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OPINION NUMBER 2010-4

DATE: September 20, 2010

SUBJECT: Study by the Joint Committee on Retiree Health

PREPARED FOR: Honorable Mayor and Members of the City Council

PREPARED BY: City Attorney

INTRODUCTION

The City of San Diego presently faces an unfunded liability of more than \$1.3 billion, based on actuarial estimates by Buck Consultants, for health coverage for retired City employees and active City employees who are eligible for a future retiree health benefit.¹

The current benefit for most eligible retirees, known as Health Eligible Retirees, is a defined benefit plan, which is paid for entirely by the City “from any source available to it other than the [City’s Retirement] Plan.” San Diego Municipal Code (SDMC) § 24.1204. “Health Eligible Retirees are entitled to participate in and obtain health coverage under any currently available City-sponsored health insurance plan or any other health insurance plan of their

¹ This is the actuarial estimate from June 30, 2009, prepared by the City’s actuary, Buck Consultants, pursuant to GASB 45. Letter from Buck Consultants to Valerie VanDeweghe, dated September 17, 2009. (See Supporting Materials for Item 331 on the City Council Docket for Tuesday, September 7, 2010, on the City Clerk’s website); see also *City of San Diego Comprehensive Annual Financial Report for Fiscal Year Ended June 30, 2009*, pp. 146-48.

choice.” SDMC § 24.1202(a)(1). Subject to certain limitations set forth in the San Diego Municipal Code, Health Eligible Retirees are paid or reimbursed for their premiums. SDMC § 24.1202(a)(1).²

One method of addressing the liability is to change the plan for current eligible employees, who have not yet retired, from a plan funded entirely by the City to one that is “contributory,” meaning that the employee and the City would jointly contribute into the plan. A “contributory” plan could be either a defined benefit plan, in which the benefit level is “defined” and does not end until the death of the participant, or a defined contribution plan, in which the amount the City contributes is defined, but not the benefit level or its duration. A third option is a defined contribution plan with an annuity feature. The account balance, upon retirement, would be used to purchase an annuity providing a specified benefit for the life of the participant. Under any defined contribution plan, the investment risk is borne entirely by the participant.

On September 7, 2010, a committee composed of three City employee organizations and the City Mayor’s Office, called the Joint Committee on Retiree Health (Committee), presented a study they had jointly drafted to the San Diego City Council. The employee organizations were the San Diego Municipal Employees’ Association (MEA); Local 145, International Association of Fire Fighters (Local 145); and the Deputy City Attorneys Association (DCAA) (collectively, Participating Unions).

The stated purpose of the “Study by the Joint Committee on Retiree Health” (Study) was “to describe, quantify and analyze retiree health benefits for eligible employees, including an exchange of legal analyses related to the current benefit program based on its history and evolution.” Study, at 1.³

In the course of the Study, the Participating Unions took the position that the retiree health benefit is a “supplemental pension benefit under the [R]etirement [S]ystem.” Appendix 5 to Study, “Submittal to Study Committee on Behalf of MEA and Local 145,” April 5, 2010, at p. 20.⁴

² General Members of the City’s Retirement System who were hired or assumed office on or after July 1, 2005, but before July 1, 2009, are not entitled to the Health Eligible Retiree benefit. SDMC § 24.1201(d). A separate Retiree Medical Trust benefit administered by the City is available to any General Member hired on or after July 1, 2009. SDMC § 24.1201(c). This benefit is a defined contribution plan, with a mandatory City contribution and a matching mandatory employee contribution. SDMC § 24.1202(c). Safety Members of the City’s Retirement System and Elected Officers hired or assuming office on or after July 1, 2005, are not eligible for any retiree health benefit. SDMC § 24.1201(e). There is a class of retirees, who retired or terminated City employment as a vested Member before October 6, 1980, and who are eligible for and receiving a retirement allowance from the City’s Retirement System, who are entitled to a “Non Health Eligible Retiree” benefit. SDMC § 24.1201(b). These retirees are entitled to be paid or reimbursed up to \$1,200 per year for health insurance expenses. SDMC § 24.1202(b).

³ See Supporting Materials for Item 331 on the City Council Docket for Tuesday, September 7, 2010, on the City Clerk’s website (<http://www.sandiego.gov/city-clerk/>).

⁴ See Supporting Materials for Item 331 on the City Council Docket for Tuesday, September 7, 2010, on the City Clerk’s website (<http://www.sandiego.gov/city-clerk/>).

