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Opinion No. 05-058

Legality of Permitting Political Subdivisions to Discontinue or Modify Non-Contributory Retirement for Their Employees

QUESTIONS

1. Whether the law governing the Tennessee Consolidated Retirement System ("TCRS") can be amended to allow political subdivisions that have adopted non-contributory retirement to pass a subsequent resolution to require their current and future employees to pay all or a portion of the employee contributions to the TCRS for future accruals of credit.

2. If such an amendment cannot be effectuated due to the 3.6% indexing in setting the average final compensation figure, would the proposed action be legal if the 3.6% indexing rights are preserved in the law?

OPINIONS

1. The power to discontinue or modify the non-contributory aspects of a government pension plan is dependent upon the retirement status of the employee to whom the changes would be applied. As to employees who are vested, that is, those who have met the minimum service requirements for receiving retirement benefits at some point in the future, no detrimental changes to the retirement plan may be made. As to employees who have begun participating in a retirement plan but have not yet vested, the plan may be altered, but only if it can be demonstrated that the change is necessary to protect or enhance the actuarial soundness of the fund. The government may alter the retirement plan in any respect it sees fit on a going-forward basis and apply the new terms to employees hired after such a change, but detrimental changes for preexisting employees must meet the standards stated above.

2. Like all other terms of a pension plan, the mutability of 3.6% indexing is determined under the same analysis that governs the legislature's power to alter the non-contributory feature of a pension plan.

ANALYSIS

1. Under Tenn. Code Ann. § 8-35-201, political subdivisions may choose, via their chief legislative body, to become participants in the TCRS. The TCRS requires that contributions be

made by both the employer and each employee, *see* Tenn Code Ann. § 8-34-206(a)(1), but as of July 1, 1981, the state assumed responsibility for the contributions of its employees, with some exceptions. *Id.* Political subdivisions were again given the option of following suit under Tenn. Code Ann. § 8-34-206(d), pursuant to which the local employer may itself assume the contributions for its employees.

The scope of the power possessed by government bodies in Tennessee to change their retirement systems was directly confronted in *Blackwell v. Quarterly Court of Shelby County*, 622 S.W.2d 535 (Tenn. 1981). In that case, Shelby County had adopted a new definition of the benefit base used to calculate benefits: "an average of the three highest consecutive years' salary paid to an employee." *Blackwell*, at 539. The previous definition had been an option "permitting an employee to use the last twelve months' salary prior to retirement, if higher than the five-year average previously authorized." *Id.* This change "resulted in a potential reduction in benefits for most employees, apparently for the first time in the twenty-eight year history of the plan." *Id.* Employees of the county proceeded to challenge the change based upon an argument "that upon employment the employee has a vested contractual right with the County and that no matter how reasonable any subsequent change might be to that plan, it's unconstitutional to change it as to those present employees." *Id.*

In *Blackwell*, the Supreme Court noted that the Court of Appeals below had stated that "[e]mployees of public bodies . . . ordinarily are not hired by formal contracts, and compensation for them . . . is ordinarily subject to increase or diminution." *Id.* at 540. The Supreme Court did not disagree, but stressed that

> direct compensation and pension benefits are not necessarily controlled by identical principles. At some point after an employee has performed services or has paid into a pension and retirement plan, he acquires fixed and immutable rights in the system. Such rights are subject to the terms and conditions of the pension plan, however, and no contractual rights, other than those conferred by the plan, exist simply by reason of employment.

Id. This is a clear indication that an employee's rights in a retirement plan are wholly different from any other form of compensation or inducement of employment and are protected by higher standards. While it may be true that the non-contributory feature of the plan was provided at one time in lieu of a direct salary increase, that "back door" approach to increasing compensation made the new benefits subject to the particular protections afforded to an employee's rights in the terms of his or her public pension plan. Having recognized the rights of an employee to the terms of the retirement plan, the Court also went on to note "that public policy demands that there be a right on the part of the public employer to make reasonable modifications in an existing plan if necessary to create or safeguard actuarial stability, provided that no then accrued or vested rights of members or beneficiaries are thereby impaired." *Id.* at 541. The Court found such a policy in the language of Tennessee's retirement statutes. *Id.*

Having acknowledged both the rights of employees in the terms of a retirement system and the public policy of permitting flexibility in altering the terms of those systems, the Court adopted a rule to govern the balancing of those competing interests. After a brief survey of approaches from other states, the Court settled on the "Pennsylvania rule" as being the optimal choice for this task. *Id.* at 543. As described by our Supreme Court in *Blackwell*, this rule "permits reasonable modifications when necessary to protect or enhance the actuarial soundness of the plan, provided that no such modification can adversely affect an employee who has complied with all conditions necessary to be eligible for a retirement allowance." *Id.* It is clear then that, as to vested employees, a government employer in Tennessee may not modify a retirement plan detrimentally without the consent of the employee. *Id*. Shelby County acknowledged this meaning of the rule, but proposed that the Pennsylvania rule be modified to allow employers to apply the amended plan to current vested employees "insofar as [their] future accruals are concerned." *Id.* The Court rejected this suggestion, saying that those employees, "as of the effective date of the amendment, were eligible for retirement benefits on a base consisting of twelve months' earnings immediately prior to retirement. We do not believe that this right should be or that it could validly be taken from them without their consent." *Id*.

