COUNCIL AGENDA: 3/6/12
ITEM: 3.5

CITY OF SAN JOSE
CAPITAL OF SILICON VALLEY

Memorandum

TO: HONORABLE MAYOR AND CITY COUNCIL

FROM: Richard Doyle
City Attorney

SUBJECT: **Legal Opinion Related to the Revised Ballot Measure**

DATE: March 5, 2012

Attached is a public legal opinion from Meyers Nave related to the Revised Ballot Measure recommended by the City Manager under item 3.5 for Council consideration on March 6, 2012. In the past several months the Council has received oral and written legal advice related to pension reform and proposals for ballot measures. That advice was provided to the Council as privileged attorney-client communications in closed session and is subject to the confidentiality of those sessions. The contents of that advice are confidential unless and until there is a decision to waive the privileged and confidential nature of the communications.

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By_____
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MEMORANDUM

DATE: March 5, 2012

TO: Richard Doyle, City Attorney

FROM: Arthur A. Hartinger
Linda M. Ross
Jennifer L. Nock

RE: Proposed Charter Amendment -- Sustainable Retirement Benefits and Compensation Act

I. INTRODUCTION

In December 2011, the San Jose City Council voted to place on the ballot a Charter Amendment that addresses City employee retirement benefits. The City Manager is recommending that the Council consider a revised ballot measure entitled the "Sustainable Retirement Benefits and Compensation Act" (the "Act"), dated February 21, 2012. You asked us to provide a summary of the legal authority relevant to the Charter Amendment.

Whenever an agency modifies retirement-related benefits, there are legal risks, particularly with respect to vested rights challenges. But as set forth below, we believe the Act overall is defensible against a potential legal challenge. We review key sections of the Act, and note that these sections involve different degrees of legal risk.[1]

We are aware that since the City published and circulated the first draft of the Act last summer, the City has made numerous amendments. As a result, subsequent versions eliminate or significantly reduce many of the legal risks identified in the first draft.

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[1] We note that this opinion does not encompass legal risks that may be brought related to bargaining obligations under the Meyers-Milias-Brown Act (MMBA), California Government Code section 3500, et seq. It is our understanding, however, that the City has met and conferred with City labor unions under the MMBA as required by law.

The "Findings" for the Act state that the City's ability to provide its citizens with "Essential City Services" -- such as police and fire protection, street maintenance and libraries -- is threatened by budget cuts. The stated "Intent" of the Act is to "ensure the City can provide reasonable and sustainable post employment benefits while at the same time delivering Essential City Services."

The key provisions of the Act include: a requirement that employees receive adjusted compensation in the form of additional employee contributions towards their retirement systems' "unfunded liability" (Section 6); the creation of a new less expensive plan into which employees may voluntarily "opt in" (Section 7); the creation of a "Tier 2" hybrid plan for new employees (Section 8); authority to reduce COLA payments in the event of a fiscal emergency (Section 10); the elimination of the supplemental retiree benefit reserve (Section 11); and a "savings" clause that adjusts employee compensation in the event a court does not permit the increase in employee contribution rates pursuant to Section 6 (Section 14).

Below we provide legal background and then discuss each of these sections.

II. LEGAL BACKGROUND

Charter City. San Jose is a Charter City. The California Constitution, section 5, subdivision (b)(4), gives charter cities "plenary authority to provide in their charters for the compensation of their employees." *Sonoma County Organization of Public Employees v. County of Sonoma*, 23 Cal. 3d 296, 317 (1979). The San Jose City Charter itself affirms the City's "power to make and enforce all laws and regulations in respect to municipal affairs ...." (Charter, Section 200 [General Powers].)

Retirement Plans. Whether to have a pension plan, and the level of benefits provided, is a municipal affair subject to the City's home rule authority. The San Jose Charter grants the City Council the authority to create and change retirement plans for City employees. "Subject to other provisions of this article, the Council may at any time, or from time to time, amend or otherwise change any retirement plan or plans or adopt or establish a new or different plan or plans for all or any officers or employees." (Section 1500 [Duty to Provide Retirement System]; *see also* Section 1503.)

The Charter provides for certain "Minimum Benefits" for employees. The Charter requires that employee contributions to their retirement plans "because of current service or current service benefits" (called "normal cost" contributions) be paid in a ratio of "three (3) for such officers and employees to eight (8) for the City." (Sections 1504(b); 1505(c).) But the Charter does not address the payment towards pension plan unfunded liabilities.

In 2010, the voters amended the Charter to authorize the Council to enact ordinances that exclude new employees from any existing retirement plan or retirement benefit. (Charter section 1501(b).)

