Employee Benefits and City Budgets:

Can The Planets Align?

Presentation to the

League of California Cities City Attorneys Department

Spring Conference Santa Barbara, California

May 6, 2010

Ву

Jeffrey C. Chang, Esq.

JCC@seethebenefits.com

I. Introduction

California cities and public agencies facing severe budget crises must examine all alternatives available to them for cutting current costs and controlling future expenses – including general employee benefit costs, pension costs and costs for providing retiree health benefits.

In this paper we will:

- Discuss the differences in perspective between cities and their employee groups with respect to benefits issues and look at what could happen if nothing is done to reconcile these views;
- Provide some legal and historical background on the "impairment of contract" doctrine in California as it relates to public employees' benefits;
- Discuss a number of ways in which cities can modify and reduce their short term and long-term employee benefit costs; and
- Explain why it makes sense for cities and their employees to collaborate in making necessary and responsible benefit changes rather than engaging in brinksmanship over these issues.

II. The Differences in Perspective; What Could Happen in 2012

After several years of budget and cost cutting, the "low-hanging" fruit options are all picked over. State and local governments are being forced to look at one of their highest expenses – pension and retiree health benefits. Last summer, CalPERS' chief actuary admitted, "We are facing . . . decades of . . . unsustainable pension costs of between 25 percent of pay for a miscellaneous plan and 40 to 50 percent of pay for a public safety plan." In February of this year, the Pew Center on the States issued a report stating that, "as of the middle of 2008, there was a \$1 trillion gap" between what the states owed for retirement benefits and what they had set aside. Of course, this number would be even worse if the market losses of late '08 and early '09 were factored in. Looking again at California, the State's unfunded OPEB liability as of last June was in excess of \$50 billion.

Many of these are the same fiscal issues that forced the City of Vallejo to declare bankruptcy in 2008: employee salaries, benefits and retirement packages. At the time, the city's bankruptcy attorney commented that, "Vallejo is not the only city in California or the U.S. that

is saddled with employee contracts that are burdensome." For more on this, see *In re: City Of Vallejo*ⁱ.

But for those California cities facing the same threat as Vallejo, the prospect of aligning pension and retiree health benefits with fiscal realities quickly turns on the question of the cities' understanding of their cost-cutting options and unions' willingness to come to the table. On one hand, cities may not appreciate the extent to which they can make necessary benefit reductions. On the other hand, the unions may not understand that the cities have options — a number of which can be exercised unilaterally. Although the applicable case law has been "popularly" misunderstood for a number of years, cities actually have significant legal basis for modifying or reducing pension and retiree health benefits. The question then becomes one of how to educate the unions on the city's options, which range from reasonable and sustainable structural changes to their benefit programs all the way to contracts voided by municipal bankruptcy.

Much of the confusion over the rights of public employees to retirement benefits stems, in our view, from the way in which the California courts have described these rights. For example, in San Bernardino Public Employees Association v. City of Fontanaii, the Court of Appeal quoted Kern v. City of Long Beachiii stating, "[w]hile payment of these benefits is deferred, and is subject to the condition that the employee continue to serve for the period required by the statute, the mere fact that performance is in whole or in part dependent upon certain contingencies does not prevent a contract from arising, and the employing governmental body may not deny or impair the contingent liability any more than it can refuse to make the salary payments which are The clear implication of this language is a immediately due." governmental body cannot modify or reduce a promised pension or retirement benefit without running afoul of the prohibition against impairment of contract. During the course of our discussion, we plan to share our views on this and explain why we believe local governments actually have considerably more latitude to change retirement benefits.

- III. General Legal Principles Governing the Modification or Reduction of Public Agency Benefits
 - A. Modifying or Reducing a Public Employee Benefit Plan May Constitute a Prohibited Impairment of Contract

Under article I, section 9 of the California Constitution, a law impairing the obligations of contracts may not be passed. Similarly, article I, section 10, clause 1 of the Constitution of the

United States, among other things, provides "No state shall ... pass any ... law impairing the obligation of contracts,"

A state may no more impair the obligation of its own contracts than impair the obligation of the contracts of individuals.