This was not the end of the inquiry in *Blackwell*, however. The Court noted that the reasons for the change in the Shelby County system were explained at trial by "an independent consulting actuary for the County." *Blackwell*, at 539. The actuary testified that "[i]n his opinion the one-year benefit base previously authorized was too volatile and was actuarially unsound for this system." *Id.* The Supreme Court chose to accept the actuary's testimony and concluded that "the facts testified to by him should be deemed established, if relevant under applicable legal principles" because it was "uncontradicted and unimpeached . . . and since there was ample opportunity for the beneficiaries to challenge it or to offer countervailing testimony." *Id.* In light of this testimony, the Court ultimately ruled that while no "lock-in provision or new benefit base could be applied adversely" to any vested employee, "[a]s to employees who did not at that time have such eligibility [the "ten years' creditable service in the system" required for the vesting of rights], the new benefit base, subject to the lock-in clause, could be properly applied, since the evidence show[ed] that it [met] the requirements of the Pennsylvania rule." *Id.* at 543. In other words, a detrimental modification to the plan was permitted with respect to current but non-vested employees based on the testimony that the modification eased an element of actuarial unsoundness in the plan.

In *Roberts v. Tennessee Consolidated Retirement System*, 622 S.W.2d 544 (Tenn. 1981), the Court clarified the requirements for vesting. The Court there held that "the Pennsylvania rule does not require that the employee actually retire or attain retirement age in order to be protected against changes which adversely affect credits, rights, and benefits accrued as the result of and attributable to years of service rendered prior to the effective date of such changes." *Id.* at 544. Vesting, then, does not require that the employee be able to draw benefits under the plan if he or she retired at any given moment, but that the right to receive those benefits at some future date, such as the attainment of a specified "retirement age," has already accrued at the time of the modification.

The result of the rulings in *Blackwell* and *Roberts* is that the Pennsylvania rule, as formulated in *Blackwell*, clearly controls any attempt by a public employer to modify its retirement system to

the detriment of its current employees. These cases say nothing about the effect of modifications on employees hired after they are in effect, and so those employees are completely subject to any modification of its retirement plan that a public employer chooses to make before they are hired.

It is important to note that these cases were decided after Tenn. Code Ann. § 8-34-204 became effective. This statute states that "[e]very provision of chapters 34-37 of this title shall be subject to amendment or repeal by any session of the general assembly; provided, that no such amendment or repeal shall diminish or annul, in any respect, any right acquired by a member or beneficiary under the provisions of chapters 34-37 of this title." Because *Blackwell* has clearly determined there to be a right on the part of current employees in the terms of the pension plan at the time they became employees, this statute gives the legislature no greater authority to modify a public pension plan.

In the proposed amendment at issue here, the legislature would grant political subdivisions the authority to revoke the non-contributory status they had earlier adopted pursuant to Tenn. Code Ann. § 8-34-206(d), thereby once again requiring contributions directly from employees. While this obviously would not necessarily affect the level of each employee's gross pay, it would affect their net take-home pay and so reduce the flexibility employees have in disposing of this same level of salary. It would also deprive them of a benefit from the state in the form of the contributions that, while not a part of the employee's salary, are an economic benefit for the loss of which the employee becomes personally responsible. Therefore, however reasonable and necessary to the political subdivision fiscally, the modification in question is clearly detrimental with respect to each employee; thus, the Pennsylvania rule will control the application of that modification to current employees of the political subdivision, pursuant to *Blackwell*.

With respect to vested employees, it is clear from the above discussion that under *Blackwell*, the political subdivisions may not deprive them of the non-contributory terms of their retirement plan without their consent. As to non-vested, current employees, the Pennsylvania rule requires that any modifications be "reasonable" and "necessary to protect or enhance the actuarial soundness of the plan." *Blackwell*, at 543. As noted earlier, this inquiry is fact-specific. While the standard is a flexible one, it should not be read so broadly as to negate what the Court treats as a real impediment to modifying the retirement plans of non-vested employees. It is obvious that any modification of a retirement plan that reduces the employer's financial obligations under the plan will increase the plan's actuarial soundness. Since this literal reading would essentially abrogate the *Blackwell* Court's assertion that non-vested employees are protected from detrimental modifications by some standard, the standard must amount to something more than this. Because *Blackwell* is the only case in Tennessee to address this question, however, and because it arose in a context dissimilar to the non-contributory question at issue here, it is difficult to predict how the courts might construe terms such as "reasonable" and "necessary" in order to give teeth to the restriction on public employers' power to modify their retirement plans. It seems likely that a Tennessee court would have to determine the actual value of the detriment to employers under a modified system in light of that system's actuarial state of affairs and from those inquiries determine the reasonableness and necessity of the modification. At this point in the development of this area

of law in Tennessee, the room for public policy arguments on both sides of the issue in beginning to define the scope of the *Blackwell* rule would likely be significant.

2. For purposes of computing an employee's "average final compensation" under Tenn. Code Ann. § 8-34-101(4), the figure upon which the employee's retirement benefits are calculated, annual earnable compensation, is increased by 3.6% pursuant to Tenn. Code Ann. § 8-34-101(4)(B)(i). Because changing a pension plan from a contributory to a non-contributory scheme is an explicit modification of the terms of the plan, it cannot be treated as an indirect adjustment of salary levels since any modification of a public pension plan will implicate the *Blackwell* rule. That rule restricts changes in retirement plans but does not apply to other forms of compensation and benefits. Preservation of 3.6% indexing then, while it may function to maintain retirement benefits at their pre-modification level, does not alter the fact that the terms of the plan are still being modified in a significant way. The operation of the *Blackwell* rule is therefore unaffected by the preservation of 3.6% indexing, although it should be noted that any change in the application of that term of the pension plan would be governed by the same rule.

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