This Office disagrees that the retiree health benefit is a supplemental pension benefit under the Retirement System. In our January 21, 2010 Legal Opinion (2010-1), we opined that the retiree health benefit is an employment benefit subject to modification through the meet and confer process. Op. City Att’y 2010-1 (Jan. 21, 2010). This opinion is supported by the recent decision of the Ninth Circuit Court of Appeals, *San Diego Police Officers’ Ass’n v. San Diego City Employees’ Retirement System*, 568 F.3d 725 (9th Cir. 2009), in which the court reviewed the historical facts related to implementation of the City’s retiree health benefit and determined that the benefit was a longevity-based benefit that has been treated as an employment benefit and that has been negotiated through the collective bargaining process. *Id.* at 740. Further, the City Council removed the retiree health benefit from the Retirement System by ordinance adopted on April 15, 2008. San Diego Ordinance O-19740 (Apr. 15, 2008).

However, assuming for the sake of argument that the retiree health benefit remains a benefit under the City’s Retirement System, this Memorandum analyzes the issues raised by this contention.

QUESTION PRESENTED

If the retiree health benefit for eligible employees is a benefit under the City’s Retirement System, what legal ramifications are raised by this contention?

SHORT ANSWER

If the retiree health benefit for eligible employees is a benefit under the City’s Retirement System, the benefit must be a “contributory plan, the City contributing jointly with the employees affected thereunder.” San Diego Charter § 143. Further, the Board of Administration of the Retirement System (Board) would have plenary authority and fiduciary responsibility to invest the funds and administer the benefit. San Diego Charter § 143. The Board would be required to utilize its actuary to determine funding obligations of the City and the employees related to the benefit. San Diego Charter § 143.

The only mechanism by which the Retirement System could pay retiree medical benefits is a 401(h) account, which the City Council eliminated from the Retirement Plan by Ordinance O-19740, in order to comply with the Internal Revenue Service Voluntary Correction Program Compliance Statement (Compliance Statement) issued to the Retirement System and the City in December 2007. The City could establish a new 401(h) account, provided that the new 401(h) account complies with all requirements under section 401(h) of the Internal Revenue Code (IRC) and related Regulations. A 401(h) account may be designed to accept mandatory employee contributions.

ANALYSIS

I. THE SAN DIEGO CHARTER PROVIDES THE FRAMEWORK FOR THE CITY'S RETIREMENT SYSTEM, WHICH IS A CONTRIBUTORY SYSTEM.

The San Diego City Charter (Charter), at article IX, sections 141 through 149, authorizes a retirement system for compensated public officers and employees, which is to be managed by a Board of Administration. *See* San Diego Charter §§ 141, 142, 144. The Charter authorizes the San Diego City Council (City Council) to establish the Retirement System and to provide for certain benefits under the Retirement System. San Diego Charter § 141. The City Council must act by ordinance in exercising its authority. San Diego Charter § 141.

Charter section 143 mandates that employees contribute jointly with the City to fund retirement benefits: "The retirement system herein provided for shall be conducted on the contributory plan, the City contributing jointly with the employees affected thereunder." San Diego Charter § 143. This provision was part of the original 1931 Charter, and has remained unchanged. "Contributory" means "[o]ne who contributes or who has a duty to contribute." Black's Law Dictionary 378 (9th ed. 2009). The Retirement System contributions of both the City and the employees are to be determined based on advice of an actuary and contribution rates may be modified. San Diego Charter §§ 143, 144.

The Charter mandates that the Board:

[S]hall be the sole authority and judge under such general ordinances as may be adopted by the Council as to the conditions under which persons may be admitted to benefits of any sort under the retirement system; and shall have exclusive control of the administration and investment of such fund or funds as may be established.

San Diego Charter §144.

Charter section 146 provides additional authority to the City Council to enact ordinances necessary to carry into effect the Charter provisions regarding the Retirement System.

The Council is hereby fully empowered by a majority vote of the members to enact any and all ordinances necessary, in addition to the ordinance authorized in Section 141 of this Article, to carry into effect the provisions of this Article; and any and all ordinances so enacted shall have equal force and effect with this Article and shall be construed to be a part hereof as fully as if drawn herein.

San Diego Charter § 146.

