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MEMORANDUM

To: Board of Directors
Employee Relations Policy Committee
From: Patrick Whitnell, General Counsel
Date: September 15, 2011
Re: Legal Analysis Regarding Pension Reform and Vested Rights

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EXECUTIVE SUMMARY

The League of California Cities board of directors adopted a strategic goal for 2011 related to Sustainable and Secure Public Pension Systems. To further this goal, the League's City Managers' Department drafted an Action Plan to address the unsustainable pension costs that "threaten[] the delivery of basic public services" and "pose a long-term fiscal challenge to the state itself." The board endorsed this Action Plan in July 2011. The board further directed staff to address the Action Plan's recommendation that a detailed legal analysis be done to examine the ability of public agencies to make changes to the pension benefits of both current and future employees. The following memorandum provides this legal analysis.

The legal analysis concludes that:

- A public employee's pension constitutes an element of compensation;
- A vested contractual right to a pension benefit accrues upon acceptance of employment; and
- Eliminating this pension right will impair an employer's contractual obligation to the employee.

The analysis further concludes that a vested pension benefit may be modified in three circumstances:

- When both parties agree to the modification;
- When prior to the time of retirement, the employer makes a reasonable modification to maintain the integrity of the pension system; and
- When the terms of the pension plan or "contract" provide that modifications may be made.

The analysis discusses several constraints on modifying pension benefits. For example, if an agency wants to make a "reasonable modification to maintain the integrity of the pension system," the courts will sustain the modification only if the disadvantages to the employee from the modification are accompanied by comparable new advantages. The analysis further notes that the Public Employees Retirement Law (PERL) also places constraints on the ability of agencies and their employees to negotiate in certain areas.

The analysis concludes with some suggested revisions to the City Managers' Action Plan that the board may wish to consider after receiving input from the City Managers' Department. The purpose of these suggested revisions is to further the stated goal in the Action Plan with respect to improving the sustainability of PERS and safeguarding public pensions.

I. Introduction

The League board of directors met in November 2010 to chart a strategic course for 2011. It endorsed three strategic goals for 2011 including:

> **Sustainable and Secure Public Pension Systems**. Work in partnership with other groups and stakeholders to promote sustainable and secure public pension systems to help ensure responsive and affordable public services for the people of our state and cities.

To further this goal, the League's City Managers' Department submitted an Action Plan to the League board to provide information and recommendations addressing the need for pension reform.

At its July 21-22, 2011 meeting, the board endorsed the City Managers' Action Plan. The Board held for further consideration the recommendation in the Action Plan that called for a detailed legal review of the ability to make changes to the benefits of both current and future employees.

This memorandum is a result of that detailed legal review. It provides a summary of the law and an explanation of what changes in the law would be necessary to help achieve sustainable and secure public pension systems in accordance with the recommendations of the City Managers' Action Plan.[1]

II. The Problem and a Principled Approach for Solving the Problem

A. <u>The Problem</u>. The City Managers' Action Plan explains that "pension costs for many California municipalities continue to increase, threatening the delivery of basic public

[1] In drafting this memorandum, the League consulted with several attorneys who specialize in advising public agencies on pension-related matters. While their input was considered in drafting this memorandum, the analysis and recommendations set forth in this memorandum represent those of the League staff.

services, compromising general fund budgets, and … posing a long-term fiscal challenge to the state itself." Under current law, the employee's contribution is a fixed percentage of pay (9% for safety and 7% for miscellaneous), but the public employer's contribution consists of whatever is needed to meet the Annual Required Contribution (ARC), which includes the remainder of the normal cost plus the entire Unfunded Actuarial Accrued Liability (UAAL). This means that the employer is on the financial hook for all escalating costs, especially when pension assets decline because of a financial market decline, or the UAAL increases because of enhanced benefits. Current pensions are "unsustainable" because the projected employer contributions are escalating at a rate that, in some cases, is double or triple the rate of projected local revenue growth.

B. The Principled Approach. The City Managers' Action Plan recommends a principled approach to achieving public retirement systems that provide fair benefits for career employees:

1. Recognize the value of attracting and retaining high-performing public employees to design and deliver vital public services to local communities;
2. Recognize and support the value of a dependable, sustainable, employer-provided Defined Benefits Plan (DBP) for career employees supplemented with other retirement options including personal savings (e.g. 457 Plan);
3. Public pension costs should be shared by employees and employers; and
4. Pension benefits should be portable across all public agencies to sustain a competent cadre of California public servants.

