

CITY OF BALTIMORE

STEPHANIE RAWLINGS-BLAKE, Mayor



DEPARTMENT OF LAW

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

May 16, 2013

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 No. 13-0223 – Change and Grow: 10-Year
Plan – Employees Retirement System - Benefits

Dear President and Members:

You have requested the advice of the Law Department regarding City Council Bill 13-0223. City Council Bill 13-223 provides that after the effective date of the bill each Class C member of the Employees Retirement System (ERS) shall contribute a percentage of their compensation to the ERS. The Department of Finance shall deduct this amount from the employees' compensation each payroll period and it shall be deposited in the Retirement System Fund and credited on behalf of the member. The bill provides for procedures for handling contributions for military personnel. In addition, Bill 223 provides for a modification of the post-retirement increase benefit applicable to all retirement benefit increases determined on or after June 30, 2013. The Bill modifies the benefit by providing for a guaranteed increase equal to the greater of 1.5 percent or the amount of any guaranteed post retirement increase provided by the Fire and Police Employees Retirement System(FPERS) to its members. This guaranteed benefit replaces the current post-retirement increase which consists of a guaranteed 1.5 percent plus a bonus amount that is dependent upon a determination of whether a balance exists in an Earnings Increase Account and whether that balance meets the criteria for granting increases established by Art. 22, §17.1 (d)(3) and is not guaranteed. Any such increase, when combined with the guaranteed 1.5% increase may not exceed the CPI limit for the fiscal year.

CONTRACTS CLAUSE

The modifications to the post-retirement increase benefit may create an issue regarding 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). This analysis was developed to harmonize the mandate of the Contracts Clause with "those powers necessarily reserved to the state to provide for the welfare of their citizens." City of Charleston v. Public Service Commission of West Virginia, 57 F.3d 385 (4th Cir. 1995)(citing Baltimore Teachers Union v. Mayor and City Council of Baltimore, 6 F.3d 1012(4th Cir. 1993) 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 impairment created by the proposed law is justified because it is reasonably necessary to serve a legitimate or important public purpose. See Md. State Teachers Assoc. vs. Hughes, 594 F.Supp.1353(1984).

1. CONTRACTUAL OBLIGATION

With regard to the first prong, it is clear that a contractual obligation is created by statute with regard to the variable benefit at issue in City Council Bill 13-0223 for the following reasons.

The post-retirement benefit provided for in Art. 22, §17.1(d) is as follows:

(d) *Amount of benefit increase.*

- (2) As of January 1, 2008, and each subsequent January 1, an eligible retiree or beneficiary shall receive an increase in periodic benefits, which shall be calculated as the sum of:
 - (i) a guaranteed increase of 1.5%; and
 - (ii) an earnings increase determined under paragraph (3) of this subsection.

(3) *Earnings Increase Account.*

- (i) The Board of Trustees shall establish a bookkeeping account entitled the Earnings Increase Account for the sole purpose of determining whether an earnings increase is payable.
- (ii) The establishment of the Earnings Increase Account neither requires nor allows for the segregation of any Retirement System assets.
- (iii) (A) If the actuary engaged by the Board determines that there is a balance in the Earnings Increase Account as of the preceding June 30, that balance shall be allocated to provide an earnings increase to eligible retired members and beneficiaries, effective as of the following January 1.
- (B) The earnings increase shall be calculated as a percentage increase that can be provided by the balance in the Earnings Increase Account sufficient to fund a single-premium paid-up annuity, using regular interest after commencement

of benefits for valuation purposes on the June 30 preceding the effective date of the increase.

- (C) The percentage increase calculated under subparagraph (iii)(B) of this paragraph (3) may not exceed an amount that, when added to the guaranteed increase provided under paragraph (2)(i) of this subsection, exceeds the CPI limit.

Unlike its counterpart in the Fire and Police Retirement System provisions, §17.1 does not state that the benefit increase “does not become an obligation of the City of Baltimore” under §42. §42 states that certain parts of Article 22 are to be considered terms of contract for certain retirement benefits. These benefits would therefore likely be determined to be a contractual right.

2. SUBSTANTIAL IMPAIRMENT

Notwithstanding the existence of a contractual obligation with respect to the variable benefit, under the second prong of the Contract Clause analysis, no violation of the Contracts Clause will be found if there is no substantial impairment of the contract right. Not every impairment by a governmental entity of its own contractual obligations is prohibited by the Contract Clause. The “essential attributes of sovereign power necessarily reserved by the States to safeguard the welfare of their citizens impose a limit on the operation of the Contract Clause” See Md. State Teachers Union v. Hughes, 594 F.Supp.1353(1984)(citations omitted.)