In a case involving a challenge by City firefighters to an increase in the rate of employee contributions to fund Retirement System benefits, the California Supreme Court held that the City's Retirement System "does not preclude the modification in the rate of employees' contributions instituted by defendants [City of San Diego and San Diego City Employees' Retirement Board]." *International Ass'n of Firefighters, Local 145 v. City of San Diego*, 34 Cal. 3d 292, 295 (1983). The case was based on action of the Board in 1977 to raise the average rate of Safety Members' contributions to the Retirement System, effective July 1978, from 8.22 percent to 11.68 percent of the employee's gross salary. *Id.* at 296. The City firefighters' union filed a lawsuit on behalf of its members against the City and the Retirement System, seeking to invalidate the increase. *Id.*

The increase was based on the advice of the Retirement System's actuary, who determined that the impact of inflation on employees' future salaries should be an assumption factor when calculating contributions. *Id.* A primary question before the Supreme Court was whether the City's actuarially-based Retirement System was authorized "to increase the employees' contributions to the system without providing commensurate added benefits to those employees." *Id.* at 295.

The Court rejected the union's argument that the change in contribution rate violated the employees' vested contractual rights. The Court said members did *not* have a vested right to a fixed contribution rate. *Id.* at 303. "[T]he revision in the factor representing future compensation of employees and the resulting revision in the rate of contribution of employees were made *pursuant* to the charter and ordinances which delineate City's retirement system and prescribe the employees' vested rights." *Id.* at 302. The Court stated that changes in employee contributions under the Retirement System "is implicit in the operation of the City's system and is expressly authorized by that system and no vested right is impaired by effecting such change." *Id.* at 303. The Court found that the City's Retirement System "explicitly provide[s] for both setting and *revising* of employee contribution rates upon the basis of the actuarial information and revisions thereto." *Id.* Thus, Retirement System benefits must be contributory and contributions may be adjusted periodically by the Board.

II. IN APPROVING PROPOSITION D IN 1996, SAN DIEGO VOTERS PROVIDED AUTHORITY FOR THE RETIREE HEALTH BENEFIT TO BE A RETIREMENT SYSTEM BENEFIT.

By amendment to Charter section 141, on November 5, 1996, San Diego voters authorized the City Council to provide health insurance benefits for retired employees through the Retirement System (or SDCERS). The question presented to voters in Proposition D was as follows: "Rather than paying for health insurance benefits for retired City employees directly from the City's operating funds, as is the current practice, shall San Diego City Charter Section 141 be amended to authorize the City Council to provide these benefits through the San Diego City Retirement System?" Proposition D, Sample Ballot and Voter Information Pamphlet, General Election (Nov. 5, 1996). The argument in favor of Proposition D read, in relevant part:

The cost of providing health care benefits for employees in both the public and private sectors has skyrocketed in recent years. Proposition D would change the City Charter to permit shifting this costly item from the city's General Fund, paid by all taxpayers – to the city's retirement system, paid for by the retirement system's investment earnings and assets. . . . Proposition D also brings health benefits for retired city workers – especially police and firefighters – into line with workers in comparably-sized cities. . . . Most important, Proposition D protects the fiscal integrity of the city's retirement fund, using excess earnings to cover the full costs of workers retirement health benefits.

Id.

Proposition D amended Charter section 141, which now reads in relevant part:

The Council of the City is hereby authorized and empowered by ordinance to establish a retirement system and to provide for death benefits for compensated public officers and employees. . . . The Council may also in said ordinance provide: . . . (d) For health insurance benefits for retired employees.

San Diego Charter § 141.

“May” means “[t]o be permitted to.” Black’s Law Dictionary 1068 (9th ed. 2009). Under the authority provided by Proposition D, the City Council may provide for retiree health benefits under the Retirement System, but it is discretionary, not mandatory.

III. IF THE CITY’S RETIREE HEALTH BENEFIT IS A BENEFIT UNDER THE CITY’S RETIREMENT SYSTEM, IT MUST BE CONTRIBUTORY.

A charter city may not act in conflict with its charter, and any action that is violative of or not in compliance with the charter is void. *Domar Electric, Inc. v. City of Los Angeles*, 9 Cal. 4th 161, 171 (1994).⁵ A charter city’s ordinances must “conform to, be subordinate to, not conflict with, and not exceed the charter” to be valid. 5 McQuillin Mun. Corp. § 15.17 (3d ed. 2004); *see also Montgomery v. Board of Administration of the City Employees’ Retirement System of San Diego*, 34 Cal. App. 2d 514, 520-521 (1939). Therefore, if the retiree health benefit is a benefit under the City’s Retirement System, as set forth by ordinance of the City Council, it must be “conducted on the contributory plan, the City contributing jointly with the employees affected thereunder.” San Diego Charter § 143.

