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WHEN CAN A PUBLIC EMPLOYER REDUCE EMPLOYEE BENEFITS?

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For most employers, personnel costs represent a substantial and increasing share of the budget. As state and local governments and their agencies prepare their budgets each spring, they take a fresh look at employee and retiree benefit programs. In lean budget years, health and life insurance, supplemental retirement plans and longevity-pay plans may all be candidates for reduction or elimination. But before managers, governing boards, or agency administrators can decide to reduce these benefits, they must first determine whether the reduction is legal. While public employers may almost always reduce their employees' current compensation, and frequently can reduce benefits, there are some benefits in which employees may have "vested" or gained contractual rights. Generally, employers may not reduce or eliminate these vested benefits.

This Public Employment Law Bulletin uses an imaginary city to discuss the legal issues that North Carolina public employers should consider before reducing employee benefits. The first part discusses the legal limitations on a North Carolina

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public employer's ability to reduce retiree and employee health benefits.¹ The second part looks at limitations on an employer's ability to reduce or eliminate (a) employer contributions to the North Carolina 401(k) Plan, (b) employer contributions to supplemental retirement plans for public safety officers, (c) life insurance benefits, (d) severance and vacation pay, and (e) longevity pay.

Part I: When May a Public Employer Reduce Health Benefits?

Many public employers assume that because private employers may reduce the health benefits of retirees, they too may do so. That assumption is dangerous because public-sector employee benefits are subject to different laws than private-sector employee benefits. Public employers should carefully review the terms under which they have offered health and other benefits to past and present employees before they make any changes to their benefits policies. The experience of public employers in other states suggests that if they fail to do so, at least some of them are likely to be sued and to face significant liabilities—liabilities of the kind that they attempted to eliminate from their budgets in the first place.²

1. The discussion of employee and retiree health benefits reprints, with minor changes, the contents of the author's article "Can Public Employers Eliminate or Reduce Health Benefits?", which appears in the Winter 2004 issue of the School of Government's publication *Popular Government*. *Popular Government* is available for purchase through the School of Government's Publications Division. The article also appears online in PDF format at <http://ncinfo.iog.unc.edu/pubs/electronicversions/pg/pgwin04/article2.pdf>.

2. Cases in other states that have addressed public employers' rights to reduce health insurance benefits include *Duncan v. Retired Public Employees of Alaska, Inc.*, 71 P.3d 882 (Alaska 2003); *Bates v. City of Richland*, 51 P.3d 816 (Wash. Ct. App. 2002); *Davis v. Wilson County*, 70 S.W.3d 724 (Tenn. 2002); *Roth v. City of Glendale*, 614 N.W.2d 467 (Wis. 2000); *Emerling v. Village of Hamburg*, 680 N.Y.S.2d 37 (N.Y.A.D. 1998); *Thorning v. Hollister Sch. Dist.*, 15 Cal. Rptr. 2d 91 (Cal. App. 4th 1992); *Weiner v. County of Essex*, 620 A.2d 1071 (N.J. Super. 1992); *Bernstein v. Commonwealth of Pa.*, 617 A.2d 55 (Pa. Commw.), *order aff'd*, 634 A.2d 1113 (Pa. 1992); *Omer v. Tagg et al.*, 455 N.W.2d 815 (Neb. 1990); *Colorado Springs Fire Fighters Ass'n, Local 5 v. City of Colorado Springs*, 784 P.2d 766 (Colo. 1989); *Township of Tinicum v. Fife*, 505 A.2d 1116 (Pa. Commw.), *appeal denied*, 544 A.2d 1344 (1986); *Singer v. Topeka*, 607 P.2d 467 (Kan. 1980); *Betts v. Board of Admin. of the Public Employees' Retirement Sys.*, 582 P.2d 614 (Cal. 1978).

The Different Laws Governing Private and Public Employee Benefits

Private employers' retirement and welfare benefits plans (of which health insurance is one example) are governed by the Employee Retirement Income Security Act of 1974 (ERISA).³ ERISA sets minimum standards for the administration and funding of private-sector pension plans and for the information that must be provided to private-sector employees participating in employer-sponsored pension and welfare benefit plans. It also establishes fiduciary duties for those involved in administering pension and welfare benefit plans.

Government pension and welfare benefit plans are *not* subject to ERISA. Instead, they are governed by state contract law. In North Carolina that law appears to be more protective of retirees' expectations than ERISA is. So how and when may a North Carolina public employer reduce the health benefits of employees and retirees?

Trouble in Paradise

Imagine Paradise, North Carolina, a medium-sized city with a population of about 40,000. It is struggling to balance its budget. The city council has concluded that it must reduce the costs of employee compensation. It has considered and rejected both across-the-board pay cuts and a salary freeze, believing that such actions would seriously harm employee morale and hurt current recruiting efforts. Instead, the council has decided to reduce health benefits for both current employees and retirees.

Paradise has a personnel ordinance that provides for health insurance coverage of current employees and their families. The city pays the full cost of the employees' premiums and half of the cost of the premiums for the employees' spouses and dependents. The employees pay the other half.

The personnel ordinance also provides for continued coverage, at no cost, of employees who have twenty years of service with the city at the time of their retirement. Retirees may continue coverage of spouses and dependents by paying the full cost of the premiums themselves. Once a retiree reaches age sixty-five and qualifies for Medicare, coverage under the city's plan ceases. The ordinance does not specify any particular health insurance plan or a particular set of benefits in the case of either current employees or retirees.

3. ERISA is codified at 29 U.S.C. §§ 1001–1461. For the exclusion of government pension and welfare benefit plans from the statute's coverage, see sections 1002(32) and 1003(b)(1).

The city council asks the manager to suggest the best way to reduce health insurance costs. The manager makes two proposals: first, eliminate retiree health benefits for current employees who have not yet retired; and second, require current retirees to pay half of the cost of their premiums. This proposal seems reasonable to the council, so the council members and the manager are caught up short when the city attorney expresses serious reservations about whether such changes are legal.

Elimination of Retiree Benefits

Does North Carolina law permit a government employer to eliminate or reduce retiree health benefits? That question has never been directly addressed by any North Carolina state or federal appellate court. The city attorney's hesitation is based on the North Carolina Supreme Court's decision in *Bailey v. State of North Carolina*, which limits the right of the state, as a government employer, to change the terms governing payment of retirement benefits under the Teachers' and State Employees' Retirement System (TSERS) and the Local Government Employees' Retirement System (LGERS).⁴ The *Bailey* case is, at its heart, an employment contract case. The principles on which it was decided are directly applicable to when and how a public employer like Paradise can change its retiree health benefits plan. Paradise is limited in the changes it may make, despite the fact that public employers are not required to offer health insurance to their current or retired employees in the first place.⁵

Every employee has an employment contract, the city attorney explains to the Paradise council and manager. The contract is usually oral, not written, and its terms often are merely implied rather than expressly stated.⁶ Most employment contracts expressly cover only the employee's duties, hours of work, and compensation. In North Carolina (as in most other states), retirement benefits are a form of compensation. They are earned in the present, but payment is deferred to a later date. The court in the *Bailey* case reaffirmed this long-standing rule in holding that the state had made a legally enforceable promise to state and local government employees to exempt their retirement

4. *Bailey v. State of North Carolina*, 348 N.C. 130 (1998).

5. See N.C. GEN. STAT. §§ 160A-162(b), 153A-92(d). Hereinafter the General Statutes are referred to as G.S.

6. See *Hallowell v. Department of Conservation and Dev.*, 206 N.C. 206, 208 (1934); *Archer v. Rockingham County*, 144 N.C. App. 550, 557 (2001), *disc. rev. denied*, 355 N.C. 210 (2002).

income in its entirety from state income tax. The employees had worked in government service with the understanding that (1) part of their compensation would be paid after retirement and (2) the amount of their deferred compensation would not be diminished by the imposition of the state income tax. The state tried to cap the amount exempted from tax. The North Carolina Supreme Court held that to do so would deprive those employees of compensation that they already had earned.⁷ As the court said,

A public employee has a right to expect that the retirement rights bargained for in exchange for his loyalty and continued services, and continually promised him over many years, will not be removed or diminished.⁸

In the law of contracts, this expectation, along with wages and other benefits, is referred to as "consideration" for the services an employee renders. Consideration is necessary for a contract to be binding.

Retirement benefits therefore are not gratuities,—or "freebies," as the city attorney puts it more colloquially. Earlier, in *Faulkenberry v. Teachers and State Employees Retirement System of North Carolina*, a case dealing with disability retirement payments, the state had argued that retirement benefits were gratuities, but the North Carolina Supreme Court held that they were not.⁹ This is an important point. The North Carolina Constitution prohibits the state and its political subdivisions from paying any person any money

7. *Bailey*, 348 N.C. at 150–51. The plaintiffs in *Bailey* were retired state and local government employees whose payments from the various state-run retirement systems had been exempt from state income taxation before 1989. Retired federal employees living in North Carolina had not enjoyed the same privilege. In 1989 the U.S. Supreme Court held that a state could not tax the income of state and local government employees differently than it taxed the income of federal employees. See *Davis v. Michigan Dep't of Treasury*, 489 U.S. 803 (1989). Rather than extend the state tax exemption to federal retirees in its entirety and suffer a reduction in tax revenue, the General Assembly amended the North Carolina tax code to place a \$4,000 cap on the amount of annual pension payments exempt from state income taxation and to make the \$4,000 exemption available equally to state, local, and federal government retirees. See *Bailey*, 348 N.C. at 152, 153.

8. *Bailey*, 348 N.C. at 141, quoting *Simpson v. Local Gov't Employees' Retirement Sys.*, 88 N.C. App. 218, 224 (1987), *aff'd per curiam*, 323 N.C. 362 (1988).

9. *Faulkenberry v. Teachers and State Employees Retirement Sys. of N.C.*, 345 N.C. 683, 690–91 (1997).

whatsoever except in payment for public services.¹⁰ However, as the court explained, because retirement income benefits are not gifts or gratuities but a form of deferred compensation for which employer and employee have bargained and to which both have agreed, payment of those benefits does not violate the state constitution.

