FOCUS ON BENEFITS

Can California Local Government Employers Reduce Benefits Plan Costs? There's More Latitude Than You Think…

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The boom days of the millennium decade's early years are over, but the now unsustainable benefits packages negotiated by California state and local governments and their employees remain – some representing as much as 40 percent of overall budget costs. Our discussions with local government managers and their advisors suggest a tremendous amount of confusion and misinformation about their ability to align employee benefits costs with their fiscal realities. This article discusses one source of much of the confusion – interpretations by California courts of the Constitutional prohibition against impairment of contracts – and why local governments have more latitude than they think.

THE PROBLEM AND THE OBSTACLES PERCEIVED

Much of the confusion over the rights of public employees to retirement benefits stems from the way California courts have described these rights. *In San Bernardino Public Employees Association v. City of Fontana,* the Court of Appeal quoted *Kern* v. *City of Long Beach*: "[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 common understanding of this language is that a governmental body cannot modify or reduce a promised pension or retirement benefit without running afoul of the Constitutional prohibition against impairment of contracts. However, we believe that local governments actually have considerably more latitude to change retirement benefits.

For the uninitiated, the principal constraint upon California governmental agencies against making changes to pension and retiree medical benefits stems from language in both the U.S Constitution and the California State Constitution that generally prohibits California from impairing any contract it has entered into. A number of public employee organizations and individual public employees have aggressively, and understandably so, 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. In a number of important cases, such as *Kern*, the facts of the case practically cried out for a resolution in favor of the employee. 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 appropriate circumstances.

LESSONS FROM THE KERN CASE

Kern is one of the leading and most oft-cited cases. Let's take a closer look at the background of the case and what the court said.

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

In concluding that Kern 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:

- In California, pensions for public employees are more than a mere gratuity.
- 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.
- An employee has actually earned some pension rights as soon as he has performed substantial services for his employer.
- The payment of pension benefits, while contingent upon the performance of services required to earn the benefits, could not be rejected once all contingencies were satisfied.
- A city cannot deny or impair the contingent liability (to provide a pension) after the contractual duty to make salary payments has arisen.

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

- *Kern* involved an attempt by a city to <u>deprive an employee of all benefits under a pension program</u>.

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- 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."
- 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. Instead, it 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 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.

Taken as a whole, we do not believe that *Kern* stands for the proposition that pension benefits become vested upon commencement of employment and cannot be changed or reduced. Rather, we believe that *Kern* should be read for the following more moderate propositions:

- Upon commencement of employment, a public employee may, according to the terms of a local government charter, ordinance or plan, earn a vested right to participate in a retirement plan. This includes an expectation of receiving a substantial or reasonable pension in accordance with the terms of the program.
- Although a public employee may have a right to participate in a public pension program, the governing body has the right to make modifications and changes to the system – particularly if the changes are necessary to address changing conditions facing the agency (such as a budget crisis) and the changes do not deprive employees of pension or retirement benefits to the extent they have been "earned" under the system.

THE PROGENY OF KERN

Of course the law in this area has not remained static. In a few instances, language has crept into judicial decisions suggesting further restrictions on the ability of government to make pension benefit changes. For example, the post–*Kern* cases of *Allen v. City of Long Beach, Wallace v. City of Fresno* and *Packer v. Board of Retirement* introduce the notion that any pension change that disadvantages employees should be accompanied by a comparable new advantage. At first blush, it is easy to think that the "comparable new advantage" language would effectively preclude any "real" pension system changes with significant cost savings. Not so. We believe the intent of the courts in these cases was to prevent local governments from completely taking away already accrued benefits without providing comparable benefits in exchange.

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We do not think these court decisions would prevent a local government from reducing or modifying pension benefits to the extent they have not yet been earned.

LESSONS FROM OTHER DECISIONS

Because the purpose of this article is to make California governmental employers aware of their options to modify or reduce pension and other post-employment benefits, we have summarized below a number of cost-saving actions that local government employers may wish to consider:

- California's courts have found on several occasions that there is no prohibited impairment where the terms of the legislation (or plan) providing for the benefit expressly reserves the right to modify or reduce such benefits. Furthermore, the decision from *Walsh v. Board of Administration* clearly implies that there was nothing wrong with the subsequent addition of a reservation of rights to a pension scheme for legislators. Therefore, it is critically important for local government employers to review the various charter, ordinance and administrative code sections authorizing their plans to make sure that they have expressly reserved the right to modify and change benefits.
- 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 (California Government Code Section 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.* and *San Bernardino Public Employees Association v. City of Fontana*).
- Because it is well settled that public employees have no vested right in any particular measure of compensation or benefits (that is pay and pay-related benefits), and that these may be modified or reduced by proper statutory authority, governments should be able to reduce items of compensation, including the employer's payment for the following types of costs:
  - The employee's share of a contribution to a Social Security replacement plan (i.e., a "retirement system");
  - An annual cafeteria plan benefit, or flexible spending account benefit; and
  - The employee's mandatory contribution to a pension plan, such as CalPERS.
- In *California Association Of Professional Scientists v. Schwarzenegger*, 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 to prohibit changes in pension benefits as to new employees. Therefore, so long as the government

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employer's pension system can accommodate multiple classifications or tiers of benefits, the employer should be able to control future benefit costs by placing new hires in a less expensive benefit structure.

One of the more significant public relations problems that governmental pension systems have is the adverse publicity associated with pension and benefits "spiking" (e.g., increasing final compensation upon which a pension is based by getting paid for unused vacation time). There are ways to design and administer plans to avoid and discourage pension spiking, including abandoning plan formulas and compensation definitions that make it possible in the first place.

HOPE FOR THE BEST BUT PLAN FOR THE WORST

In an ideal world, a local government would be able to discuss with its employees and their bargaining representatives the critical and real need to reduce various compensation and benefit costs, and reach some reasonable compromise through the collective bargaining process. Fortunately, 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 a government employer is 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 last only 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.

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