Charter Revisions. Under the home rule provisions of the state constitution, the "governing body . . . of a county or city may propose a charter or revision." (Cal Const., Art. XI, Section 3(b).) Under this authority, the City Council is proposing an amendment to establish new Charter requirements in connection with employee compensation and retirement. The City Council has the authority to place an amendment on the ballot after the City conducts "meet and confer" with employee organizations. *Seal Beach Police Officers Assn. v. City of Seal Beach*, 36 Cal. 3d 591, 601 (1984).

Vested Rights. A retirement benefit is considered "vested" if the employees or retirees are deemed to have a legal right, protected under the Constitution, to receive that benefit. The enforceable legal right between the employer and employee generally stems from an official enactment – Charter, statute or ordinance – that sets the terms of the benefit the employer agrees to provide. *See International Association of Firefighters v. City of San Diego*, 34 Cal. 3d 292 (1983).

Before a Court will enforce a claimed contractual right there must be "clear" and "unmistakable" evidence that the public entity intended itself to be bound to provide the benefit. The California Supreme Court recently held that: "legislation in California may be said to create contractual rights when the statutory language or circumstances accompanying its passage '*clearly... evince a legislative intent* to create private rights of a contractual nature enforceable against the [governmental body].' " *Retired Employees Assn of Orange County, Inc. v. County of Orange*, 52 Cal. 4th 1171, 1187 (2011). [Emphasis added] Federal law similarly requires "clear and unmistakable" evidence that a governmental entity "intends to bind itself contractually." *San Diego POA v. San Diego City Employees Retirement System*, 568 F.3d 725, 737 (9th Cir. 2009).

III. LEGAL DISCUSSION

We discuss below the key provisions of the Act.

A. Current employees – Reduction In Compensation In Form Of Increased Employee Contribution Rates (Section 6).

1. Charter Amendment. Beginning June 23, 2013, the Act requires that the compensation of current employees be adjusted to help defray the unfunded liabilities in their pension plans. To do so, the Act requires employee compensation to be reduced in increments of 4% of pensionable pay per year, up to a maximum of 16% of pensionable pay per year. But in any year, employees are not required to contribute more than 50% of the yearly cost to amortize pension plan unfunded liabilities. (Section 6(b).)

Under the Act, the adjustments in compensation will be treated as additional retirement contributions credited to employees' retirement accounts. (Section 6(e).) The Act does not alter the existing 3/8 ratio that governs employee and City contributions towards the

"normal cost" of pension plans. Rather, the Act addresses only the contributions required to amortize the "unfunded liability" of the plans.

2. **Legal Discussion.** There are arguments that this requirement does not implicate employees' vested rights. The City Charter never bound the City to pay the entire amount needed to defray the "unfunded liabilities" of the retirement systems, and the City's Municipal Code and past practices reflect this understanding. Thus, the voters may amend the Charter to legally require employees to share in that burden.

a. **Charter.** As explained above, the San Jose Charter reserves the City's right to create and amend the City's retirement plans. (Charter Sections 1500, 1503.) The Charter establishes employee and city ratios (3 to 8) that pertain to the contribution rates for "current service" otherwise known as "normal cost." But the Charter does not address the "unfunded liabilities" of the retirement systems. The Charter left that topic to the City Council to address in the Municipal Code and, as indicated above, reserved the right for the Council to make changes.

Based on the information we have seen to date, the City has asserted its authority -- in the Municipal Code and Memoranda of Agreement with City unions -- to require employees to pay towards the pension systems' unfunded liability.

b. **Municipal Code.** San Jose's Municipal Code and past practices specifically permit modification of employee contribution rates. These provisions and practices are evidence that San Jose did not intend to bind itself to pay the entire amount of pension system unfunded liabilities, but reserved the right to require employee participation in the form of additional employee contributions.

Federated employees. Section 3.28.200 of the 1975 Federated City Employees Plan permits the retirement board to fix and change rates of contribution for employees and the City "as it may determine reasonably necessary to provide the benefits provided for by this retirement plan." Other Code sections require employees to pay a "normal rate" of contribution (also called "normal cost") for current service (Part 6, Section 3.28.700, 3.28.710), and require the City to pay both a "regular current service rate" (again, also called "normal cost") and a "current service deficiency rate" of contribution. (Part 7, Section 3.28.850, 3.28.860.) Consistent with this latter Code section, the City has paid a contribution rate towards pension system unfunded liabilities.

But the Code not only requires employees to make contributions towards "normal cost," it also gives the City the authority to require employees to make additional retirement contributions. In 2010, the Code was amended to read: "Notwithstanding any other provisions of this Part 6 or of Chapter 3.44, members of this system shall make such additional retirement contributions as may be required by resolution adopted by the city council or by agreement with a recognized bargaining unit." (Section 3.28.755.)

Moreover, the Code expressly gives the City an offset from its contribution obligations, as determined by the retirement system actuary, for "the additional employee retirement contributions made by employees under section 3.28.755 against the retirement contributions that the city would otherwise be required to make under this Part 7." (Section 3.28.955.)

