the Kentucky plan at issue is in the design of certain early retirement incentive programs. While there is a safe harbor for defined benefit plan programs that provide unreduced benefits to normal retirement age, that safe harbor does not apply to defined contribution plans or severance benefit plans. And the EEOC's interpretation of the alternative "Voluntary Early Retirement Incentive Plan" safe harbor (VERIP) is so narrow that the EEOC will routinely challenge a severance plan design that, for example, offers to pay a severance plan based on the years remaining until attainment of normal retirement age. It is uncertain whether the Court's interpretation of the ADEA in the *Kentucky* decision would apply in these severance benefit situations.

It appears that the existence of the alternative 20-year eligibility rule may have been crucial to the Court's decision, so that the outcome may not provide carte blanche for all pension-eligibility-related discrimination, where

pension eligibility is based solely on attained age. But where the normal retirement or early retirement eligibility includes a years of service component (without age), the case becomes closer to the *Kentucky* analysis.

Another open question is whether the *Kentucky* decision calls into question the EEOC's position on reduction or elimination of disability benefit payments for employees who become disabled after normal retirement age. Under the EEOC's current guidance, a long-term disability plan must provide actuarial justification for reducing the duration of benefits for older employees. Similar rules apply to reductions in life insurance benefit amounts for older employees.

Finally, the *Kentucky* decision appears to undercut the rationale adopted by the Third Circuit Court of Appeals in the famous *Erie County Retiree Association v. County of Erie*, 220 F.3d 193 (3rd Cir. 2000), case involving retiree medical benefits, where the defendant provided lesser benefits to retirees who were Medicare-eligible, arguing that because some retirees became Medicare-eligible before age 65 (on account of disability), the distinction was not based on age. In that case, the Third Circuit found that Medicare eligibility was a proxy for age, but as in *Kentucky*, the existence of an alternative eligibility rule might now be sufficient to permit a distinction. Note, of course, that the EEOC has finalized a waiver of the ADEA rules for medical plans, allowing them to consider Medicare eligibility, but the waiver applies only to medical plans - not life insurance or other benefit plans.

So, as is often the case, this Supreme Court decision may well have cleared up one disputed issue, but has raised a host of new issues to be worked out in the courts below.

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<sup>1</sup> The dissent brought together the unusual coalition of Justices Kennedy, Scalia, Ginsburg, and Alito.

<sup>2</sup> So if a 45-year-old with 10 years of service became disabled, his pension would be based on 20 years of service (enough extra service to get him either to age 55 or 20 years of service, but not more than his already-accrued 10 years). But if a 55-year-old with 10 years of service became disabled, his pension would be based on only 10 years of service because he was already retirement-eligible - so his pension would be half the size of the younger worker's pension.