Determining whether an impairment is substantial involves consideration of several factors. Those factors are 1) whether the abridged right was reasonably relied on by the complaining party or substantially induced the party to enter into the contract; 2) whether the obligation was abolished or merely modified; and 3) whether the abridged right was the “central undertaking” or “primary consideration” of the parties in the underlying contract. City of Charleston at 393. In addition, courts “should determine whether the abridged right was replaced by an arguably comparable provision” *Id.* at 394. If the replacement is arguably comparable no substantial impairment exists. *Id.*

With respect to the first factor, to determine reliance the court may consider whether the contract explicitly or implicitly indicates that the abridged term is subject to impairment and whether the matter has been subject to regulation in the past. As evidenced by the legislative history of the ERS post-retirement increase provisions, the post-retirement increase provisions have been subject to amendment over the years. Most significantly, in 2007, the current provision was enacted by the City Council to replace a previous version found in §17 of Art. 22. This creates a plausible argument that there was an expectation that these provisions could be subject to modification by the legislature.

The second factor requires consideration of whether the right was abolished or merely modified. In this instance, the right to a post-retirement increase is not abolished but only modified. Retirees are still guaranteed a 1.5% increase or the equivalent of any guaranteed post-retirement increase provided by the FPERs to its members whichever is greater. The portion modified is the additional variable benefit that is not guaranteed, is subject to the availability of funds in the system to provide for the benefit and has only been granted once since provision's enactment. The members clearly have no expectation of a regular increase in benefits from this provision. The right is therefore only being modified. In addition, it is being replaced by an arguably comparable provision.

The final factor involves an analysis of whether the right abridged was essential to the underlying contract and caused a fundamental change to the contract. To satisfy this factor the right must be "especially relied upon", "important," "basic" and "central" to the underlying contract. *Id.* at 394. The basic right in the contract is the right to the basic pension. The post-retirement increase and especially the variable benefit are merely enhancements to that basic benefit. Given that the variable benefit has been changed over the years, is not guaranteed and is often not even available for many years, it cannot be a right that was especially relied upon, basic or central to the complaining party to the contract.

Considering all the factors relied upon by the courts to determine substantial impairment, it can be argued that no substantial impairment of the contract would result from the passage of City Council Bill 13-0223. The legislative history indicates an expectation that the benefit was subject to legislative modification, the right was not abolished but merely modified and the right was not the central undertaking or primary consideration. The right is also being replaced by a arguably comparable provision, guaranteeing members the rights they have currently and have regularly received.

3. LEGITIMATE AND IMPORTANT PUBLIC PURPOSE

Finally, even if a substantial impairment was established, it can be justified if it is reasonably necessary to serve a legitimate or important public purpose. See Md. State Teachers Assoc. vs. Hughes, 594 F.Supp.1353(1984). The Mayor commissioned a study to project the financial needs of the City over the next 10 years and provide a methodology to sustain the City's viability and growth going forward. The study revealed that "without corrective action, this structural deficit is estimated to result in a fiscal gap of over \$30 million in FY2014, growing to nearly \$125 million by FY2022. Over the nine years from FY2014-FY2022, this cumulative shortfall would total \$744.8 million, eroding all of the City's reserves in about three years and driving the City deep into deficits." See *Change to Grow – A 10-year Financial Plan for Baltimore* Page 3. "From a fiscal perspective, growth rates for employee health and pension costs

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have been one of Baltimore's primary "budget busters," and are projected to continue to pressure the City's finances across the Ten-Year Financial Plan period if not further reformed." *Id.* at Page 5. This is just one of many initiatives in the Plan to preserve the financial integrity of the pension system as well as the City.

There is no dispute that ensuring the financial stability of the City and preserving the soundness of the pension system are significant public purposes. Baltimore Teacher's Union v. Mayor and City Council of Baltimore, 6 F.3d 1012, 1019(4th Cir. 1993) and Maryland State Teacher's Assn. v. Hughes, 594 F.Supp. 1353,1368(D.Md. 1984). 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 Court have also noted that "our task is to ensure through the necessity and reasonableness inquiry that the states neither consider impairing the obligations of their own contracts on a par with other policy alternatives or impose drastic impairment when an evident or more moderate course would serve the purposes equally well." Baltimore Teachers Union at 1021(citations omitted). The City's approach complies with this mandate as the proposals in the bill are only a small part of a much larger approach involving taxes, fees and other initiatives to streamline City government thereby reducing projected deficits in future years and averting fiscal crisis. The passage of this Bill will serve the legitimate and important public purpose of preserving the City's pension system for current and future retirees before the system becomes unstable and, preventing future fiscal crisis's for the City as a whole.

For the above-stated reasons, the passage of City Council Bill 13-0223 would not unconstitutionally impair the pension rights of ERS members and retirees. Accordingly, City Council Bill 13-0223 is consistent with the authority of the City Council. The Law Department, therefore, approves the City Council Bill 13-0223 for form and legal sufficiency.

Sincerely yours,



Elena R. DiPietro
Chief Solicitor

cc: George A. Nilson, City Solicitor
Angela Gibson, City Council Liaison
Hilary Ruley, Assistant Solicitor
Victor Tervalva, Assistant Solicitor