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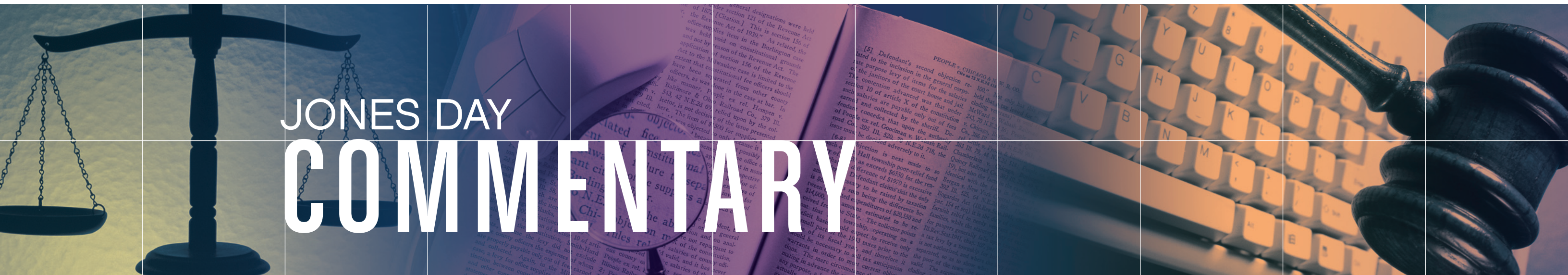

EVERYTHING YOU ALWAYS WANTED TO KNOW ABOUT A PUBLIC EMPLOYER'S ABILITY TO MODIFY RETIREE BENEFITS BUT WERE TOO AFRAID TO ASK

Mothers like to remind fighting children that there are two sides to every story. This maternal wisdom seems to underpin one of the great questions facing public-sector retirees: Can a public employee's retirement benefits be changed? No other issue makes public-sector retirees and their employers quite as mad. Changes made to a public-sector employee's retirement plan are almost always contested, and the outcome usually depends on the court's interpretation of the ordinance or statute giving rise to the retirement coverage.

The good news for baby boomers is that we are living longer. The bad news for public employers is that the longer baby boomers live, the costlier their retirement benefits become. Three trends pushing public-sector employers to reduce retirement costs are: (1) new accounting rules requiring employers to show on their books how much promises to retirees will cost; (2) the spiraling cost of providing medical benefits to retirees; and (3) the increasing longevity of retirees.

Hard choices lie ahead. State governments have promised to spend $2.73 trillion over the next 30 years on retiree benefits. This number includes $2.35 trillion for pensions. The remaining $381 billion is owed for retiree medical and other nonpension benefits. *See* Pew Center on the States, "Promises with a Price: Public Sector Retirement Benefits" ("Pew Report"), published December 18, 2007. About 97 percent ($370 billion) of the 30-year bill for retiree medical and other benefits was unfunded at the end of fiscal year 2006. The $370 billion in unfunded promised benefits is a conservative estimate because it does not include promises made to teachers or local government workers. Pew Report at p. 7. Many states owe so much that they may find it cost-prohibitive to provide the promised retiree medical benefits. *Id*. For example, California and New York each face approximately $50 billion in unfunded retiree medical liabilities.

Compounding the problem of out-of-control costs is that governmental plans are lightly regulated.

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Congress exempted its own employee benefit plan and other plans sponsored by governmental employers from the rigors of complying with the Employee Retirement Income Security Act of 1974 ("ERISA"). This "comprehensive and reticulated statute" regulates most aspects of employee benefit plans in the private sector. Although ERISA contains cradle-to-grave regulations for qualified retirement plans in the private sector, it does not contain any vesting or funding rules for public-sector retirement arrangements. ERISA § 4(b)(1), 29 U.S.C. § 1003(b)(1) (2006).

As described in more detail below, early cases—and modern cases in some jurisdictions—view public retirement benefits as a gratuity subject to change at any time. The weight of modern authorities in most jurisdictions, however, has rejected this gratuity approach and treated public retirement benefits as constitutionally protected contract rights.

THE RIGHTS OF PUBLIC PENSIONERS UNDER FEDERAL LAW

Retirement Rights as a Gratuity. The last United States Supreme Court decision concerning the rights of *public* employees to receive a pension was in 1889. The case involved a claim by the estate of a deceased police officer of the City and County of San Francisco who had participated in a mandatory Police Officers' Relief and Pension Fund ("Officers' Fund"). *Pennie v. Reis*, 132 U.S. 464 (1889). The Officers' Fund established a $1,000 death benefit payable to the officer's estate. Ten days before the officer died, the State of California repealed the Officers' Fund and established a new fund that did not offer a death benefit. James Pennie, the administrator of the officer's estate, asked Mr. Reis, the treasurer of the Officers' Fund, to pay the money to the estate. The treasurer refused to pay, and Pennie filed a writ of mandate with the state court to compel the treasurer to pay. The Supreme Court of California ultimately dismissed Mr. Pennie's writ, holding that the repeal of the Officers' Fund was lawful. The United States Supreme Court affirmed, ruling that public-employee pension programs do not create vested rights against legislative modifications. The Court explained that the deceased officer's interest in the fund was "a mere expectancy created by the law and liable to be revoked or destroyed by the same authority." *Id*. at 471. Because the "law of April 1, 1878, [was] repealed before the death of the intestate, [the officer's] expectancy became impossible of realization. The money which was to pay the amount claimed had been previously transferred and mingled with another fund and was no longer subject to the provisions of that act." *Id*.