No North Carolina cases offer a basis for distinguishing retiree health benefits from pension payments, and courts in other jurisdictions that have considered the question have generally concluded that retiree health benefits are deferred compensation.¹¹ So the North Carolina courts would likely hold that under the *Bailey* case, the health benefits that Paradise has provided for its retirees are a form of deferred compensation.

Reduction of Benefits Previously Promised

The city attorney's explanation of the *Bailey* case doesn't entirely answer the Paradise City Council's and manager's question. They now rephrase it as follows: "Okay, we owe our retirees their health benefits because they are a form of deferred compensation. But do we owe retiree health benefits to our current employees who have worked for the city for the minimum twenty-year period but not yet retired? And may we require our current retirees at least to pay half of the premium? After all, when the ordinance was adopted, no one expected health insurance costs to increase as

10. More precisely, Article I, Section 32, of the North Carolina Constitution states, "No person or set of persons is entitled to exclusive or separate emoluments or privileges from the community but in consideration of public services." In several earlier cases, the North Carolina Supreme Court had expressly held that pension payments, as deferred compensation, are not in violation of Article I, Section 32. *See* *Harrill v. Teachers' and State Employees' Retirement Sys.*, 271 N.C. 357 (1967); *Great American Insurance Co. v. Johnson*, 257 N.C. 367 (1962); *Bridges v. City of Charlotte*, 221 N.C. 472 (1942). *Cf.* *Leete v. County of Warren*, 341 N.C. 116 (1995) (holding that severance payment awarded after county manager's resignation violated Article I, Section 32).

11. *See, e.g.*, *Duncan v. Retired Public Employees of Alaska, Inc.*, 71 P.3d 882, 888 (Alaska 2003); *Calabro v. City of Omaha*, 531 N.W.2d 541, 548-49 (Neb. 1995); *Booth v. Sims*, 456 S.E.2d 167, 183 (W.Va. 1995); *Thorning v. Hollister Sch. Dist.*, 15 Cal. Rptr. 2d 91, 95 (Cal. App. 4th 1992); *Omer v. Tagg et al.*, 455 N.W.2d 815, 817 (Neb. 1990); *Township of Tinicum v. Fife*, 505 A.2d 1116, 1119 (Pa. Commw.); *Yeazell v. Copins*, 402 P.2d 541, 545 (Ariz. 1965). *See also* *Emerling v. Village of Hamburg*, 680 N.Y.S.2d 37, 38 (N.Y.A.D. 1998) (implied); *Weiner v. County of Essex*, 620 A.2d 1071, 1071 (N.J. Super. 1992).

much as they have, and the retirees will still be getting health benefits, which is what they bargained for."

The Concept of Vested Benefits

It is easy to understand how employers owe employees who already have retired, that part of their compensation represented by pension and health insurance benefits. But what about employees with five, ten, or twenty years' service who have not yet retired but have worked and continue to work in expectation of retirement health benefits? Do their employers owe them anything? How does one quantify what they are owed? Employers may raise and lower the salaries of current employees. Why can't they make changes to prospective retirement benefits?

From the perspective of a mid-career government employee, however, such changes do not seem fair. Imagine such an employee's learning on Wednesday that her rate of pay is being cut and that her paycheck for the entire week—that is, for work done on Monday and Tuesday, as well as for work done Wednesday through Friday—is being calculated at the new, reduced rate. Changing retirement benefits for employees already in the workforce is a little like that.

In North Carolina the law protects the expectations of employees in their retirement benefits through the concept of vested rights. "Vesting" occurs when an employee has fulfilled all the prerequisites to enjoyment of a benefit. For example, by statute, employees participating in both TSERS and LGERS must complete a minimum of five years of government service before they are eligible to receive retirement payments. On the date on which the employee completes five years of service, his or her right to retirement benefits vests. In *Bailey* and earlier cases involving retirement payments, the state argued that employees had no contractual right to particular service or disability retirement benefits until they actually retired or became disabled. The courts disagreed, holding that employees have a *contractual* right to rely on the terms of the retirement plans *as the terms exist at the moment their retirement rights vest*.¹² In the *Bailey* case, the court found that the state could have capped the state income tax exemption for state and local government employees who had not yet vested in their respective retirement systems, but that it could not do so for employees who had satisfied the minimum service requirement but not yet retired.¹³

12. *Bailey*, 348 N.C. at 144; *Faulkenberry*, 345 N.C. at 690; *Simpson*, 88 N.C. App. at 223-24.

13. *Bailey*, 348 N.C. at 152-53.

Thus the city attorney's response to the council members and manager is that Paradise may not eliminate its retiree health benefits for employees who have met the twenty-year vesting requirement because they have an enforceable contract right to those benefits. However, Paradise is apparently free to eliminate the benefits for both new hires and current employees with less than twenty years of service (that is, employees who have not yet vested).¹⁴

Ordinance versus Resolution

"One more question," the manager interjects. "Would our obligations be any different if we had adopted our personnel policy by resolution rather than by ordinance?" "No," the city attorney replies firmly, "none whatsoever. The ordinance-resolution distinction is important in determining whether or not local government employees have *property* rights in their employment, but does not bear on whether or not they have a *contractual* right to retiree benefits."

An ordinance that provides that employees may only be terminated for just or good cause creates a legal interest in continued employment. The Fourteenth Amendment to the U.S. Constitution prohibits the employing government from taking away that interest without due process. It may also create a property interest in retiree benefits that is also subject to due process protection.¹⁵

14. *See id.* at 152. *See also* Pritchard v. Elizabeth City, 81 N.C. App. 543, 551-53, *disc. rev. denied*, 318 N.C. 417 (1986) (holding that oral representations to municipal employees regarding accrual of vacation pay benefit constituted contractual agreement by which city was bound, but finding no impairment of contract because change to benefit applied prospectively).

15. In this context, the legislative process is due process, and a duly enacted amendment or repeal of a statute or ordinance conferring property rights in the terms of employment can take away those rights, even from those employees who currently enjoy them. It is a well-established principle that State legislative bodies—including municipal councils and county boards—may at their pleasure create or abolish offices within their statutory reach, or modify the duties of such offices. It may also shorten or lengthen the term of service. *See* Goldsmith v. Mayor & City Council of Baltimore, 845 F.2d 61, 64-5 (4th 1988) (city council did not deny employee due process when it abolished her position and deprived her of tenure benefits in that office and transferred her to new position without just cause protection) *quoting* Higginbotham v. City of Baton Rouge, 306 U.S. 535, 538 (1939). Thus, a city or county may eliminate "just cause" protection, a grievance process, and any other personnel provision that

In contrast, a personnel policy that confers just cause protection on employees (or grants them other protections or benefits), but is adopted by resolution, does not create property rights in employment because such a policy has no binding force and is not legally enforceable while it is in effect. It may be disregarded (although the city attorney and manager agree that this is a bad management practice) or repealed without due process.

In further contrast, statutes and ordinances that give rise to contract rights operate still differently. When it comes to creating contract rights, as opposed to property rights, personnel policies adopted by resolution operate in the same way as do policies adopted by statutes and ordinances. The terms of the retiree health insurance policy—however it has been adopted—form the basis of a government promise that has induced a person to enter into or continue in government employment. That promise of health insurance in retirement becomes part of the employment contract. Amendment or repeal of the statute or ordinance or of the resolution does not affect the employee's contractual right to hold the government employer to its promise.

The city attorney concludes: Had Paradise promised retiree health benefits to its employees through a personnel policy adopted by resolution, rather than by ordinance, it would not change the fact that the city's promise is binding and enforceable.

The Right to a Particular Health Insurance Plan

One of the city council members objects. He argues, not unreasonably, that the city never intended to enter into a contract with any employee to provide retiree health benefits. Further, because the retiree health insurance plan is part of the city's personnel ordinance, the council should be able to amend it like any other part of the ordinance, provided that proper procedures

may give its employees a property right in their employment. Neither individual employees, nor employees as a whole, are entitled to any particular form of due process before previously granted property rights in employment are taken away. Rather, when a state alters a state-conferred property right through the legislative process, "the legislative determination provides all the process that is due." *See* Rea v. Matteucci, 121 F.3d 483, 485 (9th Cir. 1997) (legislation reclassifying employee's job from position with property rights into at-will position, and her subsequent termination, did not deprive her of due process). This is because where a rule applies to more than a few people, it is impracticable that everyone should have a direct voice in its adoption.

are followed. Even if the retiree health provision of the ordinance is a contract, the council member continues, Paradise, as a government entity, may breach the contract as long as it does so for the public good. In the council member's opinion, saving the city money so that it can maintain services without raising taxes is clearly for the public good.

The *Bailey* case directly addresses these issues too, the city attorney explains. The court in that case held that laws can act as contracts. When a statutory provision becomes the basis for an individual's decision to act (in this instance, to go to work for the government employer), the statutory provision becomes part of a contract between the government and the individual. Even if the statute is repealed or amended, the contract remains good and enforceable.¹⁶ As the North Carolina Supreme Court said earlier, in a decision addressing the right of the state to make changes in the way disability retirement benefits were calculated,

At the time the plaintiffs' rights to pensions became vested, the law provided that they would have disability retirement benefits calculated in a certain way. These were rights they had earned and that may not be taken from them by legislative action . . . We believe that a better analysis is that at the time the plaintiffs started working for the state or local government, the statutes provided what the plaintiff's compensation in the way of retirement benefits would be. The plaintiffs accepted these offers when they took the jobs. This created a contract.¹⁷

16. As the court in the *Bailey* case put it, "A legislative enactment in the ordinary form of a statute may contain provisions which, when accepted as the basis of action by individuals or corporations, become contracts between them and the State within the protection of the clause of the Federal Constitution forbidding impairment of contract obligations; rights may accrue under a statute or even be conferred by it, of such character as to be regarded as contractual, and such rights cannot be defeated by subsequent legislation. When such a right has arisen, the repeal of the statute does not affect the right or an action for its enforcement." 348 N.C. at 145, quoting *Ogelsby v. Adams*, 268 N.C. 272, 273-74 (1966), quoting 16 AM. JUR. 2D *Constitutional Law* § 442 (1966).

