Can Public Employers Eliminate or Reduce Health Benefits?

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For most employers, personnel costs represent a substantial and increasing share of the budget. What employer hasn't "gulped" at the escalating costs of health insurance? What employer hasn't seriously considered either reducing health benefits or reducing other benefits to offset the increased cost of health insurance?

Many public employers assume that because private employers may reduce the health benefits of retirees, they too may do so. That assumption is erroneous 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.[1]

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).[2] 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 benefits plans. It also establishes fiduciary duties for those involved in administering pension and welfare benefit plans.

Government pension and welfare benefits 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? This article uses a hypothetical case featuring an imaginary North Carolina city to discuss the legal issues that North Carolina public employers should take into account in attempting to control the costs of health benefits for both current employees and retirees.

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Trouble in Paradise

Paradise, North Carolina, is a medium-sized city with a population of about 40,000. Like many North Carolina jurisdictions, 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 a particular health insurance plan or a particular set of benefits in the case of either current employees or retirees.

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

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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 both 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).[3] 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.[4]

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.[5] 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 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.[6] As the court said,

Health benefits are critically important to many retirees. Without benefits, some may have to choose between medication and food.

> *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.[7]

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.[8] This is an important point. The North Carolina Constitution prohibits the state and its political subdivisions from paying any person any money whatsoever except in payment for public services.[9] 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.[10] 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 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*.[11] 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.[12]

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).[13]

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 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 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.[14] 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.*[15]

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.[16] 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."[17] 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*.[18] Minimal impairments, or actions that effect changes incidental to the basic contract, will not violate the Contract Clause.[19]

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.[20] 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, rather than in the aggregate, the argument that the impairment would be substantial is strong.[21] 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.*[22]

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.[23]

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.[24] 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, the Contract Clause would provide no protection at all.*[25]

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.[26] The North Carolina Supreme Court gave short shrift to this argument, noting with impatience,

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.

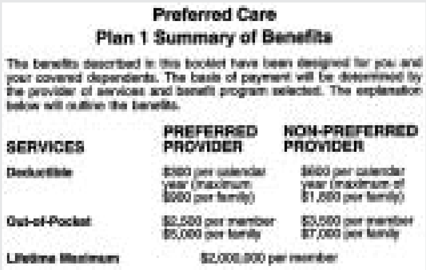
> *We do not believe that just because the pension plan has developed in some ways that were not anticipated when the contract was made, the state or local government is justified in abrogating it. This is not the important public purpose envisioned which justified the impairment of a contract.*[27]

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."[28] 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 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 were 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

Employee Health Benefits: The Law in Brief



Preferred Care

Plan 1 Summary of Benefits

The benefits described in this booklet have been designed for you and your covered dependents. The basis of payment will be determined by the provider of services and benefit program selected. The explanation below will outline the benefits.

SERVICES	PREFERRED PROVIDER	NON-PREFERRED PROVIDER
Deductible	$300 per calendar year (maximum $900 per family)	$600 per calendar year (maximum of $1,800 per family)
Out-of-Pocket	$2,500 per member $5,000 per family	$3,500 per member $7,000 per family
Lifetime Maximum	$2,000,000 per member	

Must public employers provide health benefits to employees?

No. There is no legal requirement that public employers provide health benefits to their employees. Sections 160A-162(b) and 153A-92(b) of the North Carolina General Statutes authorize cities and counties respectively to offer health insurance and other benefits to their employees if their governing boards so choose.

Why do public employers offer health benefits if they aren't required to do so?

For two reasons. First, for employees it is a valuable form of compensation. Through group insurance plans, the employer can make health insurance available to employees at a more affordable rate than the employees could find on their own. Second, because it is common for private-sector employers to provide health insurance benefits, public employers must do so to remain competitive in the labor market.

May public employers offer to pay some or all of the cost of their employees' health insurance after they retire?

Yes. Payment of retirees' health insurance premiums is considered a form of deferred compensation—that is, payment made after retirement for services the retirees provided before retirement.

If a public employer has promised to pay all or some of the cost of health insurance premiums for its retirees, may it change its mind and cease paying premium costs?

Probably not. When the employer told employees before they retired that it would pay a certain level of the premium costs after retirement, it entered into a contract with the employees (even though the contract did not take the form of an actual contract document). Generally speaking, the government cannot disavow such a contractual obligation. To do so would be an "impairment of contract" that violates the U.S. Constitution.

May a public employer reduce the amount of the premium contribution it makes for retired employees?

Probably not, for the same reasons.

How about employees who have not yet retired but have "vested," or fulfilled a minimum service requirement to qualify for employer-paid retiree health benefits? Can a public employer eliminate or reduce its premium contributions on their behalf?

Again, probably not. The contract to provide retirement health benefits is formed when the employee vests, not when the employee actually retires.

May public employers reduce the coverage provided to retirees under the health insurance plan as long as they continue to pay the promised part of the health insurance premium? Can they increase deductibles or require co-payments?

This is an open question right now. The North Carolina courts have not yet addressed the issue. One possibility is that the courts would say that as long as the public employer meets its obligation to pay its promised share of the premium, it may reduce coverage. More likely, the courts would say that the coverage does not have to stay exactly the same but that the overall benefit to the employee does. That is, if there is an increased deductible or co-payment (a disadvantage to the employee), it must be offset by some corresponding advantage (increased coverage of certain conditions, for example).