More recently, the United States Supreme Court reached a similar conclusion with regard to railroad retirement benefits created by statute. It concluded that such benefits were changeable at any time: "There is no claim here that Congress has taken property in violation of the Fifth Amendment, since railroad benefits, like Social Security benefits, are not contractual and may be altered or even eliminated at any time." *U.S. R.R. Ret. Bd. v. Fritz*, 449 U.S. 166, 174 (1980) (*citing Hisquierdo v. Hisquierdo*, 439 U.S. 572, 575 (1979), and *Flemming v. Nestor*, 363 U.S. 603, 608–11 (1960)).

Because *Pennie* has never been overruled, some lower federal courts have felt obliged to support its holding. For example, in *Zucker v. United States*, 578 F. Supp. 1239, 1243 (S.D.N.Y. 1984), claims by federal civil-service retirees to a constitutionally protected property interest in a pension were rejected, based on "85 years of unbroken Constitutional law at the Federal level beginning [with *Pennie*]," *aff'd*, 758 F.2d 637 (Fed. Cir. 1985), *cert. denied*, 474 U.S. 842 (1985). *See also Muzquiz v. City of San Antonio*, 378 F. Supp. 949, 955–60 (W.D. Tex. 1974) (rejecting due process and equal protection claims of unconstitutionality of a statute barring refunds of pension contributions to departing employees), *aff'd*, 520 F.2d 993, 1001–02 (5th Cir. 1975).

More recently, the Third Circuit ruled that changes to a Pennsylvania public pension plan did not violate either state or federal constitutional impairment of contract clauses where the public plan expressly reserved the right of modification. *Transp. Workers Union v. SEPTA*, 145 F.3d 619, 629 (3d Cir. 1998). The Third Circuit did observe, however, that "[w]hile *Pennie* has never been expressly overruled, most state supreme courts subsequently rejected the 'gratuity' approach in favor of an approach that viewed such programs as creating implied-in-fact unilateral contracts." *Id*. at 623.

Retirement Rights Are Contractual in Nature. The two other circuit courts of appeal that have more recently considered the question have sided with the state-law-created "implied-in-fact unilateral contract" approach. For example, in *Nevada Employees Ass'n v. Keating*, 903 F.2d 1223, 1227 (9th Cir. 1990),

the Ninth Circuit agreed with the Nevada Supreme Court that the "better reasoned view recognizes that non-vested employees have contractual rights in pension plans subject to reasonable modification in order to keep the system flexible to meet changing conditions, and to maintain the actuarial soundness of the system" (*quoting Public Employees' Ret. Bd. v. Washoe County*, 615 P.2d 972, 974 (Nev. 1980)). In *Keating*, the Ninth Circuit ultimately concluded that a Nevada law penalizing the withdrawal of pension contributions (which altered a previous law that did not contain a penalty) violated the Contract Clause because it was not a reasonable modification of the pension plan. Likewise, the Fourth Circuit in *Kestler v. Bd. of Tr. of North Carolina Local Gov't Employees Ret. Sys.*, 48 F.3d 800, 804 (4th Cir. 1995), observed that it too did not view pensions as gratuities. However, the court ultimately decided that legislative amendments to a North Carolina disability benefit plan did not violate the Contract Clause because rights to disability benefits did not vest until retirement.

The issue of whether a contract was established for protection by the federal constitutional Contract Clause is to be decided under federal law. In *General Motors v. Romein*, 503 U.S. 181, 186 (1992), the Supreme Court developed a three-part test to determine whether a contract has been impaired under the Contract Clause. Under this paradigm, a court is to first ask whether a contract exists. If it does, the court is then to determine whether the law in question impairs an obligation under the contract. If it does, the court is then to inquire whether the discerned impairment can fairly be characterized as substantial. If the answer to each of these three questions is yes, a federal court is compelled to void the proposed application of the challenged state law. *Id*.

THE RIGHTS OF PUBLIC PENSIONERS UNDER STATE LAW

A review of the state case law surrounding public employees' pension rights yields one sobering conclusion—it is a mess. While some cases take the *Pennie* approach and view the promise of a pension as a gratuity, most states addressing the issue have rejected the gratuity theory as outdated.

California Law. Probably the most prolific jurisdiction to have rejected the gratuity theory is the State of California. In general, the terms and conditions of public employment in California are controlled by statute or ordinance rather than by contract. *See Miller v. State of California*, 18 Cal. 3d 808, 813 (1977) ("It is well settled in California that public employment is not held by contract but by statute"). Nevertheless, "[u]nlike other terms of public employment, which are wholly a matter of statute, pension rights are obligations protected by the contract clause of the federal and state Constitutions."[1] *United Firefighters of Los Angeles City v. City of Los Angeles*, 210 Cal. App. 3d 1095, 1102 (Ct. App. 1989).

In the seminal case of *Kern v. City of Long Beach*, 29 Cal. 2d 848 (1947), the California Supreme Court reversed course from *Pennie v. Reis* and announced:

> [P]ublic employment gives rise to certain obligations which are protected by the contract clause of the Constitution, including the right to the payment of salary which has been earned. . . . Since a pension right is an "integral portion of contemplated compensation" . . . it cannot be destroyed, once it has vested, without impairing a contractual obligation.