17. *Faulkenberry*, 345 N.C. at 690. Although most jurisdictions that have considered the issue have found an offer of pension benefits to be a binding contractual obligation once an employee has met the applicable service prerequisites and has vested in the retirement system, a few take a different approach. Under Colorado law, for example, a statute or an ordinance is considered a contract (and subject to the provisions of the Contract Clause) only when its language and the

Justifiable Impairments of Contracts

As for the council member's observation that a local government may breach a contract for an important public purpose, the city attorney responds that it is an oversimplification. Article I, Section 10, of the U.S. Constitution, the "Contract Clause," says, "No state shall . . . pass any . . . law impairing the Obligation of Contracts." This clause is applicable not only to state governments but also to local governments and other political subdivisions of the state.¹⁸ It is not, however, an absolute prohibition. The U.S. Supreme Court has held that a state may pass legislation or take other official action that impairs its contracts without violating the Contract Clause, when it does so to protect the general welfare of its citizens and when the impairment is "reasonable and necessary to serve an important public purpose."¹⁹ Thus not every impairment violates the Contract Clause. As with ordinary breaches of contract, when a state takes an action that impairs its contracts, the impairment, like a breach, must be substantial.²⁰ Minimal impairments, or actions that effect changes incidental to the basic contract, will not violate the Contract Clause.²¹

surrounding circumstances manifest a legislative intent to create private contract rights enforceable against the state or the municipality. The presumption is that a law governing government employee benefits merely declares a policy that will be followed until that law is changed. See *Colorado Springs Fire Fighters Ass'n, Local 5, v. City of Colorado Springs*, 784 P.2d 766, 773 (Colo. 1989), citing *Indiana ex rel. Anderson v. Brand*, 303 U.S. 95, 100 (1938), *Dodge v. Board of Educ.*, 302 U.S. 74, 79 (1937).

18. See *Northern P.R. Co. v. Minnesota ex rel. Duluth*, 208 U.S. 583 (1908); *Hogan v. City of Winston-Salem*, 121 N.C. App. 414, 418 (1996).

19. See *U.S. Trust Co. of N.Y. v. New Jersey*, 431 U.S. 1, 21 (1977).

20. When a person, a corporation, or a public entity fails to perform one of its promises or duties under a contract, the person or the entity is said to be in "breach" of the contract. The ordinary remedies for breach of contract are either money damages or an order from the court to the breaching party to perform its promise. When a state or local government takes an official action that has the effect of diminishing the value of its contractual obligation to the point that the contract becomes invalid or the other party loses the benefit of the contract, the action is said to be an "impairment" of contract. See *BLACK'S LAW DICTIONARY* (7th ed. 1999) under "breach of contract" and "impair."

21. *Bailey*, 348 N.C. at 151, citing *Allied Structural Steel Co. v. Spannaus*, 438 U.S. 234 (1978).

There are two additional questions, then, about Paradise's plan to eliminate retiree health benefits for current employees who have a vested and enforceable contractual right to them but have not yet retired. The first question is whether their elimination would be a *substantial* impairment of the city's contract with affected employees. The answer is undoubtedly yes. The *Bailey* case establishes that the extent of the impairment is to be determined by the overall impact of the change in the law and the estimated loss of expected benefits to retirees in the aggregate, rather than by the change's impact on individuals.²² Premium payments of several thousand dollars per retiree per year, multiplied by even a small number of eligible retirees and by, for example, an average of five years of payment before Medicare eligibility, add up to a significant amount fairly quickly.

Even if the court considered the impact of the change on individuals,²³ rather than in the aggregate, the argument that the impairment would be substantial is strong. For a retiree on a fixed income, a few thousand dollars can determine whether he or she can meet a mortgage payment, put enough food on the table, or heat the house during the winter. As a court in another jurisdiction commented in a case that involved a municipality's attempt to terminate the retiree health benefits promised in a collective bargaining agreement,

An economic consideration that cannot be swept under the rug is that many retirees live solely on their retirement benefits. Retirees with fixed incomes are generally ill-prepared to meet additional financial obligations that were unanticipated and that may be incrementally modified without notice.²⁴

22. *Bailey*, 348 N.C. at 151. In that case the court estimated the loss in expected income to retirees in the aggregate to be in excess of \$100 million.

23. The North Carolina Court of Appeals considered such an impact in *Hogan*, 121 N.C. App. at 420. In that case the court found that the change in Winston-Salem's disability retirement terms for police officers had a substantial impact. Under the plan as it existed at the time his rights vested, Hogan was entitled to disability retirement after an injury in the line of duty. Under the amended plan (that is, the one in existence at the time he became disabled), he would not have been allowed to retire but would have been transferred to other, unsworn duties in the police department.

24. *See* *Roth v. City of Glendale*, 614 N.W.2d 467, 473 (Wis. 2000). This case was brought and decided on a theory of breach of contract, rather than on a theory of unconstitutional impairment of contracts.

Indeed, research for this article has found no cases involving an attempt by a public employer or a government retirement plan to reduce either retirement income or health benefits, in which the court has found the impact not to be substantial.²⁵

The second question to ask about Paradise's plan is whether it is "reasonable and necessary to serve an important public purpose." If so, it will not violate the Contract Clause, the city attorney advises the council. The council members argue, "Doesn't the elimination of Paradise's retiree health benefit plan serve an important public purpose if it allows the city to maintain programs and services at current levels and obviates the need for layoffs, salary freezes, or tax hikes?"

"Probably not," says the city attorney. Or perhaps more accurately, he continues, eliminating retiree health benefits may serve an important public purpose in the context of a city budget stretched to the limits, but the courts are unlikely to find it "necessary."

Although courts determine whether an impairment of a contract is reasonable and necessary to serve an important public purpose on a case-by-case basis, North Carolina case law suggests that "reasonable and necessary" is a difficult standard to meet. Both the U.S. Supreme Court and the North Carolina Supreme Court have rejected the notion that the courts should defer to a legislature's or governing board's assessment of what is reasonable and necessary, noting that the legislative body has an inherent conflict of interest in making this determination.²⁶ As the U.S. Supreme Court observed,

[A] governmental entity can always find a use for extra money, especially when taxes do not have to be raised. If a State could reduce its financial obligations whenever it wanted to spend the money for what it regarded as an important public purpose,

25. *See Bailey*, 348 N.C. at 151; *Faulkenberry v. Teachers and State Employees Retirement Sys. of N.C.*, 345 N.C. 683, 692-93 (1997); *Miracle v. North Carolina Local Gov't Employees Retirement Sys.*, 124 N.C. App. 285, 291 (1996), *disc. rev. denied*, 345 N.C. 754 (1997); *Hogan*, 121 N.C. App. at 420; *Board of Admin. of the Public Employees' Retirement Sys. v. Wilson*, 61 Cal. Rptr. 2d 207, 234-38 (Cal. Ct. App. 1997); *Calabro v. City of Omaha*, 531 N.W.2d 541, 551 (Neb. 1995); *Weincke v. City of Indianapolis*, 429 N.E.2d 295, 298 (Ind. Ct. App. 1981). *See also Booth v. Sims*, 456 S.E.2d 167, 186-88 (W.Va. 1995) (based on provision of W.Va. Constitution).

26. *Bailey*, 348 N.C. at 151-52, *citing* *U.S. Trust Co. of N.Y. v. New Jersey*, 431 U.S. 1, 25-26 (1977).

the Contract Clause would provide no protection at all.²⁷

In the *Faulkenberry* case, the first on this issue that the North Carolina Supreme Court decided, the state argued that a change in the method of calculating disability retirement payments served the important purpose of encouraging people to remain employed even after they incurred a disability. The old method of calculating payments, the state claimed, encouraged employees to take disability retirement.²⁸ The North Carolina Supreme Court gave short shrift to this argument, noting with impatience,

We do not believe that just because the pension plan has developed in some ways that were not anticipated when the contract was made, the state or local government is justified in abrogating it. This is not the important public purpose envisioned which justified the impairment of a contract.²⁹

In the *Bailey* case, the court deemed the General Assembly's "revenue neutral" approach to equalizing the state income tax exception for state and local government retirees with that for federal retirees as no more than a "legislative convenience" that would allow it to avoid having to cut programs or raise taxes. Legislative convenience, the court said, is "not synonymous with reasonableness."³⁰ The court thus signaled that attempts to balance government budgets at the expense of retirees will face close scrutiny and will likely be found "reasonable and necessary" only when there are no other alternatives.

In *Paradise* the council rejected layoffs and salary freezes and did not discuss either cutting programs or raising taxes as a way of offsetting its increased health

27. *U.S. Trust*, 431 U.S. at 25–26, quoted by the N.C. Supreme Court in *Bailey*, 348 N.C. at 151–52.

28. *Faulkenberry v. Teachers and State Employees Retirement Sys. of N.C.*, 345 N.C. 683, 693–94 (1997).

29. *Id.* Similarly, in the *Hogan* case, the city claimed that the purpose of the change to its disability retirement plan was to permit disabled officers to transfer to another position and to continue employment with the city at the same salary and with the same possibility of pay increases that they would have had in their original sworn positions. The court said that although the city might have good intentions, there was no evidence that this justification was reasonable and necessary to protect an important government interest. See *Hogan*, 121 N.C. App. at 420.

30. *Bailey*, 348 N.C. at 152. See also *U.S. Trust*, 431 U.S. at 26; *Miracle*, 124 N.C. App. at 291; *Wilson*, 61 Cal. Rptr. 2d at 238.

insurance costs. Council members ask, "Would it have made a difference if we had implemented some or all of these measures but still found it difficult to absorb the cost of health benefits?"