A number of public employee organizations and individual public employees have aggressively, and understandably, litigated the impairment issue so as to create a general impression that pension and post-employment benefits of practically every sort cannot be changed, reduced or eliminated. However, a close reading of the pertinent cases suggests that a public employee's right to a pension benefit is not inviolate, but may be changed or even eliminated under the appropriate circumstances.

B. A Closer Look at Kern v. City of Long Beach

One of the leading and oft-cited cases is *Kern*. Let's take a closer look at what *Kern* said.

Kern was a 1947 California Supreme Court decision and involved an action by a retiring firefighter (Kern) against the City of Long Beach. In essence, the City rejected Kern's application for retirement benefits following his attainment of eligibility for retirement benefits on the grounds that the pension benefits pertaining to his years of service for the City and set forth in the City's charter had been eliminated by charter amendment some 32 days before he completed the required 20 years of service. The question before the California Supreme Court was "whether petitioner acquired a vested right to a pension which the city could not abrogate by repealing the charter provisions without impairing its obligation of contract." All of you are familiar with the legal adage, "bad facts make for bad law." As one can see, these were not very good facts – at least for the City of Long Beach.

1. Pro-Employee Points

In concluding that the petitioner had a vested pension right and that the city, by completely repealing all pension provisions, had attempted to impair its contractual obligations, the court found:

a. In California, pensions for public employees are more than a mere gratuity.

- b. Pension rights acquired by public employees under statutes similar to the Long Beach Charter become vested as to each employee at least on the happening of the contingency upon which the pension becomes payable.
- c. Moreover, an employee has actually earned some pension rights as soon as he has performed substantial services for his employer.
- d. The payment of pension benefits, while contingent upon the performance of services required to earn the benefits, could not be rejected once all contingencies had happened.
- e. A city cannot deny or impair the contingent liability (to provide a pension) after the contractual duty to make salary payments has arisen.

2. Pro-Employer Points

Despite the various pro-employee determinations that can be found in *Kern*, there are several important pro-employer aspects of the case:

- a. Kern involved an attempt by a city to deprive an employee of all benefits under a pension program. Kern did **not** involve an attempt to reduce, but to totally eliminate, pension benefits.
- b. The court recognized that "the rule permitting modifications of pensions is a necessary one since pension systems must be kept flexible to permit adjustments in accord with changing conditions and at the same time maintain the integrity of the system and carry out its beneficent policy."
- c. Overall, an employee may acquire a vested contractual right to a pension, but that right is not rigidly fixed by the terms of the legislation (i.e., charter) at any particular time, and is subject to the implied qualification the governing body may make modifications and changes in the system.

- d. The employee does not have a right to any fixed or definite benefits, but only to a substantial or reasonable pension.
- e. There is nothing inconsistent about conferring a vested right to a pension, but at the same time holding that the amount, terms and conditions of the benefits may be altered.

C. The Progeny of Kern

Of course the law in this area has not remained static. The legal principles expressed in *Kern* have been expanded:

1. An interesting expansion of Kern can be traced to the California Supreme Court decision in Allen v. City of Long Beach^v. Allen was a case involving police and firefighters who had been employed by the City of Long Beach at the time it amended its charter to eliminate substantially all pension benefits. Although Kern held that this action by the City was invalid and did not apply to persons employed before March 29, 1945, Allen involved a challenge to a 1951 amendment of the City's charter and police and fire pension system that would have increased the employees' rate of contribution, moved from a final pay to a five-year final average pay formula, and require contributions to the system for periods of military leave. A somewhat disconcerting aspect of Allen is that, in its attempts to explain what might constitute a "reasonable" modification of a pension system, it stated: "... alterations of employees' pension rights must bear some material relationship to the theory of a pension system and its successful operations, and changes ... which result in disadvantage to employees should be accompanied by comparable new advantages." (citing Wallace v. City of Fresno and Packer v. Board of Retirement).