Id. at 853.

The *Kern* case involved unusual facts. Mr. Kern had been a member of the City of Long Beach's fire department for 19 years and 11 months. When he began working as a firefighter, the city's charter had a provision that provided a pension for firefighters equal to 50 percent of annual salary after completing 20 years of service. For 15 years of his service, 2 percent of Mr. Kern's salary had been deducted and paid into the pension fund. On March 29, 1945, 32 days before Mr. Kern completed the required 20 years' service, a new section was added to the city charter repealing the pension provisions and eliminating pensions as to all persons not then eligible for retirement. *Id*. at 850. Upon completing his 20 years of service, Mr. Kern requested that he be retired and paid a pension. The city refused, and Mr. Kern filed suit. *Id*. The Supreme Court in *Kern* decided that Mr. Kern's right to his pension ben-

1. Both the United States and the California Constitutions prohibit the impairment of contractual rights. Article I, section 10, of the U.S. Constitution states: "No State shall . . . pass any Bill of Attainder, ex post facto Law, or Law impairing the Obligation of Contracts, or grant any Title of Nobility." The California Constitution similarly states at Article I, section 9: "A bill of attainder, ex post facto law, or law impairing the obligation of contracts may not be passed."

efits vested upon his acceptance of employment. *Id*. at 852.

The Supreme Court, while recognizing the unilateral nature of a public employee's pension rights, did not make them unchangeable:

> Thus it appears, when the cases are considered together, that an employee may acquire a vested contractual right to a pension but that this right is not rigidly fixed by the specific terms of the legislation in effect during any particular period in which he serves. The statutory language is subject to the implied qualification that the governing body may make modifications and changes in the system. The employee does not have a right to any fixed or definite benefits, but only to a substantial or reasonable pension. There is no inconsistency therefore in holding that he has a vested right to a pension but that the amount, terms and conditions of the benefits may be altered.

Id. at 855.

The Supreme Court concluded that Mr. Kern had a vested pension right and that the City of Long Beach, by completely repealing his pension, had improperly attempted to impair its contractual obligations. *Id*. at 856.

A more modern and refined version of this "vested rights" doctrine was set forth by the California Supreme Court in the leading case of *Betts v. Bd. of Admin.*, 21 Cal. 3d 859, 863 (1978):

> A public employee's pension constitutes an element of compensation, and a vested contractual right to pension benefits accrues upon acceptance of employment. Such a pension may not be destroyed, once vested, without impairing a contractual obligation of the employing public entity [*citing Kern*]. The employee does not obtain, prior to retirement, any absolute right to fixed or specific benefits, but only to a "substantial or reasonable pension."

In summary, "[b]y entering public service an employee obtains a vested contractual right to earn a pension on terms substantially equivalent to those then offered by the employer," *Carman v. Alvord*, 31 Cal. 3d 318, 325 (1982) (*citing Betts*), and to earn additional pension benefits pursuant to improved terms conferred during continued employment. *See Betts*, 21 Cal. 3d at 866 ("An employee's contractual pension expectations are measured by benefits which are in effect not only when employment commences, but which are thereafter conferred during the employee's subsequent tenure"). This means that the employee has a vested right not merely to preserve the pension benefits already earned, but also to continue to earn benefits under the terms previously promised through continued service. *See Legislature v. Eu*, 54 Cal. 3d 492, 530 (1991) ("We conclude that incumbent legislators had a vested right to earn additional pension benefits through continued service"); *see also Pasadena Police Officers Ass'n v. City of Pasadena*, 147 Cal. App. 3d 695 (Ct. App. 1983) ("the employee has a vested right not merely to preservation of benefits already earned pro rata, but also, by continuing to work until retirement eligibility, to earn the benefits, or their substantial equivalent, promised during his prior service").

Under *Kern* and its progeny, determining whether a particular change to retirement benefits impairs a vested right involves a two-step inquiry. The first question is whether the change actually alters the contract between the employer and the employee. If it does, the next question is whether the change constitutes a reasonable modification.

Looking at the Terms of the Contract. In California, whether a proposed change impairs a vested right under a public pension plan depends upon how the member's rights are defined under the terms of the governing "contract." *See Int'l Ass'n of Firefighters v. City of San Diego*, 34 Cal. 3d 292, 302 (1983). Thus, the nature and extent of a member's vested right to a retirement benefit must be ascertained from the language of the statute and other legally operative documents, such as resolutions implementing the retirement plan—*see*, *e.g.*, *id.* at 302 (looking to city charter and ordinance); *Ventura County Retired Employees' Ass'n v. County of Ventura*, 228 Cal. App. 3d 1594, 1598–99 (Ct. App. 1991) (looking to the Government Code to determine an employer's obligations), *rev. denied*, 1991 Cal. Lexis 3034 (1991); *Orange County Employees Ass'n, Inc. v. County of Orange*, 234 Cal. App. 3d 833, 843–44 (Ct. App. 1991) (looking to the Government Code), *rev. denied*, 1991 Cal. Lexis 5658 (1991); *Thorning v. Hollister School. Dist.*, 11 Cal. App. 4th 1598, 1607–08 (Ct. App. 1992) (looking to official declaration of policy issued pursuant to Government Code); 2000 Cal. AG Lexis 3 (January 28, 2000) (benefits provided pursuant to city resolution adopted under Government Code)—and judicial construction of those provisions or similar provisions at the time the contractual relationship was established. *Kern,*

29 Cal. 2d at 850. "[I]t is necessary to perceive the terms of the contract and to utilize those terms to measure the claimed impairment." *Lyon v. Flournoy*, 271 Cal. App. 2d 774, 783 (Ct. App. 1969), *appeal dismissed*, 396 U.S. 274 (1970). It is the reasonable expectations of the employee that are protected. *See generally Allen v. Bd. of Admin*., 34 Cal. 3d 114 (1983); *see also Ass'n of Blue Collar Workers v. Wills*, 187 Cal. App. 3d 780, 792 (Ct. App. 1986) (right vested in employees is their "reasonable expectation" that the city would meet its statutory obligation to fund past-service liability).

