

CITY OF BALTIMORE

SHEILA DIXON, Mayor



DEPARTMENT OF LAW

GEORGE A. NILSON, City Solicitor
101 City Hall
Baltimore, Maryland 21202

March 11, 2009

The Honorable President and
Members of the Baltimore
City Council
c/o Karen Randle, Executive Secretary
409 City Hall
Baltimore, MD 21202

RE: City Council Bill 08-0220 – Fire and Police Retirement System-Benefits-Post-Retirement Increases

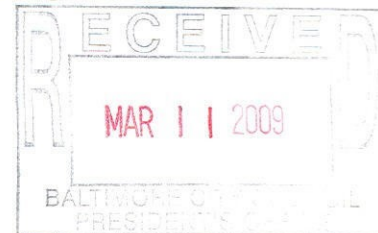
Dear President and Members

You have requested the advice of the Law Department regarding City Council Bill 08-0220. City Council Bill 220 discontinues the provisions of the Fire and Police Employees Retirement System (F&P) law pertaining to the method for determining annual post-retirement increases and provides for a new post-retirement increase methodology.

Currently, annual variable benefit increases are provided to F&P retirees and beneficiaries when F&P investment performance, as determined each June 30, exceeds 7.5%. Earnings between 7.5% and 10% and one-half of the earnings above 10% on F&P's Annuity Reserve Fund (which contains the contributions of retired members) and Pension Reserve Fund (which contains a combination of past City contributions and investment income for retired members and beneficiaries) are available for payment of the variable benefit. §36A (c). Funds are transferred from the F&P's Annuity and Pension Reserve Funds to a dedicated Paid-Up Benefit Fund used exclusively to support payment of variable benefits. §36A (d). In addition, the F&P law requires transfers to a Contingency Reserve Fund for the purpose of insuring payment of previously accrued benefit increases for any year in which the Paid-Up Benefit Fund is inadequate. Id.

The Bill proposes to overhaul the variable benefit structure by incorporating the following new elements in the annual retirement increase provisions:

- Liquidation of the Paid-Up Benefit and the Contingency Reserve Funds with a transfer of those assets to the Pension Reserve Fund to be invested with full range of investments otherwise used by F&P with an assumed earning rate of 8.25% (proposed §36A-2 (g))



- A new fixed 1.5% annual cost-of-living increase guaranteed by the City on par with all other F&P benefits (proposed §36A-2 (c)(2))
- A guarantee by the City of all previously accrued benefit increases under the current law (proposed §36A-2 (h))
- A new, reduced “variable” benefit tied to investment performance based on 20% of cumulative annual returns in excess of 8% (“cumulative annual returns” will be a rolling average of F&P investment performance designed to provide a smoothing effect of averaging over a number of years) phased in over 4 years (proposed §36A-2 (d)(8))
- Total annual fixed + variable increase limited to CPI (proposed §36A-2 (c)(4))

The legal sufficiency of City Council Bill 08-0220 hinges upon an analysis of whether the law affects a contract right and whether the impact rises to the level of a violation of the U.S. Constitution, Art. I, Section 10, cl 1, known as the Contract Clause. The Contract Clause states that no State shall pass any law impairing the obligation of contracts.

Determining whether a law impinges upon the obligations of contracts involves a three-pronged analysis. See U.S. Trust vs. New Jersey, 431 U.S. 1 (1977) and Allied Structural Steel v. Spannaus, 438 U.S. 234(1978). First, it must be determined whether a contractual obligation is created by the statute. Second, it must be determined whether the proposed law will substantially impair that contract right. Finally, assuming a substantial impairment, it must be determined whether the proposed law is reasonably necessary to serve a legitimate or important public purpose. See Md. State Teachers Assoc. vs. Hughes, 594 F.Supp.1353(1984).

With regard to the first prong, it is clear that no contractual obligation is created by statute.

Art. 26, Section 36A(e)(ii) provides:

- (e) *Benefit increases to be paid only from Paid-Up Benefit Fund and Contingency Reserve Fund.*
- (ii) The granting of any benefit increase under this section is contingent on the performance of the Retirement System’s investment funds. The continuation of any benefit increase previously accrued under this section is specifically made contingent on the ability of the Paid-Up Benefit Fund and the Contingency Reserve Fund to provide these benefits in

the future. §§ 37 and 42 to the contrary notwithstanding, any benefit increase provided under this section is not and does not become an obligation of the City of Baltimore. In the event of any conflict between this section and either or both § 37 or § 42, this section prevails.