"Possibly," replies the city attorney. He explains. When Baltimore, Maryland, reduced the annual salaries of its employees by a little less than 1 percent, the city's teachers and police officers sued, claiming that the reduction was an impermissible impairment of their collective bargaining agreements and their individual employment contracts. In *Baltimore Teachers Union v. Mayor and City Council of Baltimore*, the Fourth Circuit Court of Appeals (the federal appeals court whose jurisdiction includes both Maryland and North Carolina) agreed that the salary reduction was a substantial impairment of the teachers' and police officers' contracts but found that it was nonetheless permissible under the Contract Clause as reasonable and necessary to serve an important public purpose. Baltimore already had instituted a round of layoffs, eliminated positions, and encouraged early retirement. It also had sold some city property, dipped into its general fund balance, and delayed going to the bond market in an effort to save on interest costs. When it initiated the salary reductions, it did so in response to a second set of cuts in state aid that was made halfway through the fiscal year. The court accepted the city's claim that it was at the point of cutting basic services and "initiating the breakdown of government." Also important to the court's analysis was the temporary nature of the salary reduction. Baltimore, in fact, discontinued the salary reduction once it became clear that the budget shortfall would not be as dire as expected.³¹

The decisions in the *Bailey* and *Baltimore Teachers Union* cases may appear to be inconsistent, the city attorney notes, but they are not.³² In the *Bailey* case, the North Carolina Supreme Court emphasized the potential for state and local governments to avoid making hard choices by declaring impairment of their contracts necessary for an important public purpose. In the *Baltimore Teachers Union* case, the Fourth Circuit

31. See *Baltimore Teachers Union, AFT Local 340, AFL-CIO v. Mayor and City Council of Baltimore*, 6 F.3d 1012, 1021–22 (4th Cir. 1993), cert. denied, 510 U.S. 1141 (1994).

32. Strictly speaking, the *Bailey* and the *Baltimore Teachers Union* cases do not have to be consistent, since the *Bailey* decision is based on a combination of North Carolina law (the contract issue) and federal law (the Contract Clause issue) and was decided by a North Carolina court, while *Baltimore Teachers Union* is a federal appeals court case addressing an issue of federal law (the Contract Clause issue). Neither is binding on the other.

Court of Appeals noted that it could *always* be said that a city could have shifted the burden from another government program or could have raised taxes, in which case *no* impairment of a government contract could ever be found necessary for an important public purpose.³³ Read together, the decisions in the *Bailey* and *Baltimore Teachers Union* cases highlight the case-by-case approach that the courts take in deciding this issue and the stringent standard of financial necessity that a jurisdiction seeking to impair its employment contracts must meet. That Paradise may not eliminate its retiree health insurance program for vested employees does not mean that no jurisdiction may ever do so.

Understanding why it may not eliminate its retiree health benefits except for new hires and for those who have not yet vested in the benefits, the Paradise City Council also realizes that it may not require current retirees to contribute to their premiums: the retirees were promised health insurance until age sixty-five at no cost to themselves, and the decision in the *Bailey* case says that employees have contractual rights to the terms of their retirement plans as those terms existed at the moment that the employees' rights vested.³⁴ To require a 50 percent—or any—premium contribution would be to change the terms of the employment-compensation agreement. The impairment-of-contract analysis would be almost identical to the one the city attorney did with respect to the elimination of the retiree health benefit plan for vested current employees.

Change in the Coverage but Not the Cost

One of the Paradise council members has another question: "Can we offer a less generous package of health benefits to retirees? What I mean is, can we replace the current plan with one that seeks to control use of medical care more closely so as to reduce costs, with savings passed on to us in the form of less expensive premiums? We could look for a plan with higher co-payments or co-insurance, that omits coverage of experimental procedures and requires prior approvals for a greater number of accepted procedures and for use of non-generic drugs."

The city attorney sighs. He is not sure what to tell council members, for the North Carolina courts have never addressed this issue. "The vested rights approach to retirement income that the North Carolina Supreme Court adopted in the *Faulkenberry* and *Bailey* cases,"

33. Cf. *Bailey*, 348 N.C. at 151–53, with *Baltimore Teachers Union*, 6 F.3d at 1019–20.

34. See *Simpson v. Local Gov't Employees' Retirement Sys.*, 88 N.C. App. 288, at 223–24.

he says, "doesn't translate well when you try to answer this particular question." The decisions in the *Bailey* and *Faulkenberry* cases and in *Simpson v. Local Government Employees Retirement System* all stand for the proposition that at the moment of vesting, an employee "locks in" to the terms under which the benefit is being offered at that particular time. That makes sense for a pension—a cash benefit, established by a formula. But the world of medicine changes rapidly, and health insurance changes almost equally rapidly. Locking in to a specific health benefit does not seem desirable: new conditions and new treatments for existing conditions may not be covered. Neither does it seem practical: either the health insurance product or the health insurance company or both may not exist in several years time, or the company may cease to write health insurance policies in the relevant market.

Should this issue reach a North Carolina appellate court, the law in this area might go one of two ways. The court might decide that the vested rights approach does not apply in the health benefits context, or it might decide that the approach does apply but must be modified to reflect the changing nature of health insurance.

Given the court's reasoning in the *Bailey* case, it is hard to see the basis on which a court might distinguish retiree health benefits from pension payments and find that the vested rights approach does not apply. The cost of an individual health insurance policy for someone of retirement age is beyond the reach of many retirees, and for some, the retiree health benefit is worth more than the retirement income benefit. The court in the *Bailey* case recognized the importance of retirees' expectational interests, and for that reason it seems unlikely that the North Carolina courts would reach a different conclusion with respect to vested rights in health insurance benefits than they did on retirement income benefits.

Alternatively, the court might extend the rule of the *Bailey* case and the related vested rights cases to health benefits. But in recognition of the practical problem posed by the changing nature of health insurance, it could borrow the "disadvantages v. new advantages" approach adopted by California and a number of other states for resolving issues such as this. The "California Rule" holds that even when pension rights are contractual, they may be modified by a legislature when doing so is necessary and reasonable. The singular feature of this approach is that to be reasonable, any disadvantages effected by the changes must be offset by comparable new advantages.³⁵

35. See *Allen v. Board of Admin. of the Public Employees' Retirement Sys.*, 665 P.2d 534 (Cal. 1983), *cert.*

The Alaska Supreme Court applied the California Rule to the question of retiree health benefits in 2003 in *Duncan v. Retired Public Employees of Alaska, Inc.* The Alaska Constitution, like a number of other state constitutions,³⁶ explicitly protects the accrued retirement benefits of public employees from being diminished or impaired. The Alaska courts have interpreted this provision of the constitution as including retiree health benefits.³⁷ Although in Alaska, the right to benefits vests at the moment employment begins, there, as in California, the courts allow reasonable modifications to promised benefits if changes that result in disadvantages to employees are accompanied by comparable new advantages. In assessing the plaintiff retirees' challenge to changes in their health benefits package, the Alaska Supreme Court noted that one reason the U.S. Congress had exempted the health insurance plans of private-sector employers from ERISA's vesting requirement was that the cost of such plans fluctuates in response to unpredictable variables. In contrast, the actuarial decisions behind the fixed annuities offered by pension plans are based on fairly stable data.³⁸

The Alaska Supreme Court concluded that in the context of health insurance, "the natural and ordinary meaning of 'benefits'"—that is, the measure of whether retirees are getting the benefits for which they contracted—is the coverage provided, not the cost to the government employer of providing the insurance. What the retirees have, the court said, is a vested right to a reasonable health insurance package, "one which is in keeping with the mainstream of such

denied, 465 U.S. 1015 (1984); *Betts v. Board of Admin. of the Public Employees' Retirement Sys.*, 582 P.2d 614 (Cal. 1978). Like North Carolina's vested rights approach, the California Rule was first adopted in the context of retirement income benefits. For other states that have adopted this approach, *see, e.g.*, *Duncan v. Retired Public Employees of Alaska, Inc.*, 71 P.3d 882 (Alaska 2003); *Calabro v. City of Omaha*, 531 N.W.2d 541, 551 (1995); *Booth v. Sims*, 456 S.E.2d 167, 184–86 (W.Va. 1995). For a survey of approaches taken by other states as of 1987, *see Simpson*, 88 N.C. App. at 222.

36. *See, e.g.*, ILLINOIS CONST. art. XIII, § 5-; MICHIGAN CONST. art. IX, § 24; NEW YORK CONST. art. V, § 7; HAWAII CONST. art. XVI, § 2-. *See also* Opinion of the Justices, 303 N.E.2d 320, 327 (Mass. 1973) (interpreting MASSACHUSETTS CONST.).

37. ALASKA CONST. art. XII, § 7. *See also Duncan*, 71 P.3d at 888.

38. *See Duncan*, 71 P.3d at 886.

packages, as they are negotiated and implemented for similarly situated employees over time."³⁹

Where does this leave the Paradise City Council? The city attorney feels comfortable telling council members that they could change the retiree health benefits package, because, in fact, they already have done so several times in the last twenty years and because the original plans in which several employees and retirees vested are no longer even offered by health insurers. He can point to no North Carolina case law prohibiting the council from reducing the substantive benefits offered. But he suggests that in light of the California Rule and the *Duncan* case, the least risky and perhaps fairest course of action is to give retirees the same coverage offered to city employees currently on the payroll.

Health Benefits as Current Compensation

The council now asks the city attorney whether it can reduce the health benefits the city provides to current employees. "For heaven's sake, we've already changed plans, increased co-payments, and limited the network of doctors from whom they may seek care, all within the last three years!" exclaims one council member. The council member's confusion and exasperation are understandable. The city attorney assures the council that with respect to current employees, public employers can almost certainly change health plans, ask employees to share the cost of premiums, or, where they are already sharing the cost, ask them to contribute more. Benefits may be reduced in scope, prior approvals may be required, and co-payments may be added.

What accounts for the different treatment of health insurance benefits of current employees and those of retirees? Health insurance benefits are universally regarded as a form of *current* compensation for employees who still are on the payroll.⁴⁰ With the

39. *See Duncan*, at 888–89, 891, *quoting* *Studier v. Michigan Public Sch. Employees Retirement Bd.*, File 00-92435-AZ, Cir. Ct. for Ingham County, Mich., Ct. Order of Feb. 21, 2001.