The case law bears out the conclusion that the scope of a member's vested right is defined by the terms of the promise. For example, the California Supreme Court has held that if a member's contribution rate under a pension plan is fixed and the pension plan does not give the plan sponsor the right to change the rate, any increase in that rate would constitute an impairment. *See generally Allen v. City of Long Beach*, 45 Cal. 2d 128 (1955); *see also Abbott v. City of Los Angeles*, 50 Cal. 2d 438, 451–53 (1958) (changes, including imposition of member contributions where plan provisions previously required full cost to be paid by employer, held invalid), *Wisley v. City of San Diego*, 188 Cal App. 2d 482, 486 (Ct. App. 1961) ("It is obvious that the increase in the percentage of the employee's contribution to the retirement fund is a detriment"). In contrast, where the plan terms state that a member's contribution rate is subject to adjustment based upon actuarial assumptions, an increase in the member's contribution rate attributable to changes in such actuarial assumptions is not an impairment. *See Int'l Ass'n of Firefighters*, 34 Cal. 3d at 300, 302–03; *see also Pasadena Police Officers Ass'n*, 147 Cal. App. 3d at 711 (because the authority of the retirement board to adopt and approve actuarial assumptions was a condition of entitlement to benefits at all times, the decision of the board in the exercise of that authority to use an assumption as to salary inflation in calculating contributions did not deprive members of vested rights); *accord Walsh v. Board of Admin.*, 4 Cal. App. 4th 682, 700 (Ct. App. 1992) ("If the modification of Walsh's retirement benefits was consistent with the reservation of power to the Legislature, then it was valid regardless [of] whether the [retirement system] can be said to have granted contractual rights to members of the Legislature").

***The Reasonable Modification Doctrine*.** Generally, a California public pension plan may be modified *prior to an employee's retirement* for the limited purpose of keeping the system sufficiently flexible to accommodate changing conditions so as to maintain the integrity of the system. *Int'l Ass'n of Firefighters v. City of San Diego*, 34 Cal. 3d at 300–01. Thus, modifications to public pension plans must be "reasonable" as determined under a two-part test. Under the first part, if the change results in disadvantages to a member, it must be accompanied by comparable, offsetting advantages. *Miller,* 18 Cal. 3d at 816. Under the second part, the modification of pension rights must bear some material relation to the theory of a pension system and its successful operation. *Abbott*, 50 Cal. 2d at 453. Courts have concluded that retirees, unlike active employees, are not subject to the reasonable modification doctrine. *See Terry v. City of Berkeley*, 41 Cal. 2d 698, 702–03 (1953); *Claypool v. Wilson*, 4 Cal. App. 4th 646, 664 (Ct. App. 1992).

Employers have been successful in applying this doctrine in only a handful of cases. In most cases, the courts have concluded that there were insufficient (if any) offsetting advantages to justify the change.

Comparable Offsetting Advantages. In determining whether a disadvantage to employees is offset by a comparable new advantage, California courts focus on the particular employees who are disadvantaged and whether those employees tend to gain advantages from the proposed pension plan amendment. *Abbott*, 50 Cal. 2d at 453. Changing a public pension plan so that a person convicted of a felony would forfeit all pension rights was not "reasonable," according to the California Supreme Court, because forfeiture was a "detriment" without any corresponding advantages to the particular disadvantaged employee. *Wallace v. Fresno,* 42 Cal. 2d 180, 185–86 (1954).

Similarly, the "comparable new advantages" test was used to invalidate an increase in the employee contribution rate to a retirement system from 2 percent of salary to 10 percent. *Allen v. City of Long Beach*, 45 Cal. 2d at 130. The California Supreme Court ruled that the 8 percent increase constituted a substantial increase in the cost of pension protection to the affected employees without any corresponding increase in the amount of pension benefit payments. *Id.* at 131. In other words, when the employee's contribution rate is a fixed element of the pension system under the governing documents, the rate cannot be increased unless the employee receives comparable new advantages for making an increased con-

tribution. *Pasadena Police Officers Ass'n*, 147 Cal. App. 3d at 702. On the other hand, a "comparable offsetting advantage" was found when the Public Employees' Retirement Law was changed to eliminate the ability of state employees to retire at age 55. *See Amundsen v. PERS*, 30 Cal. App. 3d 856, 859 (Ct. App. 1973). In *Amundsen*, a public employee who was on the verge of attaining age 55 filed suit, claiming his pension rights had been impaired because the new law required state employees to complete five years of service before retiring. *Id*. at 858. An offsetting comparable advantage was found by the court in upholding the new law because the amount of employee contributions was decreased and substantially higher pensions would be paid. *Id.* at 859.