III. The *Vested* Right to a Pension[2]

Many of the legal rules that govern any major change with pensions derive from the concept of "vested rights."

A. The vested right of a public employee to a pension benefit is based upon a "contract of employment." In 1947, the California Supreme Court firmly established that the right of a public employee to a pension benefit is a right that is based on contract principles.[3] The *Kern* decision was based, in part, on earlier court decisions that had construed pension provisions to be a part of the contemplated compensation for employment services. Compensation in the form of pension benefits accrued as soon as employment services were rendered. In a sense, the pension benefit was "part of the contract of employment itself."[4] Employer contributions to the pension fund represent deferred compensation.[5]

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[2] In June 2011, CalPERS published a paper called "Vested Rights of CalPERS Members." The purpose of this paper was to present CalPERS' institutional views regarding the level of assurance the law provides that promised pensions will be available upon retirement. This publication can be found at: http://www.calpers.ca.gov/eip-docs/about/press/news/vested-rights.pdf.
[3] *Kern v. Long Beach* (1947) 29 Cal.2d 848.
[4] *O'Dea v. Cook* (1917) 176 Cal. 659.
[5] *Terpinas v. Seafarer's Intern. Union of North America* (9th Cir. 1984) 722 F.2d 1445.

Pension benefits are an "integral portion of the contemplated compensation set forth in the contract of employment between the city" and its employees and are "an indispensable part of that contract."[6] Therefore, the "right to a pension becomes a vested one upon acceptance of employment by the applicant."[7] Based on these cases, it appears that a public employee's contractual right to receive a pension benefit vests on the first day on which the employee performs any work for the employer. This is the day that triggers the obligation to pay wages, and based on *Kern*, by extension, also triggers the obligation to pay any deferred wages in the form of a pension benefit.[8]

B. The State and Federal Constitutions Prohibits an "Impairment" of Contracts.[9]

The courts' determination that a public employee has a vested contractual right to a pension benefit forms the basis of the courts' conclusion that the "contracts clause" of the California Constitution prevents the "impairment" of that right.[10] Similarly, the U.S. Constitution prohibits a state from enacting a law that "impairs" a contract.[11]

The courts have consistently confirmed that both the federal and state contract clauses protect the vested pension rights of public officers and employees from unreasonable impairment.[12] This means that an amendment to the California Constitution may not by itself avoid the impairment issue.

C. Vested Rights and Collective Bargaining. The vesting of current employees' pension benefits apparently means that some "terms and conditions of employment" are not within the scope of collective bargaining under the Meyers-Milias-Brown Act (MMBA). Under the MMBA and similar public employee bargaining statutes, the public employer is required to negotiate proposed improvements in pension benefits because they constitute future compensation. But negotiating parties cannot reduce benefits without complying with the limitations discussed below.

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[6] *Dryden v. Board of Pension Commissions of the City of Los Angeles* (1936) 6 Cal.2d 575.
[7] *Id*. at 578.
[8] We note that more recent case law reaffirms the statement in Dryden, *supra*, providing for the vesting of pension benefits upon the acceptance of employment. See *Miller v. State of California* (1977) 18 Cal.3d 808. Thus, despite the language in *Kern,* an applicant may be able to assert that s/he is entitled to those pension benefits that were in effect on the date of his/her acceptance of employment.
[9] The inquiry into whether a law impairs a contract includes (1) whether a contract exists; (2) whether the law in question impairs an obligation under that contract; and (3) whether the discerned impairment can be fairly characterized as substantial. *General Motors Corp. v. Romein* (1992) 503 U.S. 181, 186; cited in *San Diego Police Officers' Association v. San Diego City Employees' Retirement System* (9th Cir. 2009) 568 F.3d 725. Laws that substantially impair state or local contractual obligations are nevertheless valid if they are "reasonable and necessary to serve an important public purpose." *U.S. Trust Co. v. New Jersey* (1977) 431 U.S. 1, 25.
[10] Article I, section 9 of the California Constitution provides: "A…law impairing the obligation of contracts may not be passed."
[11] Article I, section 10, clause 1 of the U.S. Constitution provides: "No state shall…pass any law…impairing the obligations of contracts…."
[12] *Legislature v. Eu* (1991) 54 Cal.3d 492, 528.