This characterization of a balancing of benefit reductions with comparable new benefits was unfortunate because neither the *Wallace* nor the *Packer* case really involved such a balance. A better view of these cases suggests that:

 Many, if not most, of these awkward decisions (at least for employers), could have been avoided had the employer decided to make its pension changes in line with principles under the Employee Retirement Income Security Act of 1974 (ERISA) – namely, that any amendment of a pension plan or system would not work to reduce or eliminate those pension benefits that had by the time of the amendment already been accrued (earned) and vested.

 A change, or even a reduction, in pension benefits would be more favorably viewed if the change were necessary to "preserve or protect the pension system" or "safeguard the pension system and carry out its beneficent purposes."

Given the critical budget situations all of your cities are facing, a compelling argument can be made for the necessity of pension system changes that are reasonable and necessary. It should be possible to argue that the provision of "comparable new benefits" is only necessary where a change takes away already accrued benefits. Otherwise, this requirement would make it practically impossible to make needed changes to a retirement system or plan.

- D. Cases Standing for the Proposition that Impermissible Impairment has Not Occurred
 - 1. No Impairment Where There Has Been an Express Reservation of the Right to Modify

This point is critical. California's courts have found on several occasions that there is no prohibited impairment where the terms of the legislation (or plan) providing for the benefit expressly reserves the right to modify or reduce such benefits. Furthermore, the *Walsh* decision clearly implies that there was nothing wrong with the subsequent addition to a pension scheme for legislators of a reservation of rights.

<u>Observation</u>: Even where an expressed or implied reservation of rights can be found, however, the public agency still cannot totally eliminate benefits, particularly defined benefit plans, which have already been "earned."

Ideally, the reservation of the right to modify pension or retiree health benefits should be set forth in the statute or ordinance authorizing the benefits. If an employee's pension or retiree health benefits arise from the terms of a MOU, then the MOU should contain a reservation of rights. Furthermore, any reservation of the right to amend or terminate a benefit arrangement in the future should be spelled out in any plan summary and employee handbook that is provided.

2. The Change Involves Benefits Subject to Collective Bargaining and the Change Has Been the Subject of Bargaining

Most city-provided pension and post-retirement benefits are directly or indirectly the subject of collective bargaining in accordance with the Meyers-Milias-Brown Act (Cal. Govt. Code § 3500, et seq.). Although there is surprisingly little case law on the subject, it appears that benefits that are properly the subject of the collective bargaining can be bargained away in exchange for other consideration. (See, e.g., California League of City Employee Associations v. Palos Verdes Library Dist.xi and San Bernardino Public Employees Association v. City of Fontana). These two cases involved situations where the collective bargaining process broke down and no agreement was reached between the parties.

The San Bernardino Public Employees Association case is helpful on two counts:

- It confirms that for purposes of the constitutional ban on impairment of contract, "there can be no impairment of a contract by a change thereof effected with the consent of one of the contracting parties."
- It clarified that longevity-based benefits and other "terms and conditions of employment" such as annual leave were not "pension benefits" subject to constitutional protection in the event no agreement was reached. In fact, San Bernardino stands for the proposition that such benefits can be unilaterally curtailed following the expiration of a MOU under which they were conferred.
- 3. The Change Involves Employees' Terms and Conditions of Employment; These Are Non-Pension Benefits In Which They Have No Vested Right

In a number of instances, the courts have found that a particular change in employee benefits was more akin to a change in employees' compensation, which is not protected under the impairment doctrine. It is well-settled that public employees have no vested right in any particular measure of compensation or benefits, and that these may be modified or reduced by proper statutory authority. XII Therefore, it was permissible to adopt a charter amendment, as in the Butterworth case, to establish a medical service plan for employees of the city and impose a monthly deduction from employees' salaries as their payment towards coverage. In Vielehrxiii, the California Supreme Court stated: "[P]ublic employment..., and the conditions thereof are creatures of stature, not contract, and ... the Legislature may modify [them] ... without violating vested pension rights...."