Material Relation to the Theory of a Pension System. The case law interpreting the "material relation" requirement is sparse. The California Supreme Court ruled early on that a pension plan amendment that terminated all pension rights of a pensioner upon conviction of a felony after retirement did not have a "material relation" to the theory of the pension system or to its successful operation. *Wallace,* 42 Cal. 2d at 185.

The court pointed out that the change was designed to mollify taxpayers who objected to their tax monies going toward payment of a felon's pension. Similarly, the California Supreme Court found in *Allen v. City of Long Beach,* 45 Cal. 2d at 133, that amendments that increased employee contribution rates, provided for a new fixed pension, and required an additional contribution from employees returning from military service did not bear a relation to the functioning and integrity of the pension system. Rather, the changes were needed because newer employees, not eligible for the original pension, were disgruntled, and the city wished to equalize the compensation of the two employee groups to ease the tensions. *Id*.

California courts have held that to satisfy the "material relation" prong of the reasonableness test, the change:

> [m]ust relate to considerations internal to the pension system, *e.g.*, its preservation or protection or the advancement of the ability of the employer to meet its pension obligations. Changes made to effect economies and save the employer money do "bear some material relation to the theory of a pension system and its successful operation . . ." [*quoting Betts,* 21 Cal. 3d at 864]. That is not to say that a purpose to save the employer money is a sufficient justification for change. The change must be otherwise lawful and must provide comparable advantages to the employees whose contract rights are modified. We hold only that the monetary objective will not invalidate a modification which is otherwise valid.

Claypool v. Wilson, 4 Cal. App. 4th at 666.

Other State Jurisdictions. Numerous states have followed California's example and adopted some form of unilateral contract theory to enforce the rights of public employees to their pensions. *See generally Police Pension & Relief Board of Denver v. Bills*, 148 Colo. 383 (1961); *Nash v. Boise City Fire Dept*., 104 Idaho 803 (1983); *Brazelton v. Kansas Public Employees Ret. Sys.*, 227 Kan. 443 (1980); *Eisenbacher v. City of Tacoma*, 53 Wash. 2d 280 (1958).

For example, in *City of Frederick v. Quinn*, 35 Md. App. 626 (Md. Ct. Spec. App. 1977), the question presented was whether the City of Frederick could unilaterally repeal a noncontributory police pension plan. The trial court ruled that the police officers' pension rights vested upon employment and were immune from prospective legislative impairment. *Id*. at 629. The Maryland court of appeals found that the trial court had gone too far, but it agreed that a public pension is subject to significant contractual protections:

> Tracing the evolution of theories in the decisional law of public employee statutory pension rights [ ] leaves one with the same sense of disturbing disbelief we feel when we see caricatures of our neanderthal forebearers. The unfortunate result revealed by such research is that the majority of the states have not evolved from this prehistoric immaturity . . . . The medieval or even colonial concepts of a compassionate and generous sovereign rewarding his humble, devoted subjects is completely alien to our modern views of a democratic government's obligations to its citizens.
>
> Only slightly less bemusing, on the other hand, is the picture of a citizen whose contractual strength is so formidable that the government which employs him can neither terminate nor vary the terms of the employment contract which is the essence of the strict constructionist views explicated by [*Yeazell v. Copins*, 98 Ariz. 109 (1965)]. Such rigid interpretation is the inevitable pitfall of

> seeking pigeonholes with labels as substitutes for logic and common sense.

Id. at 629–30.

Ultimately, the Maryland court of appeals followed the "modified" unilateral contract approach articulated by the California courts in *City of Downey v. Bd. of Admin. Pub. Emp. Ret. Sys.*, 47 Cal. App. 3d 621, 630–31 (Ct. App. 1975):

> The contractual or vested rights of the employee in Maryland are subject to a reserved legislative power to make *reasonable modifications* in the plan, or indeed to modify benefits if there is a simultaneous offsetting new benefit or liberalized qualifying condition. Each case where a changed plan is substituted must be analyzed on its record to determine whether the change was reasonably intended to preserve the integrity of the pension system by enhancing its actuarial soundness, as a reasonable change promoting a paramount interest of the State without serious detriment to the employee.

Halpin v. Nebraska State Patrolmen's Ret. Sys., 211 Neb. 892 (1982), is likewise illustrative. It involved the question of whether a retiring employee's monthly average salary should include the lump-sum payment received for accumulated but unused vacation and sick leave. *Id* at 896. Prior to 1979, accumulated vacation and sick leave had been included in calculating a Nebraska patrolman's monthly retirement benefit. The Nebraska attorney general opined in 1978 that accumulated vacation and sick leave should not be counted in determining retirement benefits. *Id*. at 895. The Nebraska State Patrolmen's Retirement Board adopted a new rule effective January 4, 1979, that accumulated vacation and sick leave would no longer be used in calculating a patrolman's final average monthly salary. Mr. Halpin sued, claiming the Retirement Board's action was void because it impaired his vested contractual rights. The Nebraska Supreme Court concluded Mr. Halpin was right—the Retirement Board's failure to include lump-sum leave payments in his patrolman's annuity calculations was an impairment of a vested contractual right. *Id*. at 901. It explained that pension payments constitute deferred compensation for services rendered, and it agreed with the California Supreme Court that "the right to pension benefits vests upon acceptance of employment." *Id*. at 900 *(citing Miller v. State of California*, 18 Cal. 3d 808, 815 (1977)).