As noted by one court, the concept of vested compensation is inimical to the process of collective bargaining.[13] Individual rights derived from the collective bargaining agreement itself may be subsequently changed or waived through collective bargaining. On the one hand, this category of rights does not "become permanently and irrevocably vested as a matter of contract law, because the benefits were earned on a year-to-year basis under previous MOUs that expired under their own terms."[14] On the other hand, "individual statutory or constitutional rights that flow from sources outside the collective bargaining agreement itself" can create vested rights."[15]

It is not surprising that the current case law and statutory pension provisions do not conform to what we otherwise understand to be the scope of collective bargaining. Most of the key cases on vesting, and the PERS system of pensions, pre-date full collective bargaining established with the creation of the Public Employees Relation Board (PERB) in 1976.

IV. Modifying the Right that is Vested

This memo has explained that:

- A public employee's pension constitutes an element of compensation;
- A vested contractual right to a pension benefit accrues upon acceptance of employment; and
- Eliminating this pension right will impair an employer's contractual obligation to the employee.

But the courts also have recognized that the employee does not obtain, prior to retirement, "any absolute right to fixed or specific benefits, but only to a substantial or reasonable pension."[16]

The courts have identified three circumstances under which an employer may make modifications to *vested pension benefits*:

- First: when both parties agree to the change.
- Second: when, *prior to the time of retirement,* the employer makes reasonable modifications to maintain the integrity of the pension system.[17]
- Third: when the terms of the pension plan or "contract" provide that modifications may be made, such as for "optional benefits" pursuant to Government Code 20516.[18]

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[13] *San Bernardino Public Employees Association v. City of Fontana* (1998) 67 Cal.App.4th 1215.
[14] *Id*. at 1224.
[15] *Id*. at 1225.
[16] *Betts v. Board of Administration* (1978) 21 Cal.3d 859.
[17] *Id.* at 864.
[18] See *International Association of Firefighters, Local 145 v. City of San Diego* (1983) 34 Cal.3d 292.

A. Mutual agreement. Agreed-upon modifications can be made on an individual basis both prior to the time of retirement and after the time of retirement. This is because there is no impairment of a contract if both contracting parties agree to change the contract terms.[19]

B. Reasonable modifications to maintain the integrity of the pension system: The two-part test.

1. *The reasonableness of the modification*. An employee's vested contractual pension rights may be modified prior to retirement for the purpose of keeping a pension system flexible to permit adjustments in accord with changing conditions and, at the same time, to maintain the integrity of the system. For example, an employer may wish to modify pension benefits in order to maintain the fiscal integrity of the system. Such modifications must be "reasonable." Courts decide "reasonableness" on a case-by-case basis.[20]

2. *Balancing the disadvantages to employees*. Even if a court determines that a modification is a reasonable means of maintaining the integrity of the system, the modification apparently will only be sustained if changes in a pension plan that result in disadvantage to employees are accompanied by comparable new advantages.[21] In addition, the modification must also "relate to the benefit that was diminished."[22] For example, a court has upheld a change in the mandatory retirement age from 70 to 65 because the age reduction was offset by an increase in the percentage of benefits provided for each year in service, which resulted in enhanced benefits.[23] Another court upheld a requirement that employees who were reclassified from miscellaneous to safety members pay arrears contributions. The court found that the payment of arrears was outweighed by the benefit of receiving the enhanced retirement benefits available to safety members.[24]

C. Modification in accord with the terms of the pension contract and Government Code 20516. Because vested rights are based on the no-impairment-of-contract constitutional rule, if the contract itself allows a change that is adverse to the retirement system members, that change can be made.[25] The Public Employees' Retirement Law

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[19] *Mulcahy v. Bardin* (1932) 216 Cal. 517, 526. But see discussion at Section VI *infra* about those sections of the PERL that prevent parties from coming to mutual agreement on changes to the PERS pension system benefits.

[20] One court has held that changes that are based solely on a desire to reduce costs associated with providing a particular benefit do not satisfy the "reasonableness" test. In finding for the employee organization, the court stated that a "public entity cannot justify the impairment of its contractual obligations on the basis of the existence of a fiscal crisis created by its own voluntary conduct." *United Firefighters of Los Angeles v. City of Los Angeles* (1989) 210 Cal.App.3d 1095.

[21] *Manning Allen v. City of Long Beach* (1955) 45 Cal.2d 128.

[22] *Frank v. Board of Administration* (1976) 56 Cal.App.3d 236, 244.