The plain meaning of this section is that the variable benefit under Section 36(A)(e)(ii), is not guaranteed but rather is contingent on funds being available in the Paid –Up Benefit Fund and the Contingency Reserve Fund and is not an obligation of the City of Baltimore. There is therefore no contractual right to that benefit created by the law.

Not only does no contractual obligation exist, but also, under the second prong of the Contract Clause analysis, there is no substantial impairment of any contract right. While CC 08-0220 proposes to deprive F&P retirees of certain post-retirement increases, the bill balances that impairment by the prospect of a new post-retirement increase that will : (1) provide a certain, minimum annual benefit increase no longer dependent on market performance (2) provide a new, modest “variable” component in addition to the guaranteed minimum tied to cumulative investment returns in excess of 8% capped by CPI (3) be equivalent under the F&P contract to all other benefits (4) be guaranteed by the full faith and credit of the City (5) provide a new guarantee by the City of all previously accrued benefit increases under the current law and (6) preserve the actuarial soundness of the F&P. These new features certainly cannot be characterized as “lesser” though they are different. Surely, in this economic environment that presents the real possibility of F&P retirees not receiving any post-retirement increases for several consecutive years, a guaranteed, annual fixed increase of 1.5% (with the possibility of earning a modest, additional variable increase) cannot be considered a substantial impairment of the existing benefit. Any diminution in the F&P post-retirement increases proposed by CC 08-0220 intended to preserve the integrity of F&P by enhancing its actuarial soundness is reasonably balanced by the countervailing benefits. See City of Frederick v. Quinn, 35 Md.App. 626 (1977). Consequently, there is no substantial impairment of any contract right.

Finally, City Council Bill 08-0220 is reasonably necessary to serve a legitimate and important public purpose. The City’s actuary has noted that variable benefits have had detrimental effects on the City’s contribution and the F&P Board has been regularly admonished regarding the growing cost of the current structure and its exacerbation by low market rates of interest, and volatile investment performance. The actuary now estimates that the current variable retirement benefit will annually cost the City \$61 million.

The Director of Finance has also maintained that the City cannot afford to preserve the current variable benefit structure and that it is a contributing factor to the continued escalation of the City’s pension costs. CC 08-0220 is the culmination of the City’s efforts to shore up its escalating annual

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contribution to F&P so as to preserve the City's financial stability. The court in MSTA v. Hughes, 594 F. Supp 1353(D.Md. 1984), aff'd No. 84-2213(4th Cir. Dec. 5, 1985) noted even if the Plan is currently actuarially sound :

[T]his court observes that neither *Baker v. Baltimore, supra*, nor *City of Frederick v. Quinn, supra*, requires as a matter of State law that the legislature wait until a pension system is actuarially unsound before making changes in that system. Certainly, there is no such federal constitutional requirement. Such a requirement would jeopardize the pension benefits of current and future retirees, would require that the trustees of the Retirement Systems abdicate their role as fiduciaries, and would impose an irrational limitation on the legislature's police power. A pension system need not be actuarially unsound before a legislature may move to change the system and the benefits it provides its members. *Id.*, at 1368.

The passage of this Bill will serve a legitimate and important public purpose of preserving the City's pension system for current and future retirees before the system becomes unstable and is a valid exercise of the City's sovereign powers.

For the above-stated reasons, the passage of CC 08-0220 would not unconstitutionally impair the pension rights of F&P members and retirees. First, §36A(e)(ii) has specifically exempted F&P variable benefits from any contract protection. Second, CC 08-0220 would balance any deprivation to F&P members and retirees of current post-retirement increases by providing a new post-retirement increase featuring new benefits thereby avoiding substantial impairment even if a contract right existed. Lastly, City Council Bill 220 would not violate the Contract Clause because, if passed into law, it would serve the legitimate public interest of improving F&P's actuarial soundness and, ultimately, the financial condition of the City.

Accordingly, City Council Bill 08-0220 is consistent with the authority of the City Council. The Law Department, therefore, approves the City Council Bill 08-0220 for form and legal sufficiency.

Sincerely yours,



Elena R. DiPietro
Chief Solicitor

cc: Honorable Stephanie Rawlings-Blake
Angela Gibson, City Council Liaison
George A. Nilson, City Solicitor
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