A few states have provisions in their state constitutions stating that an employee's right to his or her pension vests at the time he or she starts employment. *See, e.g.,* Alaska Constitution Article XII, section 7; Hawaii Constitution Article XVI, section 2; and Michigan Constitution Article IX, section 24. Some states, like Arizona, view public pensions as property rights and guarantee a contractual right to a pension even though there is no specific state constitutional provision. In *Yeazell v. Copins*, 98 Ariz. 109, 116 (1965), the Arizona Supreme Court ruled that the Arizona legislature could not alter the eligibility rules for public pension participation, nor could it reduce the amount of contributions to the pension fund even if the actuarial soundness of the public pension fund was in jeopardy.

Minnesota is different. It uses the doctrine of promissory estoppel to determine whether a public employee's right to a pension is enforceable. *Law Enforcement Labor Serv., Inc. v. County of Mower*, 483 N.W.2d 696, 701 (Minn. 1992).

Illinois entertains due process of law claims to protect public pension benefits. It has a constitutional provision (Article XIII, section 5) that states: "Membership in any pension or retirement system of the State . . . shall be an enforceable contractual relationship, the benefits of which shall not be diminished or impaired." In *Miller v. Ret. Bd. of Policemen's Annuity & Benefit Fund*, 329 Ill. App. 3d 589 (2001), a class-action lawsuit was filed concerning a legislative amendment that reduced police officers' pension benefits. The court ruled that the Illinois constitutional provision gave the police officers a constitutionally protected property interest in their pension benefits and that the proposed statute would deprive them of this property without due process of law in violation of 42 U.S.C. § 1983 (a civil rights claim).

Finally, some states, like Texas, continue to view the promise of a pension as a gratuity. *Cook v. Employees Ret. Sys.*, 514 S.W.2d 329 (Tex. Ct. App. 1974), is illustrative. Joyce Cook's husband was killed in the line of duty as a fireman for the City of Richardson, Texas. She filed suit to protect the right of her three children to receive annuity benefits until they reached the age of 21. At the time of Mr. Cook's death, Texas law provided that children who had not reached the age of 21 would receive monthly annuities. In 1973, the Texas legislature changed the definition of "minor" to a child who had not reached the age of 18. Ms. Cook filed suit, claiming that

changing the definition of "minor" was unlawful because it caused a forfeiture of her children's entitlement to receive their father's vested pension benefits. The trial court dismissed Ms. Cook's claim. The Texas court of civil appeals affirmed, explaining that the right to benefits of a pension fund are subordinate to the right of the legislature to diminish benefits or abolish the pension fund. *Id*. at 331.

THE ROLE OF COLLECTIVE BARGAINING

While retirement benefits generally are terms and conditions of employment subject to collective bargaining, several jurisdictions have held that a collective bargaining unit may not bargain away constitutionally protected individual rights such as vested pension rights. *Welter v. City of Milwaukee*, 214 Wis. 2d 485, 495 (Ct. App. 1997), *rev. denied*, 217 Wis. 2d 519 (1998) ("The City's argument that the officers should be deemed to have consented to the modification of their vested retirement-system rights because the concessions were agreed to by their unions ignores that a union may not bargain away the vested rights of its members without the express consent of those members"); *In re Morris Sch. Dist. Bd. of Educ.*, 310 N.J. Super. 332, 345 (1998), *cert. denied*, 156 N.J. 407 (1998) (noting that "[i]n a variety of factual settings, courts have held that a union has no authority on behalf of its membership to bargain away various forms of deferred compensation earned during the terms of prior collective bargaining agreements absent knowing consent by those who would be adversely affected"); *cf. Wright v. City of Santa Clara*, 213 Cal. App. 3d 1503, 1506 (1989) (stating that a "collective bargaining agreement may not waive statutory rights which arise from an extraordinarily strong and explicit state policy"); *Phillips v. State Pers. Bd*., 184 Cal. App. 3d 651, 660 (1986), *disapproved on other grounds in Coleman v. Dep't of Pers. Admin*., 52 Cal. 3d 1102, 1123 n. 8 (1991) (holding that a collective bargaining agreement could not waive an employee's right to due process); *see also Allied Chemical & Alkali Workers of Am., Local Union No. 1 v. Pittsburgh Plate Glass Co*., 404 U.S. 157, 182 n. 20 (1971) (noting that "[u]nder established contract principles, vested retirement rights may not be altered without the pensioner's consent").

To the extent the retirement rights originate in a collective bargaining agreement, however, it may be possible to renegotiate some of these rights, at least prior to an employee's retirement. In *San Bernardino Public Employees Ass'n v. City of Fontana*, 67 Cal. App. 4th 1215 (1998), a labor union sought to set aside provisions in several memoranda of understanding relating to reductions in personal leave accrual and longevity pay benefits. The court held that personal leave and longevity pay were negotiable, which distinguished them from vested pension rights. While pension benefits are entitled to contract clause protection, personal leave and longevity pay could not become irrevocably vested because they were provided for in collective bargaining agreements of fixed duration only and because no outside statutory source protected those benefits. *Id*. at 1223–25.

