# Re-Thinking Retirement 'Rights' for Public Employees

## *Vesting should not apply to future service.*

Girard Miller | January 6, 2011

One of the most controversial issues in pension reform today is whether public employers can modify the retirement benefits of employees for their future service. There is widespread agreement that benefits promised to employees for the work they have already done should be protected by law. In the public sector, however, many states have gone overboard with an ill-conceived concept: Once employees walk in the door, they are guaranteed their pension and other retirement benefits formulas for life.

In the private sector, the federal law is really clear on this point. The Employee Retirement Income Security Act of 1974 (ERISA) provides that vested employees are legally protected for their past service, but a private employer can freeze the plan, change its terms prospectively, or even substitute a like-kind benefit as long as the employee's actuarial value is retained. This should be the law of the land in the public sector as well, but at least a dozen states have given away irrevocable lifetime "rights" to benefits for future service and tied the hands of tomorrow's elected officials.

Thwarting the will of the people? This flies in the face of representative democracy, and cries for fundamental legal reforms. The problem now is how to put the genie back in the bottle. In some cases, it would require a state constitutional amendment, and that's almost impossible to achieve, especially in the states like California and Illinois where these structural problems are exacerbated by strong public employee union presence in the state legislature.

Interested readers who are unfamiliar with the lay of the land in this area can refer to the thoughtful research of law professor Amy Monahan, whose work I have cited previously. Monahan's research paper on pension rights is a great summary of relevant state law, court cases and the principles behind them. Although it does not cover every state in the union, it provides a helpful roadmap for those seeking to understand the challenges now facing public retirement systems that have granted employees unsustainable benefits.

**Implied contracts**. Representatives and lawyers for public employees contend that they entered public service with an implied contract (which some claim to be explicit) that their career decision to work for a government would be rewarded with pension or other deferred retirement benefits that would never be reduced. Sometimes the argument is made that the employees accepted lower salaries in exchange for retirement benefits that exceed those available in the private labor market, which justifies such an entitlement. (That argument seems flimsy if salaries have since achieved parity with private pay, or changes in labor market conditions make private employment less attractive.) Whatever the "exchange transaction" is claimed to be, the idea is that today's service carries with it an expectation that retirement benefits cannot be reduced.

From the public employer's perspective, and more importantly, for the voters and taxpayers who elect officials in a representative democracy to provide public services and represent their interests, the question is really whether yesterday's elected officials have the right to forever bind future representatives of the electorate to contractual terms with respect to future services. This is where labor law gets really messy.

**Pensions, bonds, mortgages and futures contracts**. There are indeed situations in which a prior legislative or governing body can obligate its successors to contractual mandates. Whenever a state or municipality borrows money and issues bonds, or enters into a mortgage on real estate, it makes a binding commitment upon future governing bodies to meet the terms of those agreements. What is different from

retirement benefits, however, is that the exchange between present value (for the bond proceeds or the real estate) and future value (the future repayment) is direct and calculable and typically does not require a further future performance by the counterparty. The bond proceeds are received all at one time, and the real estate title is transferred. In certain "futures"-oriented financial agreements like interest-rate swaps, the parties do agree to future performance, but that involves an explicit written agreement and the terms are exclusive and complete. In pension law, the employee can walk out of the "implied contract" at any time and take another job, so this is a very lop-sided long-term option that previous elected officials have naively awarded without a clear and commensurate benefit to the taxpayers.

What rubs pension reformers raw is the idea that a public employee should be entitled to the lifetime claim that retirement benefits cannot be reduced for future service. Here, we tread into the thornier field of compensation law, and I do not purport to be an expert on the philosophical principles upon which the state courts made their decisions that gave such constitutional rights to public employees.

**Lifetime vs. temporal rights.** Common sense would suggest that in a competitive labor market, an employer (and especially an elected body in a representative democracy) must have the flexibility to determine the forms and levels of compensation necessary to attract and retain employees. In states with collective bargaining, that exchange transaction typically involves a collectively bargained labor agreement with a finite term. History has shown (witness the Bell California salary scandal) that lifetime, multi-year, self-renewing or evergreen employment agreements invite the devil's mischief and run contrary to the public's interest. The general practice in collective bargaining is that terms and conditions of employment are set for specific periods of time under the written agreement. Upon expiration, the clock starts fresh and all bets are off.

