Employee Benefits:

Identifying Solutions In Difficult Economic Times

Presentation To The

2010 NCCIPMA Annual Conference

March 4, 2010

By

Jeffrey C. Chang, Esq.
JCC@seethebenefits.com

CHANG RUTHENBERG & LONG PC
EMPLOYEE BENEFITS LAWYERS

620 Coolidge Drive, Suite 350
Folsom, CA 95630
www.seethebenefits.com
(916) 357-5660
Direct line (916) 294-3260

Employee Benefits:

Identifying Solutions In Difficult Economic Times

I. Introduction

Many California governmental employers and public agencies continue to face severe budget crises and 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.

This discussion will focus primarily on the "impairment of contract doctrine" and ways in which governmental employers can make changes without running afoul of applicable legal restrictions. Since budgets are now being cut to the bone, we may finally be at a point where governmental employers have no choice but to sit down with their bargaining units, discuss and analyze these fiscal realities and agree upon a list of reasonable adjustments to a variety of benefit programs. The concern is that unless overall pension and benefit costs can be brought to a more sustainable level, a number of municipalities may be driven into insolvency or bankruptcy. Our basic premise today is that it will be better in the long run for employee groups to agree to a series of meaningful benefit modifications, which can be sustained, rather than to attempt to block all benefits modifications until only draconian measures remain. Hopefully, governmental employers and their employees can learn to work together on constructive long-term benefit solutions – many of which can turn into win-win situations. After all, what use is a super-rich benefit program if there are no employees left to benefit from it?

II. The Misunderstanding About Public Retirement Benefits

Much of the confusion over the rights of public employees to retirement benefits stems, in my view, from the way in which the California courts have described these rights. For example, in *San Bernardino Public Employees Association v. City of Fontana*[i], the Court of Appeal quoted *Kern v. City of Long Beach*[ii] 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 immediately due." The clear implication of this language is a 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, I plan to share my views on this and explain why I 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. A Modification or Reduction of 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.[iii]

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 against the City of Long Beach. In essence, the City rejected the firefighter's (Kern's) application for retirement benefits <u>following</u> 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 <u>had been eliminated by charter amendment some 32 days before he completed the required 20 years of service</u>. 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 employer 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 not 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, but 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*[iv]. *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 3/29/1945, *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 period 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 was necessary to "preserve or protect the pension system"[v] or "safeguard the pension system and carry out its beneficent purposes."[vi]

Given the critical budget situations all of your governmental employers 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 An 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.[vii] Furthermore, the *Walsh* decision[viii] clearly implies that there was nothing wrong with the subsequent addition to a pension scheme for legislators of a reservation of rights.

Observation: Even where an expressed or implied reservation of rights can be found, however, the public agency still cannot totally eliminate benefits, particularly DBPs, which have already been "earned."[ix]

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 an 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.*[x] 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. If fact, *San Bernardino* stands for the proposition that such benefits can be unilaterally curtailed following the expiration of an MOU under which they are 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 the 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.[xi] 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 *Vielehr*[xii], 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[xiii]; 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.[xiv]

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*[xv], the Court of Appeal determined that "future employees do not have a vested right in any particular pension plan" (citing *Claypool v. Wilson*[xvi]) 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.

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;

2. 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.

C. Understand Alternative Benefit Structures and Cost-Saving Strategies

1. 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 retirement, death or disability. Examples of DBPs: a CalPERS pension promising 2.5% of pay per year of service at age 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. In other 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 theoretic 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 years. Defined benefit pensions typically are "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 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 DB Arrangements To DC 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 different set of benefits. This likely will necessitate the "grandfathering" of certain groups and their accrued benefits. 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 life-long 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).

   b. 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 to certain other plans (this could be a 2 – 5% savings). Along these lines, the voting public views the amounts of unused vacation, PTO and leave that many governmental workers are allowed to accumulate as excessive. These accruals can give rise to a considerable unfunded liability. It should be possible to place caps on such accruals.

On the subject of PTO and PTO cash-out policies, you should take a look at our article, "*When Having Your Cake And Eating It May Be A Bad Thing: Cautions About Cash-Outs Of Unused Leave Or PTO."*

5. Hope For The Best But Plan For The Worst

As mentioned earlier, 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 process (see, *San Bernardino Public Employees 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.

[i] *San Bernardino Public Employees Association v. City Of Fontana*, 67 Cal. App. 4th 1215, 79 Cal. Rptr. 2d 634 (Fourth App. Dist., 1998).

[ii] *Kern v. City of Long Beach*, 29 Cal.2d 848, 179 P.2d 799 (1947).

[iii] *Woodruff v. Trapnall (1850) 51 U.S. (10 How.) 190, 207 [13 L.Ed. 383, 390].*

[iv] *Allen v. City of Long Beach*, 45 Cal. 2d 128, 287 P. 2d 765 (1955).

[v] *Allen* at 133.

[vi] *Wallace v. City of Fresno*, 42 Cal. 2d 180, 186, 265 P.2d 884 (1954).

[vii] *International Assn. of Firefighters v. City of San Diego (183) 34 Cal. 3d 292, 300-303 [193] 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].*

[viii] *Walsh v. Board of Administration*, 4 Cal. App. 4th 682, 6 Cal. Rptr. 2d 118 (1992).

[ix] *Kern v. City of Long Beach*, 29 Cal.2d 848, 179 P.2d 799 (1947).

[x] *California League of City Employee Associations v. Palos Verdes Library Dist.,* 87 Cal. App. 3d 135, 150 Cal. Rptr. 739 (1978).

[xi] *Pennie v. Reis, 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].*

[xii] *Vielehr v. State of California, 104 Cal. App. 3d 392, 163 Cal. Rptr. 795 (1980).*

[xiii] *Id.*

[xiv] *San Diego Police Officers' Association v. San Diego City Employees' Retirement System, 46 EBC 2813 (9th Cir. 2009).*

[xv] *California Association Of Professional Scientists v. Schwarzenegger*, 137 Cal. App. 4th 371, 40 Cal. Rptr. 3d 354 (2006).

[xvi] *Claypool v. Wilson*, 4 Cal.App.4th 646, 6 Cal. Rptr. 2d 77 (1992).