Are public employers forever locked in to promises made to employees in better economic times?

Only with respect to current retirees and current employees who have vested in the retiree health benefit. Public employers may give notice now to new employees or current employees who have not yet vested that they will receive different health benefits in retirement.

What about current employees? May a public employer reduce the amount it pays toward a current employee's health insurance premium or reduce the coverage provided?

Yes. The employer may change these whenever it sees the need, provided that it gives adequate notice of the change.

Why is the law that governs changes in health insurance benefits different for retirees and current employees?

Because current coverage for current employees is not deferred compensation. It is not the promise of doing something in the future in return for work done today. Current coverage for current employees is current compensation for current work. Generally speaking, employers, including public employers, can increase or decrease the compensation of their employees at their discretion.

In short, what are public employers to do?

Public employers should continue to fulfill the promises that they have made to retirees and currently vested employees to provide health benefits in retirement. These have become contractual commitments. For the future, public employers might wish to consider the extent to which they want to commit themselves to providing retiree health benefits. They must balance fairness to employees and the needs of recruitment and retention against an uncertain, unmeasurable future liability.

fact, discontinued the salary reduction once it became clear that the budget shortfall would not be as dire as expected.[29]

The decisions in the *Bailey* and *Baltimore Teachers Union* cases may appear to be inconsistent, the city attorney notes, but they are not.[30] 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 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.[31] 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.

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.

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.[32] 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 nongeneric 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," 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.[33]

The Alaska Supreme Court applied the California Rule to the question of retiree health benefits in 2003 in *Duncan v. Retired Public Employees of*

CODE	NEW PATIENT	CPT	FEE	COD
505	Office Visit (Limited)	99201		57
509	Office Visit (Expanded)	99202		58
511	Office Visit (Detailed)	99203		PE2
513	Office Visit (Comprehensive)	99204		PE3
515	Office Visit (Comprehensive/High Complex)	99205		444
186	Vasectomy Consult	99241		445
	ESTABLISHED PATIENT			446
516	Office Visit (Brief)	99211		
518	Office Visit (Limited)	99212		35
519	Office Visit (Expanded)	99213		36
520	Office Visit (Detailed)	99214		37
521	Office Visit (Comprehensive)	99215		38
390	History & Physical (Pre-op)	99215		39
473	Brief History & Physical (Pre-op)	99214		40
	OFFICE/OUT PATIENT-NEW OR ESTABLISHED			41

Alaska, Inc. The Alaska Constitution, like a number of other state constitutions,[34] 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.[35] 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.[36]

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 packages, as they are negotiated and implemented for similarly situated employees over time."[37]

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 already are 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.[38] With the 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

Date of Service	Rx Number	Amount Submitted	Amount Approved	Deductible Applied	Cop App
01/15/2002	0859551	94.99	94.99	94.99	0.(
04/17/2002	0859551	94.99	94.99	2.26	20.(
06/04/2002	0883787	94.99	94.99	94.99	0.(
08/08/2002	0893498	9.11	7.76	7.76	0.(
08/08/2002	0893497	99.20	99.20	0.00	20.(
08/08/2002	0893499	9.02	8.79	0.00	8.7
PATIENT TOTAL		402.30	400.72	200.00	48.7
STATEMENT TOTAL		402.30	400.72	200.00	48.7

EXPLANATION CODES:
03 - THIS CLAIM WAS PROCESSED TO MEET YOUR PLAN'S LIMIT
05 - YOUR PLAN COPAYMENT IS 100% OF THE APPROVED AMOUNT

so comes from the General Statutes.[39] 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.[40]

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 public employers well know, 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 ordinance.[41] 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.[42] 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.[43]

This principle does *not* mean that employers may not 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, 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.[44]

Similarly, 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.[45]

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.

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.

Maintaining the Ability to Change Health 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 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.[46]

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

The legal holdings and principles discussed in this article are applicable to other forms of employee benefits, such as supplemental retirement programs [for example, jurisdiction-specific public safety supplemental retirement benefits or the North Carolina 401(k) Plan], as well as to longevity pay and life insurance benefits. For further discussion of these issues, see *Public Personnel Law Bulletin* #30.[47]

Notes

1. 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).

2. 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).

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

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

5. *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).

6. *Bailey*, 348 N.C. at 150–51. The plaintiffs in this case 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.

7. *Id.* 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).

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

9. 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).

10. *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).

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

12. Bailey, 348 N.C. at 152–53.

13. *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).

14. 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).

15. *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 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).

16. *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).

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

18. 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."

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

20. *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.

21. 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.

22. *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.

23. *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. Rtpr. 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).

24. *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).

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

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

27. *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.

28. *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.

29. *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).

30. Strictly speaking, the *Bailey* and *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.

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

32. *See* Simpson v. Local Gov't Employees' Retirement Sys., 88 N.C. App. 218, at 223–24.

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

34. *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.).

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

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

37. *See id.* 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.

38. 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 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.

39. 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.

40. *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).

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

42. *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).

43. *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).

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

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

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

47. *Public Personnel Law Bulletin* #30 is available on the School of Government's website at www.nchr.unc.edu/pdfs/200401pubperlaw30.pdf or from the Publication Sales Office at (919) 966-4119.