40. Despite that universal understanding, very few legal cases stand for such a proposition. This is due, in part, to the fact that under ERISA, which governs almost all private-sector health insurance benefit plans, "welfare benefits plans" (of which health insurance is one example) are distinguished from "compensation," which is generally limited to payment of cash wages. *See* 29 CFR §§ 2510.3-1(a)(2), (b). In public-sector employment, how each state defines "compensation" in its statutes varies. *See, e.g.*, *Police Ass'n of Mount Vernon v. New York State Public Employment Relations Bd.*, 510

exception of employment agreements for a specific term (such as those that cities and counties frequently enter into with their managers), public employers are generally free to increase or decrease employee compensation as they see fit. For North Carolina cities and counties, the authority to do so comes from the General Statutes.⁴¹ Public employees have on occasion challenged reductions to their rate of pay or to other forms of compensation, but the courts have routinely rejected the notion that a public employee has a vested right in any rate or method of compensation.⁴²

Although a health benefit may be part of an employee's total current compensation, certain rules apply to benefits that are not applicable to wages. As discussed above, when personnel policies are set forth in a personnel manual or a policy enacted by resolution of the governing board, no property interest either in continued employment or in the terms and conditions of employment is created. To create a property interest in employment, a personnel policy must be adopted by

N.Y.S.2d 742, 744 (N.Y. App. Div. 1987), *Slattery v. City of New York*, 686 N.Y.S.2d 683, 691–92 (N.Y. Sup. Ct. 1999), both of which held that health insurance is a form of current compensation within the meaning of the New York Public Laws.

41. G.S. 160A-162(a) grants to municipal councils the power to “fix or approve the schedule of pay, expense allowances and other compensation for all city employees . . .” G.S. 160A-162(b) gives them the authority to “purchase life, health, and any other forms of insurance for the benefits of all or any class of city employees and their dependents.” G.S. 153A-92(a) and (d) grant identical authority to county boards of commissioners with respect to county employees.

42. *See, e.g., Abeyounis v. Town of Wrightsville Beach*, 102 N.C. App. 341, 344 (1991) (holding that town may increase or decrease salary of its police officers in its discretion); *Keeling v. City of Grand Junction*, 689 P.2d 679, 680 (Colo. App. 1984) (holding that firefighters and police officers do not have vested contract right and could reasonably have relied on continuance of particular rate or method of compensation); *Chicago Patrolmen's Benevolent Ass'n v. City of Chicago*, 309 N.E.2d 3, 6 (1974) (holding that public employees have no property rights in continuance of any specific rate or method of compensation). *But cf.* *Baltimore Teachers Union, AFT Local 340, AFL-CIO v. Mayor and City Council of Baltimore*, 6 F.3d 1012, 1015–16 (4th Cir. 1993), *cert. denied*, 510 U.S. 1141 (1994) (holding that inclusion of wage rate negotiated by teachers' and police officers' unions with city in city budget ordinance created contractual right to that rate of compensation for life of budget).

ordinance.⁴³ This is consistent with the broader rule adopted by the North Carolina courts, applicable to both public- and private-sector employment, that an employer's issuance of a personnel policy manual or handbook for employee use does not create an implied contract of employment incorporating the document's terms.⁴⁴ One exception to this rule is relevant in this context: when a handbook or a manual has promised employees certain benefits, the promise is enforceable, and the employer must provide the benefits promised.⁴⁵

This principle does *not* mean that public employers lack the authority to alter or eliminate a benefit promised in a handbook. Rather, it means that employers must provide the benefit as long as the provision and the handbook that contains it remain in effect.

For example, in one case, an employee manual represented that certain management employees were entitled to a severance payment if their employment was terminated without cause. The court ruled that it was the employer's burden to prove that it had eliminated the benefit and communicated the change to employees before a particular plaintiff's termination.⁴⁶

Similarly, in another case, an employer promised in its handbook that employees could maintain coverage under the employer's group health plan in the event that they became permanently disabled during their employment. The court ruled that the promise was enforceable even when changes in the terms of the group health plan made the cost of covering a disabled employee much more expensive than anticipated.⁴⁷

Therefore, when a public employer changes some aspect of its health insurance benefit for current employees—for example, the contribution rate, the availability of coverage for spouses and dependents, or the scope of benefits—it should clearly communicate the change to employees. If information about the benefit is contained in an employee handbook, manual, or policy, the employer should ensure that it records the change there.

43. *See Pittman v. Wilson County*, 839 F.2d 225 (4th Cir. 1988); *Kearney v. Durham County*, 99 N.C. App. 349 (1990).

44. *See Rucker v. First Union Nat'l Bank*, 98 N.C. App. 100 (1990); *Smith v. Monsanto Co.*, 71 N.C. App. 632 (1984); *Griffin v. Housing Auth.*, 62 N.C. App. 556 (1983).

45. *See, e.g., Brooks v. Carolina Telephone*, 56 N.C. App. 801 (1982) (severance payments); *Welsh v. Northern Telecom, Inc.*, 85 N.C. App. 281, *disc. rev. denied*, 326 N.C. 601 (1987) (vacation and retirement benefits); *White v. Hugh Chatham Mem'l Hosp.*, 97 N.C. App. 130 (1990) (extended insurance benefit).

46. *See, e.g., Brooks*, 56 N.C. App. at 804.

47. *See White*, 97 N.C. App. at 131–32.

How a Public Employer Can Maintain the Ability to Change Health Insurance Benefits

What can a public employer do to maintain flexibility in providing retiree and employee health benefits? The North Carolina cases on retirement income benefits, taken together with cases from other jurisdictions that address the issue of retiree health benefits, suggest that public employers should continue to provide health insurance to retirees and to current employees who have vested in the benefit on the same terms as they have previously promised to do. They also should maintain the same premium contribution rates unless they have reserved the right to change the rates.

As for the provisions of the plan itself, an employer is unlikely to be able indefinitely to offer the health insurance plan that was in effect at the time of an employee's vesting. It therefore should provide retirees with a plan that has generally comparable coverage or, at a minimum, that offers the same benefits provided to current employees.

To position themselves better for the future, public employers should take a fresh look at what they want to offer employees in the way of both current and retiree health benefits in light of existing and projected resources. They then should undertake a comprehensive review with legal counsel of all the documents—policies, resolutions, ordinances, handbooks, and memoranda—that set forth the terms under which they now offer health benefits to current employees. If they do not wish to make a contractual commitment to providing retiree health benefits to current employees when they retire, they must clearly reserve the right to alter or eliminate the benefits in the appropriate documents.

There is no "right" decision. Some employers may view a promise of retiree health benefits as an important tool for recruitment and retention and make an enforceable promise to provide them. Within that group, some may reserve the right to change the plan or to ask for increased retiree contributions to cover the cost of the premium. Other employers may simply not have the option of firmly committing themselves to a retiree health benefit. They may need to eliminate it altogether for the future. Alternatively, they might consider offering it with the proviso that the employer may eliminate it at any time in its sole discretion or subject to the availability of funds.⁴⁸

Public employers should take the same approach with health insurance for current employees. Although

48. *Cf. Norris v. City of Wilmington*, 110 F.3d 60 (4th Cir. 1997), 1997 WL 159532 (unpublished opinion).

the law generally allows an employer to change current compensation (including health benefits) prospectively, it would be prudent—as well as fair to employees—to make clear that the offer of health benefits is not absolute and unchanging but can be modified in response to economic conditions, medical advances, and employees' needs.

Part II: Reducing Benefits Other Than Health Insurance

It is clear to the Paradise city council that whatever savings they may be able to realize within the law are not going to solve their budget problems. They now look to the other employee benefits the town provides to see where the law might permit cuts:

- the North Carolina 401(k) supplemental retirement plan
- the law enforcement and firefighter supplemental retirement plan
- the life insurance program
- the severance pay package for layoffs
- vacation benefits
- the longevity pay plan.

To which of these are current employees or retirees entitled, and which may be changed now?

Supplemental Retirement Programs

Like most local governments, Paradise participates in the North Carolina Local Government Retirement System (LGERS). Paradise cannot, of course, make any changes to the formula governing its contributions to LGERS, or to the formula determining how much its employees will receive as an annuity upon retirement. Those matters are governed by statute and only the General Assembly can change them.⁴⁹

Like many North Carolina cities, Paradise also participates in the Supplemental Retirement Income Plan of North Carolina (the NC 401(k) Plan). In addition, Paradise has its own supplemental retirement plan for law enforcement officers and firefighters (the Paradise LEO Retirement Plan).

At the outset of its budget deliberations, the Paradise city council had assumed that it could eliminate the city's contribution to employees' NC 401(k) Plan accounts. There was also consensus for reducing the amount of the supplemental retirement payment made under the LEO Plan. Now, after working with the city attorney to understand the issues

49. The statutory scheme governing LGERS may be found in Article 3 of Chapter 128 of the General Statutes.

involved in reducing employee and retiree health benefits, council members assume that they cannot make any changes in either of the city's supplemental retirement programs. They are wrong in one case: they can eliminate the city's contribution to the 401(k) plan. They cannot, however, make changes to the LEOF Plan except for those who have not yet vested in the plan.

The North Carolina 401(k) Plan

Each year, Paradise has contributed to each employee's NC 401(k) account an amount equal to 3% of the employee's annual salary.⁵⁰ There is a one-year minimum service requirement before an employee becomes eligible for the employer contribution.

"You have told me that you need to cut total compensation costs," the city attorney tells the council. "The 401(k) plan is one place where you can do so." Council members are surprised. "This is a retirement plan," one member notes, "just like in the *Bailey* case."

The city attorney explains. At issue in the *Bailey* case was the way in which retirement income payments would be calculated under LGERS, a defined benefit plan. The North Carolina 401(k) Plan, by contrast, is a defined contribution plan.⁵¹ Although withdrawals from 401(k) plans are treated as deferred compensation for income tax purposes, there is a significant difference between employer contributions to the NC 401(k) Plan and to LGERS. The employer makes a contribution to a defined-benefit plan like LGERS in fulfillment of a promise to pay an employee a sum in the future—during retirement—for work done in the present. As the city attorney explained earlier, the statutes fix the way in which the amount of that future payment will be calculated.

There is no such promise of future payments on the part of the employer when it tells employees that it will make a contribution to a defined-contribution plan like the NC 401(k) Plan. Instead, employers pay employees a sum in the present for work done in the present—the payment is made in the form of a current contribution to the employee's account in the defined contribution plan (usually employees are also contributing a portion

50. For the North Carolina 401(k) Plan, see G.S. §§ 135-90–135-95.

51. Government-employer retirement income plans, like government-employer welfare benefit plans, are not governed by ERISA. This is true both of defined-benefit plans like LGERS, the Teachers and State Employees Retirement System, and supplemental retirement plans established by individual jurisdictions, and of defined-contribution plans like the North Carolina 401(k) Plan.

of their current compensation to the accounts through salary-reduction agreements).