⁵ *See also Katsura v. City of San Buenaventura*, 155 Cal. App. 4th 104, 108 (2007); *Currieri v. City of Roseville*, 4 Cal. App. 3d 997, 1001 (1970); *Myers v. Stringham*, 195 Cal. 672 (1925); *McCracken v. City of San Francisco*, 16 Cal. 591 (1860).

In 1997, the City Council exercised its authority provided by Proposition D, and brought the retiree health benefit under the Retirement System. The City Council, by ordinance, established a retiree health insurance benefit for eligible employees. San Diego Ordinance O-18383 (Feb. 25, 1997).⁶

By ordinance adopted on March 31, 1997, the City Council “clean[ed] up” and “technically amend[ed]” its February 1997 ordinance “to assure that the provisions meet with and satisfy all applicable state and federal requirements.” San Diego Ordinance O-18392 (Mar. 31, 1997). The City Council also defined benefits for “Non Health Eligible Retirees.” O-18392.⁷

The City Council provided that all post retirement health benefit payments must comply with all applicable federal laws, including the IRC and the regulations issued thereunder, and that the Code and regulations would govern in any conflict with the retiree health provisions in the San Diego Municipal Code. The City Council provided: “The 401(h) Fund shall be a separate account solely for providing health benefits and shall be established and maintained by the [SDCERS] Board to reflect the amounts contributed for the payment of post retirement health benefits.” O-18392.

As a Retirement System benefit, retiree health must be “conducted on the contributory plan, the City contributing jointly with the employees affected thereunder.” San Diego Charter § 143.⁸

⁶ A “Health Eligible Retiree” was defined as any retired General Member, Safety Member, or Legislative Officer who was (1) on the active payroll of the City on or after October 5, 1980, and (2) who retired on or after October 6, 1980, and (3) is eligible for and is receiving a retirement allowance from the City’s retirement system. O-18383; *see* SDMC § 24.1201(a). The class of eligible employees for the retiree health benefit is presently closed. By ordinance adopted on January 17, 2007, the City Council eliminated the benefit for members of the retirement system who were hired or assumed office on or after July 1, 2005. *See* San Diego Ordinance O-19567 (SDMC § 24.1201.1), SDMC § 24.1201(d).

⁷ A “Non Health Eligible Retiree” was defined as any retiree who (1) retired or terminated employment as a vested member from the City prior to October 6, 1980, and (2) is eligible for and is receiving a retirement allowance from the retirement system. O-18392. *See also* Footnote 2 above.

⁸ The Charter provides that employees shall contribute according to the actuarial tables adopted by the Board for normal retirement allowances. San Diego Charter §143. The Charter further provides that the City “shall contribute annually an amount substantially equal to that required of the employees for normal retirement allowances, as certified by the actuary.” San Diego Charter § 143.

IV. IF THE RETIREE HEALTH BENEFIT IS A RETIREMENT SYSTEM BENEFIT, IT MUST BE PROVIDED THROUGH AN IRC SECTION 401(H) ACCOUNT.

The only method by which a qualified pension plan may provide for payment of health benefits is a 401(h) account, which must be established as a subaccount within a qualified pension plan.⁹ Although the Internal Revenue Service (IRS) disapproved the City's earlier 401(h) account, the City is not precluded from establishing a new 401(h) account, provided the City and the Retirement System comply with all applicable federal tax rules.

A 401(h) account may be structured to include mandatory employee contributions, as well as employer contributions. The trust may include individual accounts for each participant or a pooled fund for all participants. The trust may be pre-funded and the assets co-invested with the SDCERS pension assets. Importantly, the City and its employees must provide separate funding for the 401(h) account, apart from the City's annual required contribution to the Retirement Plan, and there must be separate accounting for 401(h) account's contributions, benefits and earnings.¹⁰

The primary disadvantage of using a 401(h) account to pre-fund retiree health benefits is the requirement that the health benefits be "subordinate" to the pension benefits. This means that the total contribution to the 401(h) health trust must not exceed 25 percent of the aggregate total contributions to the qualified retirement plan not including contributions to fund past service liability. This may preclude the City and employees from adequately prefunding the retiree health benefits.