[23] *Townsend v. County of Los Angeles (*1975*)* 49 Cal.3d 263.

[24] *Barrett v. Stanislaus County Employees Retirement Association* (1987) 189 Cal.App.3d 1593.

[25] See, e.g., *International Association of Firefighters, Local 145 v. City of San Diego, supra,* fn. 18.

(PERL) allows a contracting agency and its employees to agree to share the costs — for whatever proportion the parties agree to — of any "optional benefit" the contracting agency elects to be subject to. The agreement specifies the amount of the member contribution to the cost of the optional benefit. The contribution must be uniform with respect to members in each of the following classifications: local miscellaneous, local police officers, local firefighters, and county peace officers.

In addition, the courts have recognized that some elements that affect a pension are not part of the pension contract and therefore are not considered vested benefits.[26] The two-part test applies only to pension benefits that are vested. Changes to other parts of the employment relationship (i.e., non-vested benefits) can be made through collective bargaining. But only a few cases have described what falls within this category of pension benefits. For example, existing case law has defined the following to be employment benefits subject to agreement between the parties in collective bargaining: the mandatory retirement age,[27] the amount of interest paid to public employees who withdraw their pension contributions before retirement,[28] and salary reductions for employees participating in a Deferred Retirement Option Program (DROP).[29] These cases are based generally on the principle that "indirect effects on pension entitlements do not convert an otherwise unvested benefit into one that is constitutionally protected."[30]

V. The Voters' Attempt to Modify Pension Benefits

In *Legislature v. Eu*, the California Supreme Court considered the constitutionality of a voter-approved proposition that limited a member of the Legislature from earning future retirement benefits.[31] Under the proposition, the state would cease contributions to the Legislators' Retirement Fund and only contribute the employer's share of any contribution to the Social Security system. The terms of the proposition applied to any individual elected to or serving in the Legislature on or after November 1, 1990.

Incumbent legislators challenged the proposition on the grounds that it impaired a vested right. Relying on the principle that pension rights vest upon acceptance of employment, the incumbent legislators argued that this principle includes the right to continue to earn pension benefits through continued service on terms that are substantially equivalent to those offered at the time the individual first begins service. The Court agreed with the incumbent legislators, and held that they had "the vested right to earn additional pension benefits through continued service."[32]

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[26] Pension benefits that are not vested are sometimes referred to as "non-core pension benefits."
[27] *Miller v. State of California* (1977) 18 Cal.3d 808; *Amundson v. Public Employees' Retirement System* (1973) 30 Cal.App.3d 856.
[28] *Vielehr v. State of California* (1980) 104 Cal.App.3d 392.
[29] *San Diego Police Officers Association v. City of San Diego* (9th Cir. 2009) 568 F.3d 725.
[30] *Vielehr v. State of California*, *supra* at 797.
[31] *Legislature v. Eu* (1991) 54 Cal.3d 492.
[32] *Id.* at p. 530.

In finding for the legislators, the Court acknowledged that an employer may make reasonable modifications to the pension system during the employment relationship, so long as employees receive some comparable new advantage in exchange for any substantial reduction in benefits. The Court found that the change made by the proposition was more than a mere modification or adjustment; rather the proposition terminated the ability of individuals to earn <u>any</u> future benefits.[33] The Court also noted that even if the changes made by the proposition were considered to only be modifications, the transition to only Social Security benefits did not constitute a comparable new advantage that would offset any reductions arising from the elimination of benefits through the Legislators' Retirement Fund. This was because it was undisputed that the anticipated benefits provided through Social Security would be far less than those provided through the Legislators' Retirement Fund. Thus, the Court held that eliminating future pension benefits a legislator could earn through continued service was unconstitutional as applied to incumbent members of the Legislature. But the proposition was allowed as to non-incumbent legislators who first assumed office after its passage.[34]

VI. Restrictions of the Public Employees Retirement Law (PERL)

Although a retirement benefit for current and future employees is a mandatory subject of bargaining, the public pension system's statutes and regulations establish aspects of the retirement system that supersede bargaining and thus make those aspects nonnegotiable. For example:

- Employees are only allowed to pay a portion of the employer's contribution under very limited circumstances.[35]
- All employees within specified employee groups (local miscellaneous; police officers, firefighters) must have the same benefit structure.[36]

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[33] *Id.* at p. 529-530.

