



COUNCIL AGENDA: 03-06-12
ITEM: 3.5

Memorandum

TO: HONORABLE MAYOR AND
CITY COUNCIL

FROM: Councilmember Ash Kalra

SUBJECT: PENSION REFORM

DATE: March 5, 2012

Approved

Date

Ash Kalra s.o.

3/5/12

BACKGROUND

As everyone on the Council knows by now, I am extremely concerned with the legal risks that are inherent in the proposed pension reform ballot measure, particularly with respect to the way it proposes to impact current employees and retirees. So as we approach the point of no return, I have decided to set forth, on paper, some of my concerns with the proposal. As an attorney, I am aware that these are complicated legal matters, so I will try my best to make this simple and to the point. I hope that this is helpful to my Council colleagues and members of the public who may ultimately be asked to vote on this measure.

The starting point for this discussion is the “contract clause” of both the United States Constitution and the California Constitution, which prohibits governments from enacting any law that impairs contract rights. California courts have consistently held that the contract clause applies to the pension benefits of public employees because the terms of employment between the City and its employees are considered contracts. This was stated clearly in a case involving the City of Long Beach back in 1947 (*Kern v. City of Long Beach*, 29 Cal. 2d 848, 852 (1947)).

More specifically, it is an employee’s “vested rights” that are protected by the Contract Clause. The vested rights doctrine is essentially a doctrine of basic fairness and square dealing: if we, as a city, promised to pay our employees certain benefits if they worked a certain number of years, and they live up to their end of the bargain, the law says that we have to make good on our promise. A 1978 California court case sums up this principle perfectly:

“A public employee’s pension constitutes an element of compensation, and a vested contractual right accrues upon acceptance of employment. Such a pension right may not be destroyed, once vested, without impairing a contractual obligation of the employing public entity.” *Betts v. Board of Administration*, 21 Cal. 3d 859 (1978).

The same principle, restated, in 1984:

“After the services have been rendered by a public officer under a law, specifying his compensation, there arises an implied contract under which he is entitled to have the amount so fixed. And the constitutional protection extends to such contracts just as it does to those specifically expressed.” *California Teachers’ Assoc. v. Cory*, 155 Cal. App. 3d 494, 505 (1984).

So, for retirees and for current employees who will fulfill the terms of their employment, these pension benefits are vested, contractual rights, which cannot just be taken away.

This is why the earlier proposal for a declaration of a “fiscal and public safety emergency” in San Jose was significant. The theory was that only by declaring a state of emergency would the City have a right to impair the vested pension rights of employees. This legal strategy was shaky at best, but the point is now moot since this strategy has been abandoned.

This is not to say that reasonable changes cannot be made to pension benefits. The California Supreme Court has set forth a “reasonableness” test to determine whether changes to an employee’s vested contractual pension rights are permissible:

“[1] An employee's vested contractual pension rights may be modified prior to retirement for the purpose of keeping a pension system flexible to permit adjustments in accord with changing conditions and at the same time maintain the integrity of the system. (citations omitted) [2] Such modifications must be reasonable, and it is for the courts to determine upon the facts of each case what constitutes a permissible change. [3] To be sustained as reasonable, alterations of employees' pension rights must bear some material relation to the theory of a pension system and its successful operation, and changes in a pension plan which result in disadvantage to employees should be accompanied by comparable new advantages. (citations omitted). *Allen v. City of Long Beach*, 45 Cal. 2d 128, 131 (1955).

The last part—the “comparable new advantages” part—is crucially important language. Stated simply, if we’re going to take something of value away, we have to give something of value back. This is why in previous years cities have reduced employee salaries but offset that reduction by increasing the employee’s benefits.

If we apply this test to the proposed San Jose ballot measure, and assume for the moment that the first two prongs of this test are met, the question becomes whether there are any “comparable new advantages” being offered to our employees under the ballot measure.

This is an extremely important point. There have been references to Proposition C, San Francisco’s recently-enacted ballot measure on pension reform, and to the fact that San Francisco’s charter requires voters to approve changes to pension and retirement benefits. But San Francisco’s Proposition C is significantly more likely to pass legal muster than our measure for a couple of reasons. First, Proposition C was a joint proposal that was crafted in collaboration with San Francisco’s labor unions, making it much less likely that it will be challenged in court, and making the odds of a successful challenge less likely as well because the changes to the employees’ vested rights were agreed to by the employees. Second, Proposition C is on much more solid legal footing than our current ballot measure because the San Francisco measure offers a “comparable new advantage”. Proposition C will raise the employees’ contributions to the pension plan, but going forward employee contributions will be variable. If the economy improves and if the City’s contribution to the plan dropped below a certain amount, San Francisco employees will have to

contribute less to the plan than they are currently contributing. This constitutes a “comparable new advantage” that makes Proposition C much less likely to be rejected by the courts.

Frankly, some legal analysts question whether Proposition C contains enough of a “comparable new advantage” to survive a court challenge, but there is no doubt that it has a significantly better chance of passing legal muster than San Jose’s current proposal, even with the recent changes. While the recent changes might reduce how much more San Jose employees will have to contribute if the unfunded liability is reduced, it does not go the extra step of lessening employees contributions compared to what they are contributing today. The deal struck recently between the City of Sunnyvale and its public safety employees in which the employees agreed to increase their pension contribution rates were offset by pay increases provides a good example of a “comparable new advantage.”