Along these lines, several cases have examined employee contributions to pension programs and have determined that: (a) amounts earned on such employee contributions (even within the pension program) are employment rights subject to change^{xiv}; and (b) a city's subsidization or "pick-up" of mandatory employee contributions are also in the nature of compensation, not pension benefits, and are therefore subject to unilateral reduction by the city.^{xv}

4. Changes That Apply Only To New Hires Should Be No Problem

In 2004, the California Legislature passed, and the Governor signed, a bill creating an alternate retirement program that applied to new state employees. The California Association of Professional Scientists (CAPS) challenged the law as it applied to new hires in the bargaining unit it represented. In California Association Of Professional Scientists v. Schwarzenegger^{xvi}, the Court of Appeal determined that "future employees do not have a vested right in any particular pension plan" (citing Claypool v. Wilson^{xvii}) and that it generally would not interpret a collective bargaining agreement to prohibit changes in pension benefits as to new employees.

Therefore, as long as the pension system you are operating under can accommodate multiple classifications or tiers of benefits, you should be able to control future

benefit costs by placing new hires in a less expensive benefit structure.

5. The Change Relates To an Aspect of a Benefit That Was Not Explicitly Authorized

The 2009 U.S. District Court case, Retired Employees Association of Orange County, Inc v. County of Orange xviii. stands for the proposition that certain aspects of retirement benefits (in this case, subsidized retiree health insurance premiums) are not contractual rights protected under the impairment doctrine because they were not the subject of explicit legislative or statutory authority. In this case the County of Orange had historically "pooled" their active employees and retirees for purposes of determining the cost of health insurance benefits. This resulted in a significantly lower, subsidized cost for retirees. When in the County authorized a "splitting of the pool" effective in 2008, the affected retirees sued. The court found that while the County had provided retiree health benefits on a pooled basis since the mid-1960s, the commitment to subsidize retirees' premiums was never memorialized as part of any explicit legislative or statutory authority. Therefore, it was found to be "gratuitous" and could be changed.

This case should cause all of you to carefully review the exact nature and scope of your city's benefit commitments to see what is explicitly authorized and what is not.

IV. Strategies for Reducing or Modifying Benefits Costs

A. Negotiate a New Benefit Structure

In order to negotiate a new benefit structure, it is first necessary to understand:

- 1. What levels of benefits cost savings you are trying to obtain;
- The anticipated cost savings of adopting various changes (this might involve the retention of a pension actuary to model the potential cost savings associated with various alternatives); and

3. The order or priority of these various measures (both in terms of what is needed in concessions, but also in terms of what might fly with the unions).

An important condition to successful negotiations is the proper education of the parties so that they understand what is at stake, what the preferred options are, and what the consequences of inaction or stalemate might be. This might involve an ongoing process of educating influencers and decision-makers on both sides of the equation – in particular, to make sure they understand that benefits will be on the table and that benefits will be changed, with or without union consent.

B. Review and Analyze the Various Statutes, Charter Provisions, Ordinances, and MOUs that Authorize or Deal with Employee Benefits

At a minimum, you need to make sure that the relevant documents contain an express reservation of rights to make changes. Although the right to make changes, even without an express reservation, can be implied, it only makes sense to make sure you are covered. One way to make the addition of a new reservation more palatable would be to include a statement, similar to those in most ERISA plans, that no amendment or termination of the plan will reduce or eliminate the benefits of a participant to the extent that such benefits are already accrued and vested.

You also need to catalog the exact nature and scope of various benefit practices to determine if your city has been providing levels of benefits (*e.g.*, subsidized premiums) that it is not legally obligated to provide.

- C. Understand Alternative Benefit Structures and Cost-Saving Strategies
 - The Differences Between Defined Benefit Plans, Defined Contribution Plans, and Terms and Conditions Of Employment
 - a. Defined Benefit Plans (DBPs)

These are plans that promise either a pension or welfare benefit following an event such as retirement, death or disability. Examples of DBPs: a CalPERS pension promising 2.5% of pay per year of service at 55 for the rest of the participant's life; or a retiree health insurance plan that covers some or all of a retiree's health insurance premiums for the rest of the retiree's life.