[34] *Id.* at p. 534. This case presents a significant obstacle to the legal theory that defines the pension right that is vested as the right to those benefits that have been earned prior to the benefit at issue being amended. For example, a firefighter is hired in 2010 with a pension benefit of 3% at 50. In 2020 the local agency wishes to negotiate a change to 3% at 55 without disturbing any accrued vested benefits for the prior years under the 3% at 50 formula. Some courts have recognized that changes to benefits negotiated in the collective bargaining process and provided for by MOUs "could not have become permanently and irrevocably vested as a matter of contract law, because the benefits were earned on a year-to-year basis under previous MOU's that expired under their own terms" (*San Diego Police Officers Association v. City of San Diego Employees Retirement System* (9th Cir. 2009) 568 F.3d 725; *San Bernardino Public Employees Association v. City of Fontana* 67 Cal.App.4th 1215.(1998) *Claypool v. Wilson* (1994) 4 Cal.App.4th 646). See also, California Association of Professional Employees v. Schwarzenegger (2006) 137 Cal.App.4th 361 in which the court of appeal determined that "future employees do not have a vested right in any particular pension plan" (citing *Claypool v. Wilson*) and that it generally would not interpret a collective bargaining agreement as to prohibit changes in pension benefits for new employees.

[35] Government Code 20516.

[36] Government Code 20475, 20479.

- PERL pension formulas only allow four basic options for Miscellaneous and four basic options for Safety employees.[37]
- Some changes to a PERS contract with a local agency are subject to a majority vote of the affected employees. These pension changes are subject to two employee votes — one for union ratification and another for the PERS contract change.[38]

VII. Actions Needed to Restore the Sustainability of Pension Programs — Suggested Revisions

The following are suggested revisions to the list of actions in the City Managers' Action Plan. These revisions are intended to further the stated goal in the Action Plan with respect to improving the sustainability of PERS and safeguarding public pensions. These suggested changes are indicated by underlined and ~~deleted~~ text:

1. Repeal SB 400/AB616 returning to more sustainable PERS benefit formulas of 2% at 60 for miscellaneous employees and 2% at 55 for safety employees.
2. Have PERS provide a broad range of lower pension ~~more~~ formula choices for ~~with lower benefit~~ local options for a second tier of benefits, for current employees' prospective benefits, and for current employees who volunteer to opt out of the current defined benefit plan.
3. Base final retirement salary on three highest paid years worked.
4. Require that ~~Prohibit enhancing~~ the second tier pension formulas ~~for twenty years~~ must include a termination date of no less than 10 years and no more than 25 years in order to be valid. The termination date must include the employer's reservation of right to change the plan upon termination, subject to the limitations of any requirement to negotiate under the appropriate collective bargaining statute or its successor.[39]
5. Calculate benefits only on base salary eliminating all "spiking." No overtime, vacation or sick leave included in the pension calculation.[40]
6. Eliminating the purchase of "air time" (purchase of time not served).
7. Eliminate the availability of Employer Paid Member Contribution (EPMC).[41]
8. Require employees to pay the employees share of PERS (e.g. 7-8% for miscellaneous employees and 8-9% for safety employees).

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[37] Government Code 20478.
[38] Government Code 20474.
[39] The employer's reservation of rights to change the plan upon termination allows the employer to adopt restrictions that would be considered unreasonable impairments of the contract if otherwise subsequently imposed upon employees who have served under the pension plan. *Wallace v. City of Fresno* (1954) 42 Cal.2d 180,183.
[40] We do not believe this change is necessary as the PERL already excludes vacation and sick leave cash outs from its definition of final compensation. The PERL also already excludes all overtime except for FLSA overtime that is part of an employee's regular work schedule.
[41] Some agencies may not want to lose the option of providing EPMC. They see it as a way to give more compensation to employees without increasing base salary, and by extension overtime and tax costs.