In a defined-benefit plan like LGERS, the employer promises the employee a predictable sum of money in retirement. In a defined-contribution plan like the NC 401(k) Plan, the employer pays employees a specified part of their current compensation separately, by depositing it into the 401(k) account. This portion of their compensation is shielded from present (but not future) income tax liability. The employees themselves then each make decisions about how to manage the money in the account. Employees bear sole responsibility for how much money is available for withdrawal upon retirement. In other words, employees receive the contribution in the present, but are prohibited from withdrawing the contribution, and any money made as a result of investing the contribution, until retirement.

Because a 401(k) contribution is a form of current compensation, the city attorney says in conclusion, the city could reduce or eliminate it, just as it may reduce employees' salaries and reduce their current health benefits. He pauses. "If we made the 401(k) contributions in one lump-sum payment into employees' accounts at the end of the year, maybe we would have to go ahead and make this year's payment. But since we make our payment each month, then they may be reduced effective immediately."

"What's the difference?" a council member asks. The city attorney explains that an end-of-year contribution could be seen as a form of deferred compensation for that year—not compensation deferred until retirement, but compensation for work done in this calendar or budget year whose payment is deferred until the end of the year. So maybe *Bailey* would apply to the current year's payment. On the other hand, when employers make a 401(k) contribution at the end of the year, they do not typically make a pro-rated contribution for employees who have quit or been terminated mid-year—they make no contribution for those people. So, he continues, one could argue that the contribution is a bonus given at the end of the year in the council's discretion, and not compensation deferred until the end of the year. So *Bailey* would not apply. Taking that approach, the council could eliminate an end-of-year contribution effective for this year. But because there is no case law on this issue, the city attorney says, he would recommend that to avoid litigation, a council should eliminate an end-of-year contribution to employees' NC 401(k) Plan accounts effective with the next year.

Fortunately for Paradise, the city attorney concludes, it seems clear that a monthly contribution system can be eliminated at the end of this month.

The Paradise Law Enforcement Officer and Firefighter (LEOF) Retirement Plan

“As far as the LEOF Plan goes,” the city attorney tells the Paradise city council, “you cannot make a change in the plan that affects those who have already vested. The analysis and the outcome are the same as in the *Bailey* case.”

Under the Paradise LEOF Plan, police officers and firefighters must work for the city for a continuous five-year period before they are eligible to participate in the plan. Once a police officer or firefighter reaches the five-year mark, he or she vests in the plan and, after retirement, the city pays the employee on an annual basis an amount equal to 5% of the retired employee’s annual LGERS pension payment as a retirement supplement. Retired employees who earn more than \$10,000 from post-retirement employment are not entitled to the supplement. The LEOF Plan was adopted by ordinance.

The council wants to amend the LEOF ordinance to reduce the supplement to 2.5% of an employee’s LGERS payment and to lower the cap on post-retirement income to \$5,000. Can it do so? It certainly has the power to amend the ordinance. But just as the state had done in the *Bailey* case, Paradise had promised its public safety officers compensation in retirement for work done in the present. According to the *Bailey* case, those retirees and current employees who have worked the requisite five years and vested in the plan have a *contractual* right to the 5% supplement and the \$10,000 cap on earnings. This contractual right is enforceable notwithstanding any changes to the ordinance.⁵² The proposed changes, if adopted, could apply only to new hires and to current police officers and firefighters who had not yet met the five-year continuous service requirement.

Life Insurance

Paradise also offers its employees a life insurance benefit. After completing one year of service, employees may enroll in the city’s life insurance program. For each current employee, the city pays the entire cost of the premium for a term life-insurance policy with a \$100,000 death benefit. Under discussion are proposals (a) to reduce the city’s contribution to fifty percent of the cost of the

52. See page 4 above for a discussion of why the ordinance-resolution distinction is important for establishing the existence of a property right in the terms of employment, but is not relevant in establishing a contractual right to benefits.

premium for a \$50,000 term-life insurance policy, or (b) to eliminate the benefit entirely.

“This certainly isn’t current compensation,” says the manager with a sigh. “Payable after death is about as deferred as compensation can get.” The city attorney smiles. “I know that most people think about life insurance benefits in that way,” he says, “but this is, most definitely, a form of current compensation.”

In the case of life insurance, the city is not promising to pay the employee’s beneficiaries any money; it is the life insurance company making that promise. What the city is doing is paying the premium that purchases the policy. What an employer does in providing life insurance for its employees is analogous to what it does in providing health insurance: the employer does not provide medical care; it only purchases the policy that gives the employee the right to access care under the policy’s terms. Paradise may reduce or eliminate its life insurance benefit, just as it can with health insurance for current employees and with the city’s contribution to 401(k) accounts.

One of the council members asks about the one-year service requirement. Don’t employees have a vested right in the benefits after one-year, she wonders. The city attorney answers her question with one of his own: why is the one-year service requirement there in the first place? The city’s human resources director provides the answer. Administratively, the human resources director tells them, it is more efficient to add someone to the program once it is clear that the employee is likely to stay with Paradise. Payment of the premiums going forward was never meant to be deferred compensation for work done in the first year.

“Exactly,” the city attorney says. The payment of the life insurance premium is not deferred compensation, so the vested rights and impairment of contract analysis set forth in the *Bailey* case do not apply.

Would that still hold true, the manager asks, if there were a five-year service requirement, rather than a one-year requirement? Probably, although an employee would have a somewhat stronger argument that payment of the life insurance premium is a “reward” and thus, a form of deferred compensation, for the first five-years of service. There are no cases supporting such a position. But for a jurisdiction with a longer service pre-requisite for participation in a life insurance program, it might be advisable for the employer to make clear in its employee manual and in any recruiting or other material that references the life insurance benefit, that payment of the benefit

premium is a retention tool and form of current compensation.

As is the case with current employee health insurance, a public employer that is changing or eliminating its life insurance benefit should clearly communicate the change to employees and amend any employee handbook, manual or policy to reflect that change. Otherwise, for as long as the employer's materials represent that it will pay all or some part of employees' life insurance premiums, the employer will be legally obligated to do so. A promise to provide a life insurance benefit in retirement, on the other hand, is a form of deferred compensation and is subject to a vested rights and impairment of contract analysis.

Payments Made at the Termination of Employment: Severance Pay and Vacation Pay

The manager has suggested that the city council should also take a look at payouts made to employees at the termination of their employment. Paradise has been making so-called "severance payments" to employees terminated under certain conditions set in forth in the personnel policy. It has also paid employees the cash value of accrued but unused vacation time at termination. It has become increasingly difficult to budget for such payments, so the manager would prefer to see cuts made here before they are made in retirement or health benefits.

Severance Pay

Some public employers have severance pay plans. Generally speaking, such plans provide for the payment of a fixed sum to employees who have been dismissed not because of poor performance or misconduct, but because either a reorganization has resulted in the elimination of their jobs, or budgetary constraints have led to a reduction-in-force.

Paradise had incorporated a severance pay plan into its personnel ordinance several years earlier in an effort to make its total benefits package more competitive with private-sector employers. The Paradise Severance Pay Plan provides for payment of one-month's regular wages or salary for each year's employment with the city to any permanent employee (that is, any employee who has completed the probationary period) whose position is eliminated. One of the council members observes that the plan is extremely generous in that it offers severance pay to employees with a fairly limited record of service to the city.

Instead of scrapping the severance pay plan in its entirety, the council member suggests that the city limit it to those employees with ten years or more of city service.

The city manager objects. "Won't that create a vested right that will keep the city from ever being able to eliminate severance pay as a benefit?" he asks. "We certainly don't want to do that?" responds the council member. "But how is a ten-year service requirement any different from the requirement that an employee have completed his probationary period?" They turn to the city attorney. The issue, the city attorney tells them, is whether severance pay is a form of deferred compensation, or whether it is a "fringe benefit" that employers can give and take away in their discretion.

There is only one North Carolina case in which the question of an employer's ability to eliminate severance pay arises, and unfortunately, in the end, the court does not reach this issue. The plaintiff in *Brooks v. Carolina Telephone and Telegraph Co.* claimed, among other things, that the defendant employer's personnel policy provided for payment of a severance package of thirty weeks salary to management employees in the event that they were fired, and that her employer had refused to pay her in accordance with the policy when she was discharged. The employer claimed in its defense that the severance pay policy was subject to change in the sole discretion of senior management, and that it had been revoked prior to the plaintiff's termination. The trial court found that Carolina Telephone and Telegraph had indeed terminated its severance pay program and granted summary judgment for the employer. The North Carolina Court of Appeals disagreed. It held that although the ability of management to discontinue the severance pay policy was not at issue, "whether plaintiff became entitled to such an allowance during and by reason of her employment" was still in dispute. The court said that employees who have worked in expectation of a severance package may have a contractual right to severance pay even if the employer rescinds the policy for future employees.⁵³

This is in keeping with the trend in other jurisdictions. Courts in other states have generally found that severance pay is not a discretionary "extra" or gratuity, but is a form of deferred compensation in which employees vest by virtue of their continued service.⁵⁴ One court explained it this way:

53. See *Brooks*, 56 N.C.App. at 804.

54. See, e.g., *Kirkland v. St. Elizabeth Hospital Medical Center*, 34 Fed.Appx. 174, 179, 2002 WL 486242 *3 (6th Cir. 2002); *Bolling v. Clevepak Corp.*, 484 N.E.2d 1367, 1375-76 (Ohio.Ct.App. 1984); *Kulins v. Malco, A Micordot Company*,

Severance pay is an *earned* benefit, one for which the employees work as much (and as hard) as they work for any other benefit or item of compensation . . . That being the case, it must then be realized that, as deferred compensation, severance pay accrues while it is being earned during the course of the employment relationship. . . Once earned, that right (and the amount of pay theretofore accrued) cannot thereafter be retroactively modified, diminished or eliminated by the employer . . .⁵⁵

There is another reason for considering severance pay to be a form of deferred compensation, the city attorney tells the manager and council. If severance pay is nothing more than a discretionary gift or gratuity, then it is likely in violation of Article I, Section 32 of the North Carolina Constitution, which prohibits the payment of any public money to anyone except in return for services rendered. In *Leete v. County of Warren*, the North Carolina Supreme Court held that a severance payment granted to a county manager after his voluntary resignation violated Article I, Section 32, because the payment was decided upon and made after his employment had ended. It was not, the court found, in return for services he had performed for the county.⁵⁶ In *Leete*, the North Carolina Supreme Court did not categorically hold that North Carolina public employers may not offer severance pay without violating the North Carolina Constitution. Instead, it appeared to hold open the possibility that a promise of severance pay would be enforceable if it were part of an employment contract.⁵⁷ But the Supreme Court in *Leete* made clear that whether or not severance pay for a public employee is constitutional would depend in part on how that benefit is defined. The reason for finding that the severance payment in the *Leete* case violated Article I, Section 32 was that

. . . the compensation at issue was labeled as severance pay. "Severance pay" is defined as [p]ayment by an employer to an employee beyond

Inc., 459 N.E.2d 1038, 1043-44 (Ill.App.Ct. 1984) and cases cited therein; *Mace v. Conde Nast Publications, Inc.*, 237 A.2d 360, 361 (Conn. 1967); *Botany Mills, Inc., v. Textile Workers Union of America, AFL-CIO*, 141 A.2d 107, 113-14 (N.J. 1958).