The key thing to understand about DBPs is that they provide guaranteed levels of benefits, typically for the participant's lifetime, and that the employer is bearing the risk of funding/investment. words, the employer is making a promise to provide certain described benefits over long periods of time in the future and is taking responsibility for funding those benefits - regardless of what they may cost or how long they must be paid out. Because the employer is agreeing to provide funding for benefits payable years in the future, practically all DBPs require the input of actuaries who help the employer project, monitor and revise the anticipated cost and current funding of these benefits. Therefore, when the rate of return of plan investments falls short of the actuarially assumed rate of return, the employer must make up the shortfall. This is why all public sector DBPs will be calling for a significant increase in employer contribution levels over the coming Defined benefit pensions typically are years. "earned" or accrued over the working career of the employee - that is, the employee must provide a significant number of years of credited service (generally, 20 to 40) in order to earn a full pension. Apart from the concept of benefits accrual there is also the technical concept of vesting. This is the percentage of which an employee's benefit is nonforfeitable under the terms of the applicable pension plan or system. It is not the same concept that the courts refer to when they speak of public employee earning a vested right to a pension.

b. Defined Contributions Plans (DCPs)

A DCP, on the other hand, operates much like a savings account. Common types of DCPs found in the private sector: 401(k)s, profit sharing plans and money purchase pension plans. The employer (and in some cases the employee) typically makes a defined contribution based on a flat dollar amount or

a percentage of pay and those deposits, together with the cumulative investment earnings and losses of the participant's account is what the participant will receive upon retirement, death or disability. In a DCP the participant, not the employer is bearing the investment risk. Therefore, absent a breach of fiduciary duty with respect to the plan's investment, the employer would not be responsible for making up an investment loss such as the one most portfolios suffered during 2009.

c. Terms and Conditions of Employment

These are the basic components of an employee's salary, wages and non-retirement benefits (e.g., annual leave, sick leave, longevity-based benefits) that courts have not treated as pension or retirement benefits. A typical benefit of this sort would be for the employer to pay \$200 per month toward an employee's health insurance premium. Other benefits of this type also would seem to include the employer's payment for the following:

- The employee's 3.75% of pay share of a contribution to a Social Security replacement plan;
- An annual cafeteria plan benefit, or flexible spending account benefit; and
- The employee's mandatory contribution to a pension plan, such as CalPERS.

2. Switch from Defined Benefit Arrangements to Defined Contribution Arrangements

This can be done with respect to pension and/or health and/or retiree health obligations. Although they are not necessarily less expensive over the long run, DCPs are easier to budget (e.g., 6% of pay). For example, we have designed and implemented a defined contribution-type retiree health benefit for a client with over 20,000 employees.

3. Move to a Multi-Tier Program of Benefits

Generally, but not always, this involves providing new hires with a different set of benefits. This likely will necessitate the "grandfathering" of certain groups and their accrued benefits. And, there is nothing in the pension law that says miscellaneous employees are entitled to the same pension and other benefits as safety officers.

- 4. Save Costs and Restore Greater Integrity in Existing Structure by Removing Provisions that Can be Abused or are Perceived as Gratuitous
 - a. One of the more significant public relations problems that governmental pension systems have is the adverse publicity associated with pension and benefits "spiking." There are ways to design and administer plans to avoid and discourage pension spiking:
 - Move away from a final pay formula. A lifelong pension based on final pay is just asking for it (spiking). Consider longer averaging periods (3 or 5 years) or go to career average.
 - Take certain types of pay (e.g., accrued leave, vacation, certain negotiated severance payments or buyouts) out of the definition of pensionable pay.
 - Place expressed limits on benefits in the plan document (or statute).
 - Reduce the practice and perception that many public sector workers get to retire too early and "double dip."
 - Consider raising the normal retirement age for all plans. This may have to be a prospective change. In the private sector, most employees would not be eligible for a DBP benefit until they reach age 65.
 - Analyze and regulate the practice of allowing workers to retire and then coming back as

consultants or annuitants. Many private sector plans provide for a suspension of benefits for anyone who is rehired.

C. Government agencies must review and reconsider the bargaining concessions (that may have been made out of necessity) in better times, but that cannot be afforded now. For example, we are still seeing MOUs under which the employer is paying for the employee's share of contributions to a Social Security replacement plan (this could be a 3.75% savings) or the employer is actually paying, not just "picking up," the employee's mandatory contribution plans. (Eliminating certain other contributions could yield a 2-5% savings). Along these lines, the voting public views the amounts of unused vacation, paid time off and other leave that many governmental workers are allowed accumulate as excessive. These accruals can give rise to a considerable unfunded liability. It should be possible to place caps on such accruals.