9. Remove caps on the percentages employees can pay f~~or the total cost of PERS programs~~ as "member contributions" for their pensions. Allow the member's contribution to be increased from existing rate up to 50% of the total annual required contribution for the pensions, including both the normal cost and the unfunded accrued actuarial liability. The determination of this member contribution: (1) is subject to good faith negotiations under the appropriate collective bargaining statute; (2) at agency's option, can be structured to only impact the employees within a certified bargaining unit, notwithstanding PERS designated employee groups; and (3) is not subject to a vote by employees otherwise required by PERS to amend the agency's contract.
10. Give government agencies through the collective bargaining process the option to extend retirement ages for miscellaneous employees up to social security retirement ages. Seek minimum (floor) retirement age of 60 for miscellaneous employees and 55 for safety employees before earning full retirement benefits.
11. Prohibit retroactive pension benefit increases and allow prospective benefits changes for current employees.
12. Meet any retirement needs for part-time employees with alternative to a Defined Benefit Plan.
13. Delete the 1,000 hours rule for part-time employee mandatory enrollment in CalPERS.
14. Prohibit employees and employers from taking contribution "holidays."
15. Provide employers with a hybrid pension system option that caps the Defined Benefit PERS pension at an annual maximum retiree benefit equal to 70% of the retiring employees' eligible base pay (determined by averaging the 3 highest year's pay) and supplement the DBP with a risk managed PERS defined contribution plan. A DCP should integrate with a DBP not, as some pension revision plans suggest, substitute for it.
16. Eliminate the requirement that any negotiated changes in the pensions under the PERL be voted on twice by the employees.

VIII. Conclusion

This legal analysis reflects the current state of the law with respect to pensions and vested rights. It further reflects the current law with respect to constraints on an agency's ability to modify pension, either unilaterally or through mutual agreement. Future statutory changes or court decisions may require this analysis to be revisited.

Attachment: Pension Reform Action Plan July 2011

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PENSION REFORM ACTION PLAN
July 2011

This report to the League of California Cities Employee Relations and Revenue and Taxation Policy Committees and the Board of Directors is designed to address the League's 2011 Strategic Goal related to Pension Sustainability by providing information and recommendations that may be of assistance toward meeting the competing challenges of maintaining high-quality public services while providing fair and reasonable pensions for employees.

THE PROBLEM

Pension costs for many California municipalities continue to increase, threatening the delivery of basic public services, compromising general fund budgets, and indeed, posing a long-term fiscal challenge to the State itself. A former CaIPERS actuary warned that by 2014 it will be common for local governments to budget 50% of a police officer's salary, 40% of a fire fighter's salary and 25% of a miscellaneous employee's salary for their pensions; contributions that are fiscally unsustainable. Many cities face 25% or more increases in pension contribution costs in the next three years and those rates are likely to remain high for a decade or more. Causes of the problem include:

1. Large losses on pension investments due to the Great Recession.
2. Enhanced benefit formulas granted after 1999 (SB400/AB616).
3. Increased life span of retired employees.

A PRINCIPLED APPROACH

Public retirement systems should provide fair benefits for career employees, and:

1. Recognize the value of attracting and retaining high performing public employees to design and deliver vital public services to local communities.
2. Recognize and support the value of a dependable, sustainable, employer provided Defined Benefits Plan (DBP) for career employees; supplemented with other retirement options including personal savings (e.g. 457 Plan).
3. Public pension costs should be shared by employees and employers (taxpayers).
4. Be portable across all public agencies to sustain a competent cadre of California public servants.

STAGES OF A SOLUTION

Many of the steps below can, are, and should be taken locally and immediately, as part of the collective bargaining process to move local pension costs in a more sustainable direction. Further, State action is necessary to return the PERS (or other state-authorized pension systems) to a more sustainable framework. Many of the actions below are and will be presented to the State Legislature for enactment. We believe the League of California Cities should engage the unions, Legislature, and Governor in the legislative process to formally change the structure of

PERS thus protecting the fiscal integrity of cities and PERS retirement for public employees. This could include jointly sponsoring an initiative if legislative change is insufficient.

ACTIONS CITIES CAN AND ARE TAKING NOW AT THE COLLECTIVE BARGAINING TABLE TO REDUCE COSTS

1. Have employees pay the employee's share of PERS costs: 7-8% for miscellaneous employees and 8-9% for safety employees.
2. Provide a two-tier retirement system with new hires being placed in a reduced benefit tier.
3. Allow employees to pick-up a portion of the employer's PERS costs up to PERS limits through negotiation to better share the normal costs of pensions.
4. Base final retirement salary on the three highest years worked.
5. Eliminate the PERS contract option of including Employer Paid Member Contribution (EPMC) in the calculation of an employee's base pay for retirement purposes.

A City Managers Department survey in February 2011 indicates one in five cities responding to the survey have implemented a second tier for new hires. Further, the majority of cities surveyed (61%) are currently negotiating pension reforms.