55. See *Bolling*, ., 484 N.E.2d at 1375.

56. See *Leete v. County of Warren*, 341 N.C. 116, 121-22 (1995).

57. See *Myers v. Town of Plymouth*, 135 N.C.App. 707, 712-13 (1999). Note that G.S. § 143-27.2 provides for payment of severance wages to certain state employees when budgetary constraints dictate that a state institution be closed or a reduction-in-force implemented.

his wages on termination of his employment. Such pay represents a form of compensation for the termination of the employment relation, for reasons other than the displaced employee's misconduct, primarily to alleviate the consequent need for economic readjustment but also to recompense the employee for certain losses attributable to the dismissal.⁵⁸

The city attorney concludes by saying that if the council wanted to keep a reduced severance pay plan as part of its benefits package, it probably ought to specifically designate it a form of deferred compensation in order not to run afoul of Article I, Section 32. As a form of deferred compensation, the conditions of the severance pay plan could then only be modified prospectively. Thus, employees who as of now had completed their probationary periods should be considered to have "vested" in the severance benefit. If the council wants to put a 10-year service requirement as a pre-condition to eligibility for severance pay, it must do so starting with new hires and those who are currently in their probationary period.

Vacation Pay

Paradise employees currently receive 15 days of paid vacation leave each year. At the end of the year, any unused, accrued leave may be rolled over to the next year without limit. The personnel policy provides that both employees who voluntarily quit and those who are fired are entitled to the cash value of their accumulated vacation time when they leave employment. At retirement, unused vacation leave is converted to unused sick leave, so that it may be credited to the employee's length of service under LGERS. The manager has suggested that the council change the policy to one of "use it or lose it"—that is, one in which employees must use their accrued vacation time in the year in which it is earned or have it erased from the books. At a minimum, he has told the council, it should limit the rollover of unused vacation days to maximum of 30 days at any given time.

The city attorney advises the manager and council that there will be no problem making either of the suggested changes going forward, provided that employees are properly informed of the new policy.⁵⁹

58. *Leete*, 341 N.C. at 119, citing Black's Law Dictionary 1374 (6th ed. 1990).

59. Although G.S. 95-25-14(d) provides that with exception of certain, limited provisions, the North Carolina Wage and Hour Act (Article 2A of Chapter 95) does not apply to state and local government employers, the Act is nonetheless

Since an employer is not required by any state or federal law to provide paid vacation leave, it may condition the accrual and use of this benefit as it chooses: it may give five days paid vacation leave, ten days or a month; it may give a greater number of days of paid vacation leave to one group of employees, and fewer days to another group. While an employer is free to payout unused leave at termination, it is also free to choose not to do so. Similarly, it may allow for unrestricted accumulation of vacation leave or it may limit accrual to no more than a specific number of days.

Nevertheless, the city attorney continues, once an employer has established a policy of granting employees paid vacation leave and of making a payment to employees in lieu of their use of the time off, vacation leave by its very nature becomes earned, but deferred, compensation and part of an employee's employment contract. Employees vest in the benefit as they earn it.⁶⁰

Thus, all vacation leave accrued under Paradise's current policy must be paid out before any new policy becomes effective. Alternatively, the city's human resources department may keep all vacation leave accrued under the current policy on the books until employees either use their leave, terminate employment, or retire. At the moment that the new policy takes effect, its terms—whether they turn out to be “use it or lose it” or a maximum accumulation of 30 days—become the terms of the employment contract going forward for all work done in the future.

Longevity Pay

The last item on the manager's list for discussion is the elimination of longevity pay. Although the city attorney thinks there is a strong argument that longevity pay is nothing more than a supplemental form of current compensation, he cautions the

a good source for accepted employment practices. G.S. 95-25.12, for example, provides that an employer subject to the Act (as most private employers are) may not deny an employee earned paid vacation leave or

payment of lieu of the leave unless it has notified its employees of the conditions under which such vacation pay may be forfeited prior to the time when the vacation leave is earned.

60. See *Pritchard v. Elizabeth City*, 81 N.C.App. 543, 549-50, 552 (1986). See also *Hamilton v. Memorex Telex Corp.*, 118 N.C.App. 1 (1995) (decided under North Carolina Wage and Hour Act); *Haxton v. McClure Oil Corp.*, 697 N.E.2d 1277, 1280-81 (Ind.Ct.App. 1998); *Boothby v. Atlas Mechanical, Inc.*, 8 Cal.Rptr.2d 600, 601-02 (Cal.Ct.App. 1992) (decision based in part on California Labor Code).

council that it is possible that a court might find it to be a benefit to which employees have a vested right.

The Paradise personnel ordinance says that the purpose of the longevity pay plan is “to recognize those employees who have given the City good and continuous service.” Employees are automatically eligible to receive longevity pay after completion of 10 years of continuous service with the city. Those who have served 10 years receive 1.5% of their current annual salary as an annual longevity payment. Those who have served 15 years receive 2%; those who have served 20 years receive 3% and after 25 years of service, longevity pay caps at 4% of an employee's current annual salary.

Whether longevity pay is current or deferred compensation is an open question in North Carolina, the city attorney tells the manager and council. The only two North Carolina cases that deal with longevity pay treat it as compensation that must be approved by the governing board each year, which suggests that employees do not have a vested right to longevity pay. Neither case, however, expressly addressed the issues of whether or not the right to longevity pay vests and whether a jurisdiction can eliminate longevity pay merely by failing to include it in its budget.

In *Norris v. City of Wilmington*, a group of city employees challenged the City of Wilmington's substitution of a merit pay plan for its longstanding longevity pay plan. The longevity pay plan had been in existence for over twenty years. The plaintiff employees claimed that elimination of longevity pay constituted an impairment of contract in violation of the Contract Clause. The case was brought in federal court, and both the trial judge and the Fourth Circuit Court of Appeals found for the city.⁶¹ Their decisions were not based on any idea that vesting is inherent in the notion of longevity pay, but rather on the language of the ordinance establishing the pay plan. The ordinance had said, “[o]n December 1, 1971, and thereafter as budgeted by the City Council, annual longevity pay will be provided to all full-time, permanent employees of the City” [emphasis in the original]. As the Fourth Circuit explained,

The “as budgeted” language clearly demonstrates that the payment of longevity pay was dependent on annual funding. The point is further underscored by the longevity pay's inclusion as a

61. See *Norris v. City of Wilmington*, unpublished disposition 1997 WL 159532 (4th Cir. 1997).

line item in each City budget from 1971-1993 [emphasis added].⁶²

It is unclear how the court would have held had the ordinance not contained the “as budgeted” language and had longevity pay not been a line item in the budget but been subsumed in a larger compensation or benefits line.

The factual and procedural background to *Hubbard v. County of Cumberland*, a North Carolina Court of Appeals case involving longevity pay, is somewhat similar to that of the *Norris* case. Here, the Cumberland County Board of Commissioners had adopted a longevity pay plan for the sheriff’s department in 1980. In 1997, a group of sheriff’s deputies brought suit against the county, alleging that it had failed to comply with its duties under the county’s budget ordinance and that irregularities in application of the longevity pay plan over a number of years had resulted in the deputies being wrongfully deprived of earned compensation. The Court of Appeals denied the county’s motion for summary judgment, in part because the record did not establish whether the Board continued to approve and appropriate funds in each year’s budget ordinance for the sheriff’s department longevity pay plan.⁶³ The court’s identification of the continued appropriation of funds for the longevity pay plan as a crucial factual issue in the case might suggest to the Paradise council members that the court sees longevity pay as a form of current compensation, and that they are thus free to eliminate or reduce it. But that would be to read too much into the decision, the city attorney warns. Indeed, the court says in a footnote,

whether or not the Board could revoke the longevity pay plan by merely failing to allocate funds therefore in the annual budget ordinance is an issue of law not before this Court.⁶⁴

Cases from other jurisdictions do little to clarify whether longevity pay is legally a form of current compensation and subject to reduction, or is deferred compensation that is protected by contract. The best that can be said about these other cases, the city attorney suggests, is that they are consistent with *Norris* and *Hubbard* in that their outcomes very much rest upon either the particular procedure followed in setting and approving longevity pay or the particular language used in establishing the individual longevity pay plans.

62. See *Norris*, 1997 WL 159532.

63. See *Hubbard v. County of Cumberland*, 143 N.C.App. 149, 154 (2001), *rev. denied*, 354 N.C. 69 (2001).

64. See *Hubbard*, 143 N.C.App. at 154 n. 1.

Thus, in one Alabama case, a teachers and school workers union sued the county board of education, on the grounds that it had wrongfully eliminated members’ longevity pay when it adopted a state salary schedule for the first time. The court, however, held for the board of education, finding that the longevity increases that teachers and school workers had received in previous years had not existed independently of or “on top of” the local salary schedules. The evidence showed that the school board had incorporated longevity-pay increases into its salary schedule each year and that each year a new salary schedule was considered and approved by the board.⁶⁵ Under these circumstances, longevity pay was no more than an element in current compensation.