This does not mean that retirement system laws cannot or should not provide some basic protections to employees. For example, an employer should not be allowed to arbitrarily increase the required retirement age for vested employees in such a way that the current actuarial value of the employees' vested benefits are diminished. Nobody should work for "negative compensation" — which could result from an extreme jump-shift of the retirement age. ERISA protects private employees from this hazard, and public employees deserve similar protections. However, employers ought to have the right to incrementally adjust retirement ages for incumbent employees to reflect longevity and to rebalance a retirement system that has gone out of control and become unaffordable. The key test should be whether each employee's vested actuarial value of accrued benefits has been preserved under such changing conditions.

Such a test would enable public employers to restructure the employment compensation plan in various was to meet changing labor market conditions and its own ability to pay. For example, a public employer might increase base salaries, or avoid layoffs and salary reductions, and reduce pension benefits for future service in a fair trade-off that is effectively precluded in some of these states. Otherwise, they will be forced to reduce salaries and lay off workers, curtail public services and punish both the public and the employees for the mistakes of the past.

**OPEB: The next battleground?** In the case of retiree medical benefits (known as OPEB for "other post-employment benefits") the case law is less settled, but many of the same principles protecting vested employees apply in several states. Given the magnitude of the OPEB funding problem, which is roughly double the unfunded liabilities of state and local pension plans, the ability of employers to alter the plan terms will soon become a crisis issue. Some employers will soon discover, for example, that they can no longer afford to provide retiree medical benefits to employees who retire before they attain Medicare eligibility at age 65. Under what circumstances would revocation or reduction of early retirement medical benefits be justified and fair? Should employers be able to change such terms for younger employees but not those imminently near the specified retirement age? In Texas, the legislature has declared that OPEB benefits are subject to legislative appropriation, which strengthens the hands of public employers seeking to modify retiree medical benefits through a budgetary declaration. But many states have been silent on this issue.

These will be thorny issues that public officials nationwide must confront, as they soon begin to realize that "new benefits tiers" for newly hired employees will not be sufficient to achieve fiscally sustainable plan levels or solve ongoing budgetary deficits in this decade. Although many employers will increase employee

contribution rates for incumbent workers, there will be some who must eventually confront the need to reduce benefits formulas for future service and raise the "normal" retirement age issue for current employees.

**Can pension reformers solve this problem?** Pension reformers in a few states have explored the feasibility of amending state constitutions to preserve public employers' rights to change benefits formulas on a prospective basis, but this would be a difficult idea to present to voters unless part of a more comprehensive package. Some pension critics are exploring whether a state constitution can be amended to rein in the rights of incumbent employees, especially in states in which the courts have interpreted their constitution as granting them a property or contractual right. Some are also considering language to require public sector compensation to be competitive in the labor markets from which employees are recruited, so that if pension benefits and early retirement medical benefits are excessively costly, the salaries would have to be reduced to achieve competitive total costs if the benefits are not rolled back prospectively. One legal team is outlining the "emergency" conditions that would warrant widespread revisions of pension benefits. I would not be surprised to see some creative thinking emerge from several of the watchdog and business roundtable groups in 2011.

In the meantime, public employers in states where the legal framework is either supportive or murky may want to include explicit language in their retirement plan documents and employee communications materials (such as plan descriptions). They might want to state, for instance, that benefits formulas can be changed on a prospective basis for future service so that employees cannot assert an implied contract. Caution must be taken to assure technical compliance with the "definitely determinable" tests in section 401 (a) of the federal tax code when making pension plan changes, but that is a manageable task for a competent pension lawyer.

**Evolving law.** Employees and retirees have filed suit in several states over the legal rights of a pension plan to amend its provisions in order to remain sustainable. Those cases may shed more light on how the higher courts will think about these issues in the context of what many consider to be an ongoing crisis in retirement plan finance. If the states are truly the "laboratories of American democracy," then 2011 should see a lot of chemical reactions and clinical trials.

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