A PUBLIC EMPLOYEE'S RIGHT TO RETIREE MEDICAL BENEFITS

It appears that, depending upon the nature and terms of the "contract" involved, retirement health benefits, like pension benefits, may become "vested" and constitutionally protected from impairment in some jurisdictions. For example, *Thorning v. Hollister School District*, 11 Cal. App. 4th 1598 (1992), was the first case in California to extend the vested rights doctrine to protect retirement health benefits. In *Thorning*, the court considered the decision by a school district board to eliminate retirement health benefits provided to retired board members under a declaration of policy previously adopted by the board. In 1988, during the terms of office of the plaintiffs and pursuant to Government Code section 53201, the school district adopted Policy No. 9250(a) as part of the "Bylaws of the Board." Policy No. 9250(a) provided:

> Any members retiring from the [school district] Board after at least one full term shall have the option to continue the health and welfare benefits program if coverage is in effect at time of retirement, except that Board members who have served less than twelve (12) years, but at least one term shall pay the full cost of health and welfare benefits coverage.

Id. at 1604–05. In July 1990, the Board revised this policy to provide that "[t]he Board *may* authorize payment of premiums for retired members who have served twelve (12) years or more." *Id.* at 1605. On November 27, 1990, the Board voted to continue payment of health benefits for the plaintiffs for the next 10 years. The plaintiffs' terms ended as of

December 1, 1990, and on December 11, 1990, the new Board voted to suspend payment of plaintiffs' health benefits.

The court looked to Policy No. 9250(a) as adopted in 1988 as the governing contract setting forth the plaintiffs' rights to retirement health benefits. It concluded that the July 1990 change in the Policy could not diminish the benefits already awarded to the plaintiffs during their term of office. Considering the three criteria established by the *California League* case, the court indicated that the rights set forth under the 1988 Policy were akin to pension benefits, and it concluded that they vested because they were part of the compensation promised to the Board members and as such were important to the Board members as an inducement for their continued service on the Board and a factor in their ultimate decision to retire. The court further concluded that because the terms of the policy provided that only individuals with less than 12 years of service were required to contribute to the cost of coverage, the vested contractual right for the plaintiffs (who had more than 12 years of service) included the right to have the employer pay the cost of their coverage.

While there are a number of arguments that may be made about the viability and scope of the *Thorning* decision, there do not appear to be any cases in California that hold that retiree health benefits are not constitutionally protected from impairment. A number of cases, however, have taken a careful look at the "contract" involved and have determined that the challenged changes were permitted. *See Sappington v. Orange Unified School Dist.*, 119 Cal. App. 4th 949 (2004) (finding it unnecessary to determine whether the retiree health rights at issue were vested because contract did not promise payment of the entire cost of coverage and language of contract was so broad that it obligated employer to provide only a program of health insurance, not any particular kind); *Mayers v. Orange Unified School Dist.*, 2003 Cal. App. Unpub. LEXIS 6346 (2003) (contract provided only for the same health benefits as provided to active employees; not entitled to free enrollment in a PPO if the employer did not provide the same benefit for actives); *see also Ventura County Retired Employees' Ass'n v. County of Ventura*, 228 Cal. App. 3d. 1594 (1991) (county did not have mandatory duty to provide retiree health benefits under applicable statute; provision of benefits was discretionary); *Orange County Employees Ass'n v. County of Orange*, 234 Cal. App. 3d 833 (1991) (same).

Similar to California, Alaska views retirement medical benefits as part of the overall retirement benefit package. As such, retirement medical benefits, like pension benefits, are protected by the Alaska Constitution from being diminished. In *Duncan v. Retired Public Employees of Alaska, Inc.*, 71 P.3d 882 (Alaska 2003), the Alaska Supreme Court stated that the term "accrued benefits" as used in the Alaska Constitution includes the retirement medical benefits offered to public employees.

The courts' treatment of retirement medical benefits has been less favorable to public employees in other jurisdictions. For example, in *Bremerton Public Safety Ass'n v. City of Bremerton*, 104 Wn. App. 226, 231 (Wash. Ct. App. 2001), the court permitted the city to reduce or eliminate retirement medical benefits where retirees declined to purchase available Medicare supplemental coverage because the state law that protected these benefits simply stated that the employer shall pay any medical costs incurred by the retired member "not payable from some other source."

The Michigan Supreme Court also permitted changes to retirement health benefits in *Studier v. Michigan Public Sch. Employees Ret. Bd.*, 472 Mich. 642, 645 (2005). The school retirees in that case challenged increases in prescription drug copayments and medical deductibles as violating the state constitutional provision protecting "accrued financial benefits" from reduction. The Michigan Supreme Court ruled that the definition of "accrued financial benefits" applied only to those benefits that consisted of monetary payments that were earned and became vested through the passage of time. It observed that health-care benefits were neither cash payments nor the type of benefits that increased in value over time, such as defined-benefit pension benefits. *Id*. at 664–65. The Michigan Supreme Court was guided by the fundamental principle of jurisprudence recognizing that one legislature cannot bind the power of a successive legislature. *Citing United States v. Winstar Corp*., 518 U.S. 839, 873 (1996). The Michigan Court observed that the United States Supreme Court established a strong presumption that statutes do not create contractual rights in its *Nat'l R.R. Passenger Corp. v. Atchison, Topeka & Santa Fe Ry. Co*., 470 U.S. 451, 465–66 (1985), decision:

> For many decades, this Court has maintained that absent some clear indication that the legislature intends to bind itself contractually, the presumption is that "a law

is not intended to create private contractual or vested rights but merely declares a policy to be pursued until the legislature shall ordain otherwise."