Safety employees. The Municipal Code similarly permits the modification of the employee contribution rates required from safety employees through resolution, agreement or arbitration, as appropriate, and permits an offset against the City's own obligations. (Section 3.36.1520, Section 3.36.1525, see also 3.36.1560.)

Based on the above provisions, the Code provides authority for additional employee contributions, and specifically permits the application of those contributions against the City's obligations – such as contributions towards deficiencies in the retirement system.

As stated above, in 2010 the City Council enacted the Code sections authorizing additional employee contributions. In connection with their enactment, the City and some bargaining groups agreed that employees would make payments of additional employee retirement contributions towards the retirement systems' unfunded liabilities. But the Code does not require "agreement" to impose additional contribution rates; it also permits the City to do so by resolution, or through binding arbitration. These provisions codified the City's understanding that it had the authority to require additional employee contributions to defray the retirement systems' unfunded liabilities.

Based on the Charter, Municipal Code and the City's practices, San Jose has arguments that it never bound itself to limit employee contributions, but reserved the right to increase employee contributions, including to pay for unfunded liabilities. In that case, San Jose's employees had no reasonable expectation that their contribution rates could not be raised in order to share in the expense of unfunded liabilities. *See International Association of Firefighters v. City of San Diego*, 34 Cal.3d 292, 300-302 (1983) (no vested right to contribution rates when pension plan expressly provided for modification of contribution rates based on periodic actuarial investigations).

c. **Changes in compensation.** In addition to relying on the Charter and Municipal Code, the City reasonably may argue that the changes to employee contribution rates in fact are changes to employee compensation, over which it has plenary authority under the state constitution.

As explained above, San Jose has the constitutional authority to set employee compensation in its Charter. If the City had simply reduced compensation to afford additional payments into the retirement system, no vested right would be implicated. "It is well established that public employees have no vested rights to particular levels of compensation and salaries may be modified or reduced by the proper statutory authority."

San Diego POA v. San Diego City Employees Retirement System, 568 F.3d 725, 738 (9th Cir. 2009), quoting *Tirapelle v. Davis*, 20 Cal. App. 4th 1317 (1993); *see also Butterworth v. Boyd*, 12 Cal. 2d 140, 150 (same).

Instead of reducing compensation, the proposed amendment permits employees to contribute additional amounts to the retirement system. This characterization is to the benefit of employees, because it prevents a reduction in the "final compensation" used to compute retirement allowances. Since there is no vested right to a particular level of compensation, there should be no vested right that prevents the City, in lieu of a decrease in compensation, from requiring additional employee contributions into the retirement system.

In summary, the City has reasonable arguments, based on the City's Charter and Municipal Code, and its practices, that the City never bound itself to completely subsidize the deficiencies of the retirement funds, and thus can require employees to share in that cost through higher employee contribution rates. Further, the City has an argument that its constitutional authority over employee compensation enables it to adjust compensation in the form of additional employee contributions towards unfunded liabilities.

We recognize, however, that aspects of these arguments are untested. City employees may contend that the City created the expectation, through its historical practices, that it would pay for all unfunded liabilities, despite the contrary provisions of the City Code and union agreements. And prior judicial decisions have held that the employee contribution rates at issue in those cases were vested rights. *See e.g., Allen v. City of Long Beach*, 45 Cal. 2d. 128, 130-131 (1955); *Wisley v. City of San Diego*, 188 Cal. App. 2d 482, 485-487 (1961). These decisions did not address the particular arguments that will be made by the City, and we believe the courts will revisit this issue in light of the modern practice of bargaining and treating as interchangeable, wages, employee contribution rates and other benefits. But as in any case involving vested rights, there can be no certainty as to any judicial outcome in the event of a legal challenge.

B. Current Employees - VEP (Section 7).

Under the Act, employees who do not want their pay adjusted in the form of higher contribution rates may opt into a one time "Voluntary Election Program." In exchange for no reduction in pay, the VEP provides a different pension plan. The VEP reduces the accrual rate for future service (2% per year), raises the eligibility age for retirement over time (55 to 62 for miscellaneous, 50 to 57 for safety), limits cost of living adjustments to 1.5% of CPI, and requires "final compensation" to be determined by an average of three years pay instead of one, among other changes. (Section 7(b).)

The VEP is legally permissible on its face, as a voluntary alternative to payment of additional employee retirement contributions. Courts have enforced agreements by individual employees to give up existing benefits and select a new pension plan. *See*

Pasadena Police Officers Assn v. City of Pasadena, 147 Cal. App 3d 695, 706-707 (retirees gave up fixed pension in exchange for city's promise to pay a pension that would rise or fall based on the cost of living index).