ACTIONS NEEDED FROM THE STATE TO RESTORE THE SUSTAINABILITY OF PENSION PROGRAMS

Courts have held that current and former local government employees have rights to the pensions promised them at hiring. As such, the following recommendations most likely would not pertain to former employees or the prospective benefits of current employees.

A Defined Benefit Plan is the most effective vehicle to accumulate and distribute pension benefits and is the preferred retirement system for municipal employees. According to staff of the National Institute of Retirement Security, dollar for dollar, a Defined Benefit Plan yields considerably more (46%) retirement savings than a Defined Contribution Plan.

The subsequent action items can be considered individually or in combination to improve the sustainability of PERS, thus, re-designing a system that will contribute to safeguarding public pensions. The following recommendations, with support from labor, would level the field on a statewide basis and lead to a maintainable PERS for public employees.

1. Repeal SB400/AB616 returning to more sustainable PERS benefit formulas of 2% at 60 for miscellaneous employees and 2% at 55 for safety employees.
2. Have PERS provide more formula choices with lower benefit local options.
3. Base final retirement salary on three highest paid years worked.
4. Prohibit enhancing the second tier pension formulas for twenty years.
5. Calculate benefits only on base salary eliminating all "spiking." No overtime, vacation or sick leave included in the pension calculation.
6. Eliminating the purchase of "air time" (purchase of time not served).

7. Eliminate the availability of Employer Paid Member Contribution (EPMC).
8. Require employees to pay the employees share of PERS (e.g. 7-8% for miscellaneous employees and 8-9% for safety employees.)
9. Remove caps on the percentages employees can pay for the total cost of PERS programs.

10. Give Government agencies through the collective bargaining process the option to extend retirement ages for miscellaneous employees up to social security retirement ages. Seek minimum (floor) retirement age of 60 for miscellaneous employees and 55 for safety employees before earning full retirement benefits.
11. Prohibit retroactive pension increases.
12. Meet any retirement needs for part-time employees with alternatives to a Defined Benefit Plan.
13. Delete the 1,000 hours rule for part-time employee mandatory enrollment in CalPERS.
14. Prohibit employees and employers from taking contribution "holidays."
15. Provide employers with a hybrid pension system <u>option</u> that caps the Defined Benefit PERS pension at an annual maximum retiree benefit equal to 70% of the retiring employees' eligible base pay (determined by averaging the 3 highest year's pay) and supplement the DBP with a risk managed PERS defined contribution plan. A DCP should integrate with a DBP not, as some pension revision plans suggest, substitute for it.

ADDITIONAL STEPS THAT APPEAR NECESSARY TO RESTORE PERS TO SUSTAINABILITY AND PROVIDE TRANSPARENCY

1. Pension sustainability cannot be fully achieved without addressing the benefits of both current and future employees. After a detailed legal review and to the extent permitted by federal and state law, a well-designed State Constitutional Amendment is needed for prospective retirement formula reductions and incremental retirement age increases for current employees to guarantee their already accrued earned benefits, while making the plan sustainable, affordable and market competitive on a going-forward basis. The amendment should also include a risk-managed PERS Defined Contribution Plan for public agencies.
2. The PERS Board needs to be restructured with a substantial increase in independent public members (preferably with financial expertise) to ensure greater representation of tax payer interests with regard to public pension decisions.
3. Set uniform standards and definitions for disability benefits and evaluate the level of benefit that is considered as tax exempt. The tax exempt portion should either be eliminated or allowed on a proportional basis to the severity of the disability.
4. If the above reforms prove unfeasible or ineffective, consider a standard public employee pension system where one benefit level is offered to every employee as a further option to restore sustainability to PERS.

5. While not addressed in this paper, Other Post-Employment Benefits (OPEB), such as retiree health care, represents another unfunded liability for many local agencies and must be addressed through comprehensive reform measures.
6. Develop a program with the State to ensure that pension programs offered by localities are fully transparent, and that professional actuarial evaluations of unfunded components of OPEB's and Pension Plans are completed.
7. To the extent permitted by federal and state law prohibit payment of pension benefits to a public employee convicted of a felony related to fraudulently enhancing those benefits.

While pension reform is a primary fiscal challenge facing local agencies, it represents but one of several financial challenges that, when combined, represent a "Perfect Storm" that is leading to the insidious erosion of fiscal solvency of local governments. While some changes may take years, delay in dealing with the problem, only makes the situation worse.