There have been several examples of California courts rejecting pension reform measures due to their failure to incorporate a comparable new advantage. In 1983, a court rejected the City of Pasadena’s attempt, via a ballot measure in 1981, to impose reductions to the COLA benefit promised to certain employees who were hired prior to the passing of the ballot measure. The court held:

“[T]he 1981 amendments to the COLA provisions were obviously disadvantageous to the employees. They substantially limited and reduced the protection which had previously been offered by a pension fully adjustable to changes in the cost of living. The city makes no claim that this detriment was compensated by comparable new advantages. Under the test laid down by the Supreme Court in *Allen*, and repeatedly reaffirmed by the Supreme Court, the 1981 amendments substantially reducing the cost of living benefits of the pension plan are invalid.” *Pasadena Police Officers’ Association v. City of Pasadena*, (1983) 147 Cal.App. 3d 695, 702-03.

A similar outcome was reached in a case involving Los Angeles Firefighters. In that case, there were no initial provisions for cost of living increases, but two COLA provisions were voted in, one with a cap and one without. Subsequently, a new ballot measure capped COLA at 3% based on CPI. This ballot measure was challenged by employees who had accepted employment during the uncapped COLA period. The court held:

“[O]nce the cost of living adjustment was uncapped in 1971, [the employees] did have a reasonable expectation that pension benefits earned thereafter would be fully adjusted for inflation and their post-retirement standards of living thus would be protected from any further erosion. Without question, [the ballot measure] defeats this expectation.” *United Firefighters of Los Angeles City v. City of LA*, 210 Cal.App.3d 1095 (1989).

The Voluntary Election Program, or “opt-in,” aspect of the ballot measure is also problematic. First, it is unclear at best if the IRS will approve the opt in provisions, and even if it does, there is still a good chance that a court will find that the “opt-in” program is really no choice at all but rather a “Hobson’s Choice,” which could be a basis to invalidate the ballot measure. As former Supreme Court Justice David Souter stated in his dissenting opinion in a 2002 case, “a Hobson’s choice is not a choice, whatever the reason.” *Zellman v. Simmons-Harris*, 536 U.S. 639, 707 (2002).

I am not alone in my concerns about the legality of this proposed measure, or measures like ours. Much has been said recently about how our proposed pension reform measure is similar to the one being proposed by Governor Brown. However, it is important to note that Governor Brown’s plan is premised upon phasing in a redistributed share of pension costs through collective bargaining. In

other words, Governor Brown's plan is based upon first reaching an agreement with the labor unions. Even with this major distinction, we should also take note that the nonpartisan Legislative Analyst's Office had significant concerns about the legality of Governor Brown's proposal:

"Our reading of California's pension case law is that it will be very difficult—perhaps impossible—for the Legislature, local governments, or voters to mandate such changes for many current public workers and retirees. Moreover, employer savings from these changes likely will be offset to some extent by higher salaries or other benefits for affected workers. Given all of these challenges, we advise the Legislature to focus primarily on changes to future workers' benefits. Such changes should produce net taxpayer savings only over the long run but are certain to be legally viable." *LAO Report*, p. 4.

The language in the above quote regarding changes being "offset to some extent by higher salaries or other benefits for affected workers" is a reference to the "comparable advantage" issue that I mentioned previously. Again, this is a fundamental flaw in the current plan—one which, I fear, will cause us to lose the resulting court battle, and which will result in the City realizing little to none of the savings we are trying to gain through this extreme measure. In fact, if a court ends up deciding that this ballot measure violated our employees' constitutional rights, the City could not only end up not realizing any of the savings that are supposed to result from this ballot measure, we could be forced to pay the costs and attorney fees for the unions. Given the number of bargaining units that could, and likely will, file suit against the City, this ballot measure could very likely result in San Jose ending up in worse financial shape than we are today. Just a few months ago, the County of Orange (CA) had to pay \$1.3 million to the Association of Orange County Deputy Sheriffs to cover the Association's legal fees after a unilateral attempt by the County to reduce the sheriff's deputies pension plan was rejected by the court. The County's own legal bills were estimated to be in excess of \$2 million. In addition, the cost savings sought after by the County's pension reform measure were never realized. If a similar situation arises in San Jose, it is quite likely that we will end up having to pay out far more than Orange County did in attorney fees and costs.

I hope that this has been helpful for my colleagues and for San Jose residents. I know these are difficult times, and there are no easy solutions. But following through with a plan as legally risky as the current proposal is not a solution. As noted above, the LAO's office has said that the law does not permit these types of measures. So have the attorneys for CalPERS, California Attorney General Kamala Harris, and former San Jose City Attorney Joan Gallo.

This is why I hope that we can reach a solution the same way that San Francisco reached a solution—in collaboration with, rather than in opposition to, our employees. I understand that our situation is not exactly the same as San Francisco's, but it's not "apples and oranges" either. More importantly, the way San Francisco accomplished its pension reform is how we, as a city, should approach our own reform. We should work collaboratively towards a solution that keeps police on our corners, that keeps our streets paved, and that doesn't land us in court facing an expensive and lengthy battle.