5. Hope for The Best But Plan for the Worst

As mentioned above, there are now a number of judicial precedents for making reductions in the terms and conditions of employment even when the reductions cannot be agreed upon as part of the collective bargaining San Bernardino Public Employees' process (see, Association and San Diego Police Officers' Association). This should be a back-up option in the event you are unable to negotiate sufficient concessions directly. Along these lines, it would make sense to include language in any new MOUs, if possible, that clarify that such benefits only last as long as the MOU and that any pension or benefits commitments in the MOU do not necessarily prevent the employer from making changes that would apply to new hires.

V. Conclusion

As part of the ongoing dialog between cities and their employee groups, this paper and the accompanying presentation have attempted to cut through some of the political rhetoric that is commonly used to discuss California public sector employee benefits and to examine the legal underpinnings of the "vested rights" doctrine from the perspective of an

employee benefits attorney. While this paper addresses much of the caselaw and legal theory surrounding the impairment of contract doctrine as it applies to public employees' benefits, the companion paper and presentation by Eddie Kreisberg approaches many of the same issues from the perspective of what cities have been doing both at the bargaining table and in the courts. We hope that our papers and presentations will provide city attorneys with useful information and serve as starting point for their own attempts to reconcile and address these complex and sensitive issues.

Table Of Authorities

i In re: City of Vallejo 408 B.R. 280, 2009 Bankr. LEXIS 1583 (B.A.P. 9th Cir. 2009) San Bernardino Public Employees Association v. City Of Fontana ii 67 Cal. App. 4th 1215, 79 Cal. Rptr. 2d 634 (Fourth App. Dist., 1998) Kern v. City of Long Beach iii 29 Cal.2d 848, 179 P.2d 799 (1947) Woodruff v. Trapnall (1850) İν 51 U.S. (10 How.) 190, 207 [13 L.Ed. 383, 390] Allen v. City of Long Beach V 45 Cal. 2d 128, 287 P. 2d 765 (1955) Allen at 133. νi Wallace v. City of Fresno vii 42 Cal. 2d 180, 186, 265 P.2d 884 (1954) International Assn. of Firefighters v. City of San Diego viii 34 Cal. 3d 292, 300-303, 93 Cal. Rptr. 871 [667 P.2d 675]; City of Torrance v. Worker's Comp. Appeals Bd. 32 Cal.3d 371, 379; Wallace v. City of Fresno (1954) 42 Cal.2d 180, 183 [265 P.2d 884]. Walsh v. Board of Administration İΧ 4 Cal. App. 4th 682, 6 Cal. Rptr. 2d 118 (1992). Kern v. City of Long Beach Χ 29 Cal.2d 848, 179 P.2d 799 (1947). California League of City Employee Associations v. Palos Verdes Library χi Dist. 87 Cal. App. 3d 135, 150 Cal. Rptr. 739 (1978). Pennie v. Reis хіі 80 Cal 266, 269 [22 Pac. 176]; Butterworth v. Boyd 12 Cal.2d 140,151; Snell v. Byington 2 Cal. App. (2d) 127 [37 Pac. (2d) 734]; Casserly v. Oakland 6 Cal. (2d) 64 [56 Pac. (2d) 237] Vielehr v. State of California Xiii 104 Cal. App. 3d 392, 163 Cal. Rptr. 795 (1980).

ld.

xiv

- xv San Diego Police Officers' Association v. San Diego City Employees' Retirement System 46 EBC 2813 (9th Cir. 2009)
- xvi California Association Of Professional Scientists v. Schwarzenegger 137 Cal. App. 4th 371, 40 Cal. Rptr. 3d 354 (2006)
- xvii Claypool v. Wilson 4 Cal.App.4th 646, 6 Cal. Rptr. 2d 77 (1992)
- xviii Retired Employees Association Or Orange County, Inc. v. County Of Orange 632 F. Supp. 2d 983; 2009 U.S. Dist. LEXIS 61942 (2009)