Another drawback to a 401(h) account is that because it is part of the qualified defined benefit plan, if the trust does not meet all of the requirements of IRC section 401(h), either as to form or operation, the defined benefit plan as well as the 401(h) account could be disqualified.

⁹ Treasury Regulation section 1.401-1(b) states that a pension plan within the meaning of section 401(a), is a plan established and maintained by an employer primarily to provide systematically for the payment of definitely determinable benefits to his employees over a period of years, but that a plan is not a pension plan if it provides for the payment of benefits not customarily included in a pension plan such as benefits for sickness, accident, hospitalization or medical expenses (unless the medical benefits are provided under IRC section 401(h)).

¹⁰ See Internal Revenue Service Voluntary Correction Program Compliance Statement, Failure #7, p. 6 ("The Applicant and Plan Sponsor agree that in order to comply with all of the requirements of Code sections 401(a) and 401(h) the payment of retiree health benefits must be funded by separately designated employer contributions and cannot be funded (directly or indirectly) by pension assets . . ."). See referenced exhibit back-up material (Part 2 of 2) for Item 54 on the City Council Docket for Tuesday, April 15, 2008, p. 19, on the City Clerk's website (<http://www.sandiego.gov/city-clerk/>).

V. IF THE RETIREE HEALTH BENEFIT IS OUTSIDE THE RETIREMENT SYSTEM, IT MAY STILL BE CONTRIBUTORY.

In April 2008, the City Council adopted San Diego Ordinance O-19740, as a condition of the Compliance Statement issued by the IRS, and agreed to by the City, and the Retirement System. San Diego Ordinance O-19740 (Apr. 28, 2008). The City Council exercised its discretion provided by Charter section 141 [Proposition D] and removed the funding for retiree health benefits from the Retirement System.

The reason for the modification was the manner in which the 401(h) account within SDCERS was funded, which was deemed a failure of the system, as noted in the Compliance Statement. *See* San Diego Ordinance O-19740. IRC section 401(h) requires detailed and separate accounting of trust funds and prohibits any movement of funds between the 401(h) account and the Retirement Trust Fund. San Diego Municipal Code section 24.1204 now provides: “The retiree health benefits described in [Division 12: Retiree Health Benefits] will be paid by the City, directly, from any source available to it other than the Plan.”

With removal of the funding liability from the Retirement System, the benefit is not a benefit under SDCERS. Further, it is not a benefit that is enforceable against SDCERS. *See, e.g., Elmore v. Cone Mills Corp.*, 23 F.3d 855, 860-61(4th Cir. 1994) (stating that representations not incorporated into a written retirement plan document do not become part of the plan, and are not enforceable as a valid plan amendment); *Dougherty v. Chrysler Motors Corp.*, 840 F.2d 2, 3-4 (6th Cir. 1988) (rejecting claim of salaried employees that increases in benefits to union employees because a de facto part of retirement plan for salaried employees).

Proposition D permits the City to include retiree health benefits within the Retirement System, but does not require it to do so. If retiree health is included within the Retirement System, it must be contributory under Charter section 143. There are no provisions of the Charter that require the City to solely fund the retiree health plan, nor is there any provision of the Charter that requires a contributory plan if the retiree health benefit is outside the Retirement System.

CONCLUSION

Until 1997, the retiree health benefit was not a benefit under the Retirement System and was paid for solely by the City. In 1996, San Diego voters approved Proposition D, which provided that the retiree health plan *may* be brought within the Retirement System. Following Proposition D, the City Council brought the retiree health benefit under the Retirement System and the Retirement System utilized a 401(h) account for the benefit. However, under the 2008 Voluntary Correction Program ordinance, following an agreement with the IRS, the City Council removed the funding of the retiree health benefit from the Retirement System. The Charter does not mandate the City fund any portion of a retiree health benefit. Similarly, the benefit need not be contributory, if it is not under the Retirement System.

Assuming for the sake of argument that the retiree health benefit remains a Retirement System benefit, then it is subject to the requirement of Section 143 that it be “contributory.” If the retiree health benefit is under the Retirement System, then the City and its employee organizations must negotiate a retiree health plan that satisfies the “contributory” requirement of Charter section 143 and all funding requirements as set forth in the IRC and related regulations.

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Attachments
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