As demonstrated above, the City has arguments that it may require employees to pay additional retirement contributions. But if a Court invalidated this requirement, the Court might not hold employees who elected VEP to their VEP election

C. New Employees – Hybrid Plan (Section 8).

The Act requires the City to adopt a "Tier 2" retirement program for employees hired after the program is enacted. Under the Act, the program may be designed as a "hybrid plan" consisting of a combination of social security, a defined benefit plan and/or a defined contribution plan. (Section 8(a).)

This proposal plainly does not affect vested rights. A public entity may change the benefits offered to new employees, who have only the right to benefits conferred during employment. *Legislature v. Eu*, 54 Cal. 3d 492, 534 (1991); *Claypool v. Wilson*, 4 Cal App. 4th 646, 670 (1992).

In 2010, in accordance with this principle, the voters amended the City Charter to permit the City Council by ordinance to exclude new employees from any existing plan. (Charter section 1501(b).) The Act provides further guidance by setting the parameters for the modified plans to be offered to new employees.

D. Emergency Measures to Contain Cost of Living Adjustments (Section 10).

Under the Act, if the City Council "adopts a resolution declaring a fiscal and service level emergency, with a finding that it is necessary to suspend increases in cost of living payments to retirees," the City may temporarily suspend cost of living adjustments in whole or in part for up to five years. (Section 10(a).)

Even if a court determined that a change in the COLAs would impair vested rights, "a substantial impairment may be constitutional if it is 'reasonable and necessary to serve an important public purpose.'" *Valdes v. Cory*, 139 Cal. App. 3d 773, 790-791 (1983); *see also Sonoma County Organization of Public Employees v. County of Sonoma*, 23 Cal. 3d 296, 304 (1979).

In making this assessment, courts analyze whether the enactment: (1) serves to protect the basic interests of society; (2) has an emergency justification; (3) is appropriate for the emergency, and (4) is designed as a temporary measure, during which contract rights

are only deferred. *Olson v. Cory*, 27 Cal. 3d 532, 539 (1980), citing *Sonoma County*, 23 Cal. 3d at 305-306 (1979).

Based on the above authority, it is legally permissible for the Act to grant this emergency authority to the City Council to reduce COLAs. Whether the Council's actions implicate vested rights or satisfy the above requirements cannot be determined until the time of the emergency enactment.

E. Supplemental Payments to Retirees (Section 11).

The Act discontinues the Supplemental Retiree Benefit Reserve and returns its assets to the appropriate retirement trust fund. Any supplemental payments to retirees may not be funded from plan assets.

The Supplemental Retiree Benefit Reserve ("SRBR") permits the allocation of excess investment income earned by retirement fund assets to an account to fund supplemental benefits for retirees. The City has changed the formula for distribution of benefits to retirees over the years. For example, in 2005, the City Council enacted Municipal Code Section 3.28.340(E), which stated that the Council, after consideration of the Board's recommendation "shall determine the distribution, *if any,* of the supplemental retiree benefit reserve to said persons." [Emphasis added.] Moreover, we are informed that the City has not always paid this benefit.

The language of the Municipal Code, quoted above, and the City's practices are evidence that retirees do not have a vested right to payments from the SRBR.

F. Savings Provision (Section 14).

Section 6(b) requires current employees, not enrolled in Tier 2, to have their compensation adjusted in the form of additional contributions to their retirement funds. Under Section 14, in the event Section 6(b) is determined to be "illegal, invalid or unenforceable as to Current Employees then to the maximum extent permitted by law, an equivalent amount of savings shall be obtained through pay reductions."

As explained above in the section on Legal Background, San Jose has the constitutional authority to set employee compensation in its Charter. And public employees "have no vested rights to particular levels of compensation and salaries may be modified or reduced by the proper statutory authority." *San Diego POA v. San Diego City Employees Retirement System*, 568 F.3d at 738. Although reduced compensation will affect an employee's "final compensation" for retirement purposes, "indirect effects on pension entitlements do not convert an otherwise unvested benefit into one that is constitutionally protected." *Id.*

Therefore, there is authority to support the alternative of reducing pay in order to pay the unfunded liabilities of the pension system. The City has sound arguments in favor of voter authority to determine compensation, after meet and confer with employee organizations. But this is a developing area of the law and as we stated above, in any case involving vested rights, there can be no certainty as to any judicial outcome in the event of a challenge.

V. CONCLUSION

The City has made numerous amendments since it published and circulated the first draft of the Act last summer. As a result, subsequent versions eliminate or significantly reduce many of the legal risks identified in the first draft.

We believe the Act in its present state is defensible against a potential legal challenge. But some sections involve a different degree of risk than others. We have reviewed each of these sections and identified the arguments in favor of their legality and the risk that a court may find that they violate employees' vested rights. The Act contains a severability provision. If a Court were to invalidate portions of the Act, this provision enables the City to still implement others.