A Montana city created its longevity pay plan by a resolution that stated that the purpose of the plan was “to induce a longer tenure of service” by firefighters. Under the plan as amended, firefighters with as little as one year of service received some longevity pay, and those with twenty years of service received a maximum longevity benefit. When the city repealed the resolution nineteen years later, firefighters brought suit, claiming an unconstitutional impairment of contract. The Montana Supreme Court agreed, holding that all firefighters who either began or continued in employment with the city during the period while the ordinance was in effect had a vested contractual right in longevity pay and that the repeal of the ordinance had no effect on their rights to longevity pay. The ordinance was effective only with respect to new hires.⁶⁶ Although the court’s decision does not frame it as such, longevity pay is here being treated as a form of deferred compensation.

Longevity pay was also deemed a form of deferred compensation in the 1978 case *California League of City Employee Associations v. Palos Verdes Library District*. At issue was the elimination of longevity pay increases, an additional week of vacation for certain employees, and a four-month paid sabbatical for librarians in their sixth year of service. The court observed that the three benefits in question might not be as important to an employee as a pension. But the court nonetheless found that the benefits had become fundamental to employees in that they had been an

65. See *Limestone County Education Assoc. v. Limestone County Board of Education*, 2003 WL 21715561 *6 (Ala.Civ.App. 2003).

66. See *Local #8 International Association of Fire Fighters v. City of Great Falls*, 568 P.2d 541, 545 (Mont.1977) and cases cited therein.

inducement to remain employed with the library district. They were thus a form of deferred compensation earned by remaining in employment. As the court put it,

To the librarian who has worked five and one-half years toward the right to take a sabbatical at the end of six years, or the long-term employee who has been working toward entitlement to five weeks of vacation after ten years of service, it would be grossly unfair to allow defendant to eliminate such benefits and reap the rewards of such long-term service without payment of an important element of compensation for such service.⁶⁷

More recently, however, another California court found longevity pay to be merely a method of compensation that the employer could eliminate. In *Barber v. East Bay Municipal Utility District*, the California Court of Appeal found that a longevity increase of \$20 per month for twenty-year hourly employees and a 2.75 percent increment added to a twenty-year exempt employee's monthly salary was a "particular measure of compensation" to which employees had no vested right. The court acknowledged that language in the utility district's personnel policy suggested that longevity pay was a vested entitlement; it noted in particular language that said that after twenty-years of service, "employees *shall* be entitled to a career service pay increment . . ." and that eligible employees "*shall receive*" career service increments (emphasis added). But the court also took note of the fact that longevity pay was only one of several types of what the district called "supplemental pay" that could be earned. Further, in adopting new compensation rules, the district incorporated the longevity pay increments that employees had been receiving previously into the salaries that they were assigned under the new salary plan. "On balance," the court said, the longevity pay plan was "merely a 'particular measure of compensation'" in which the employees had no vested right.⁶⁸

67. See California League of City Employee Associations v. Palos Verdes Library District, 150 Cal.Rptr. 739, 741-42 (Cal. Ct. App. 1978).

68. See *Barber v. East Bay Municipal Utility District*, 2000 WL 33313098 *2 (Cal.Ct.App. 2000). Note that although *Limestone County Education Assoc., Local #8 International Assoc. of Fire Fighters*, and *California League* all involved collective bargaining units, none of the decisions turned on the issue of whether the representations about longevity pay had been made part of the collective bargaining agreement. In *San Bernardino Public Employees Assoc. v.*

So what can we learn from these cases?, the city attorney asks rhetorically. It seems that courts may be more likely to find longevity pay to be a form of deferred compensation when the stated purpose of the pay plan is to induce employees to remain with the employer. In other words, where the employer has essentially told employees, "*In return for* remaining on the job for a specified amount of time, you will receive extra compensation," a contract has been created and the right to receive longevity pay vests, just as pension and retiree health insurance benefits do. At least, this is what the Montana fire-fighters and the *California League* cases suggest. The *Barber* case suggests that language of entitlement such as "shall be entitled" and "shall receive" can be important, although not determinative, evidence of the intention to vest.

The *Norris, Hubbard, Limestone County Education Assoc.* and *Barber* cases all suggest to one degree or another that where longevity pay is incorporated into a salary schedule that is itself subject to yearly approval, or where longevity payments appear as a line item on a budget subject to yearly approval, it is more likely to be seen as a form of current compensation.

Here in Paradise, the city attorney advises, we have set up our longevity pay plan "to recognize" long-term service rather than "to induce." "Perhaps that is a distinction without a difference," he says, "but I would argue that 'recognize' carries with it a notion of employer discretion, whereas 'induce' is more in the nature of a promise." Employers generally want to recognize and reward employees for the out-of-the-ordinary: extraordinary quality or achievement, very long hours, a job requiring extraordinary effort, or, here, substantial length of service. But rewards cannot always be as generous or as meaningful as employers and employees might like them to be and they may vary from year to year. Employer discretion and variation are accepted with respect to rewards for other types of meritorious performance. Why should length of service be any different?

On the other hand, the city attorney continues, Paradise does not separate out longevity pay as a line item in the annual budget ordinance as in *Norris*. Nor does it internally build it into individual salary figures, as in *Limestone County Education Assoc.* Instead "compensation" appears on a single line in the budget ordinance. Perhaps Paradise's longevity pay plan

City of Fontana, 79 Cal.Rptr.2d 634 (Cal.Ct.App. 1998), the court held that employees did not have vested rights in longevity-based benefits that were provided for in collective-bargaining agreements of fixed duration.

should be viewed as a form of deferred compensation in which employees vest.

The city attorney makes one final point. “I think that there is a strong practical argument to make in favor of longevity pay as current compensation. I haven’t seen it raised in any of the cases that deal with the issue,” he says, “but they are few, so that does not mean anything.” Ultimately and practically, he continues, longevity pay remains a component of total current compensation. Even if Paradise couldn’t eliminate longevity pay, it could lower the salary of each qualifying employee to the point where the practical result would be that the boost provided by longevity pay would be eliminated and total current compensation would be where the council wanted it to be. Seen in this light, the notion of longevity pay as “deferred compensation” to which employees have a “vested right” seems meaningless.

In the end, the city attorney cannot give the Paradise City Council a “yes” or “no” answer to the question of whether it can eliminate longevity pay. Given the absence of guidance from any North Carolina court, the council must determine how much risk it is willing to take in eliminating or reducing longevity pay. An employer can never entirely eliminate the risk that employees will sue, no matter how good its employment practices are and how likely it is to prevail at a trial on the merits. If the council eliminates longevity pay, the experience of other jurisdictions suggests that there is a good chance that employees may bring suit. In this case, however, it is difficult to predict which side would win. The question is whether the elimination of longevity pay and the resulting risk of a potentially successful employee lawsuit are more palatable to the council than making cuts elsewhere in its budget.

Conclusion

Public employers who are considering reducing employee or retiree benefits must carefully analyze the nature of each benefit under discussion since there is no single, bright-line rule applicable to all benefits. In general, benefits that are a form of deferred compensation—defined-benefit pension plans, severance-pay plans, vacation-pay plans and some longevity-pay plans—are subject to an analysis like that set forth in the *Bailey* case. Once an employee vests in the benefit, the employer will have a contractual obligation to provide that benefit. The only exception would be where the employer has reserved the right to eliminate, reduce or otherwise change the benefit. Employers always have the right

to make changes that will apply to new hires and those who have not yet vested.

In contrast, employers may eliminate or reduce the scope of benefits that may fairly be classified as current compensation—benefits such as contributions to NC 401(k) Plan accounts, life insurance benefits for current employees and some longevity pay plans—immediately. Forms of current compensation do not have true vesting requirements (although they may have waiting periods or service requirements) and employers do not have to distinguish between groups of employees who may be subject to the changes and groups who have a protected, contractual right to keeping things the way they are.

Whatever the benefit, human resources directors, managers, agency administrators and governing boards should not proceed with a plan for the reduction or elimination of benefits without involving legal counsel in the process.

RELATED NEWS: Offering Different Retiree Health Insurance Benefits Based on Medicare Eligibility Is Not Age Discrimination

On April 22, 2004, the Equal Employment Opportunity Commission (EEOC) approved a final rule that permits employers to coordinate retiree health benefits with eligibility for Medicare. Previously, the EEOC had taken the position that employers who provided retiree health coverage up to, but not after, age sixty-five, or who limited the coverage available to retirees over sixty-five to plans that supplement Medicare coverage (so-called “Medigap plans”), were violating the federal Age Discrimination in Employment Act (ADEA) by making distinctions based on age.

In 2000, in *Erie County Retirees Association v. Erie County*, the Third Circuit Court of Appeals (which has jurisdiction over New Jersey, Pennsylvania and Delaware, but not North Carolina) had adopted the EEOC’s earlier position, holding that under the ADEA, employers had to provide pre- and post-Medicare eligible retirees either the same benefits or ones of equal cost.⁶⁹

The new EEOC rule allows employers to provide health care coverage to retirees who are under age sixty-five without having to offer any coverage to retirees who qualify for Medicare. Alternatively, under the new rule, an employer may offer a full health insurance plan to retirees under sixty-five and a Medicare-

69. *Erie County Retirees Association v. Erie County*, 220 F.3d 193 (3d Cir. 2000), cert. denied, 532 U.S. 913 (2001).

supplement plan or “carve-out” (where Medicare is the primary insurer and the private plan provides secondary coverage) to those sixty-five and older, without having to provide a supplemental plan whose benefits are so generous that it costs as much as the pre-Medicare full coverage plan. The new rule applies equally to plans already in existence and to new plans.

The rule emphasizes, however, that under both the ADEA and the rules governing the Medicare program, employers may *not* offer a reduced health care benefit to current employees—as opposed to retirees—who are age sixty-five or older and eligible for Medicare.

Current employees who are eligible for Medicare must be offered the same health insurance benefits as similarly situated employees who are under sixty-five.

The new rule can be found at 29 C.F.R. § 1625.32 and includes an “Appendix to § 1625.32” with answers to frequently-asked questions.

Public employers should note that this new rule does not affect their obligations to provide retiree health insurance to those who have already vested in the benefit and to whom they have a contractual obligation.

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