* * *

This well-established presumption is grounded in the elementary proposition that the principal function of a legislature is not to make contracts, but to make laws that establish the policy of the state. *Indiana ex rel. Anderson v. Brand*, 303 U.S. 95, 104-105 . . . .

The first step in this cautious procession is to examine the statutory language itself. *Nat'l R.R., supra*, at 466. In order for a statute to form [an enforceable contract,] the statutory language "must be plain and susceptible of no other reasonable construction" than that the legislature intended to be bound to a contract. *Stanislaus County v. San Joaquin & King's River Canal & Irrigation Co*., 192 U.S. 201, 208 (1904). "[A]bsent an 'adequate expression of an actual intent' of the State to bind itself," courts should not construe laws declaring a scheme of public regulation as also creating private contracts to which the state is a party. *Nat'l R.R., supra*, at 466-467 . . . some federal courts, when interpreting statutes involving public-employee pension benefit plans, have expressed greater reluctance to infer a contractual obligation where a legislature has not explicitly precluded amendment of a plan. *Nat'l Ed. Ass'n-Rhode Island v. Retirement Bd. of the Rhode Island Employees' Retirement System*, 172 F.3d 22, 27 (CA 1, 1999).

472 Mi. at 661–63.

VEHICLES FOR PREFUNDING RETIREE HEALTH BENEFITS

Many public employers have made promises concerning retiree health that are being paid on a "pay as you go" basis. To the extent the looming unfunded liabilities generated by these promises cannot be reduced by changes to the retirement health program, it is at least possible to begin to ameliorate the unfunded liability by beginning to prefund the retirement health obligation.

Prefunding may be accomplished using one of several types of trust that would be tax-exempt under federal law: (i) an entity that is exempt from taxation because the entity is either an integral part of a governmental entity or maintained by a governmental entity under Internal Revenue Code section 115 (collectively "Government Trusts"), (ii) an entity organized to qualify as a voluntary employees' beneficiary association under Code section 501(c)(9) ("VEBA"), and (iii) an account established under Code section 401(h) ("401(h) account") to provide retiree medical benefits through a pension plan. All three vehicles may be funded by employer contributions on a pretax basis, and the income accrued thereon should be tax-free. In addition, amounts received by retirees and their dependents (directly or indirectly) from these entities to pay for health insurance or to provide reimbursement for incurred medical expenses generally should be excludable from gross income (unless the plan is self-insured and discriminates in favor of highly compensated employees).

The three vehicles identified above are those that, in our experience, have most often been used by employers to prefund retirement health obligations. While each vehicle has relative strengths and weaknesses, a Government Trust appears to provide employers with the greatest flexibility to prefund retirement medical benefits.

WHAT STEPS SHOULD PUBLIC EMPLOYERS TAKE TO EVALUATE AND PERHAPS LIMIT LIABILITIES?

Over the next 25 years, the ratio of active to retired workers will decrease from three active employees for every one retiree to two active employees for each retiree. 65 Ohio State Law Journal 1 (2004). As baby boomers begin to swell the ranks of the retired population, an increasing number of them will likely live longer than ever before. The Congressional Research Service reports that life expectancy for men increased from 67 years in 1960 to 75 years in 2003. Life expectancy for women increased from 73 years in 1960 to 80 years in 2003. Congressional Research Service, Life Expectancy in the United States 3 (2006). By 2025, the 65-and-over population will almost double, from 36.7 million Americans in 2005 to 63.5 million. Congressional Research Service, Older Workers: Employment in Retirement Trends 2 (2005). These demographic trends raise obvious sustainability issues for the pay-as-you-go retirement programs for public-sector employers.

Faced with this dizzying array of statistics, constitutionally protected contract rights, and judge-made mandates, what can a public employer do to control the increasing costs of retirement benefits?

1. Assess the current and project the future financial impact of retirement benefits.

   - What are the current costs?
   - What will the program cost in five years if no changes are made?
   - Ten years?
   - What is the impact on the public entity's credit rating if no changes are made?
   - What impact will retiree benefits have on the public entity's ability to provide ongoing services?
   - What is the financial impact of reducing or eliminating retirement benefits for new hires? For existing employees?

2. Carefully assess what retirement promises have been made.

   - Determine who made them.
   - Did they have the authority to do so?
   - How were the retirement promises made?
   - What do the words of the "contract"—*i.e.*, the statute, the ordinance, the governing board's resolutions, or other plan documents—say?
   - What do applicable collective bargaining agreements say?
   - Has the promise changed over time? In what way?
   - What did the legislative body say about making changes to retirement benefits?
   - Have there been court challenges to changing retirement benefits?
   - What were the results?

3. Examine the available options based on the terms of the "contract."

   - Can the public employer make future changes to retiree benefits for active employees or retirees?
   - What changes are permitted?
   - Must future changes be offset with comparable advantages?
   - Can you reach agreement with applicable bargaining units with regard to changes that can be made?
   - If you are not currently prefunding benefits (*e.g.*, retirement health), would it be advantageous to do so?

4. Initiate a dialogue.

   - Communicate the "whys and hows" of the current dilemma.
   - Solicit public comment and support for proposed changes to the retirement program.

5. Take action.

   - Develop a plan for controlling retirement costs—*e.g.*, making permissible changes and/or prefunding benefits currently paid on a pay-as-you-go basis.
   - Identify key decision makers and key dates for implementation.
   - Is there a political solution?

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