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THE VESTING, MODIFICATION, AND FINANCING OF PUBLIC RETIREE HEALTH BENEFITS IN LIGHT OF NEW ACCOUNTING RULES

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I. INTRODUCTION

New accounting rules being phased in between 2006 and 2008 will require state and local governments, for the first time, to report the full cost of public retiree health benefits ("PRHBs") for both current employees and retirees.¹ This new rule brings retiree health benefits in line with rules governing both public pensions and private sector rules governing both pensions and retiree health benefits.² This article assesses the potential impact of these new accounting rules on the vesting, modification, and especially the financing of public retiree health benefits.

¹. Gov't Accounting Standards Bd., Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions, No.45 (June 2004) [hereinafter GAS 45]. The new accounting standards are being implemented in three phases, depending on the size of the government body.  
The fifty states will owe $2.7 trillion over the next thirty years for PRHBs. Demographic concerns, such as an aging population, and economic concerns, such as the rapidly rising cost of health care, were already pressuring public employers to cut benefits or scramble for more funding. The new accounting rules will expose this enormous unfunded liability hanging over public employers for all to see, and exacerbate the existing pressures.

Part II provides an overview of the current state of PRHBs by comparing them to pensions, exploring the sources of law governing them, and examining the new accounting rules and their likely impact on PRHBs. Part III outlines the wide array of legal doctrines courts invoke in assessing whether PRHBs have vested, including: presumptions for or against vesting, extrinsic evidence, the doctrine of estoppel, and interest arbitration. Part IV surveys cases addressing when employers can modify vested PRHBs. Three rough categories emerge: reasonable modifications under Contract Clause analysis, denial of modifications without consent, absent unanticipated circumstances, or modification allowed where benefits remain substantially equal. Part V looks at current PRHB financing and likely future choices in light of the new accounting rules. Innovative funding tools will be explored, including voluntary employees beneficiary associations (VEBAs) and Internal Revenue Code § 401(h) accounts.

II. OVERVIEW OF PUBLIC RETIREE HEALTH BENEFITS (PRHBs)

A. Generally

As stated, the states are facing a $2.7 trillion bill over the next thirty years to fund their PRHBs. States vary in the amounts they owe, depending on how generous they are when it comes to paying for PRHBs. For example, Maryland faces high liability, $14.5 billion, compared with $2.3 billion that Virginia owes, largely thanks to the fact that Maryland is more generous to its retirees than Virginia. In fiscal year 2001 alone, states’ spending on PRHBs amounted to $4.4 billion.

4. Id.
5. Id.
6. Kristin Downey, Study Sizes Up States’ Substantial Retiree Benefit Costs, WASH. POST, Dec. 19, 2007, at A4. Virginia’s costs are less than Maryland’s in part because in Virginia, retirees are given only a cash subsidy so that they can purchase health insurance. Id.
7. Wisniewski & Wisniewski, supra note 2, at 12.
While there is no legal requirement for public employers to adopt and maintain retiree health plans, all fifty states voluntarily provide health insurance coverage for state employees.8 Unlike the private sector, where retiree health benefits have been cut back or eliminated altogether, public employers express deep reluctance to touch PRHBs.9 The amount of coverage provided varies from state to state, however, because it depends on who is eligible to enroll and the portion paid by the state employer and by the individual employee.10 Altogether, "states provide coverage for about 3.4 million state government employees and retirees,"11 and "74% of part-time state employees [have] the option of electing health benefits (as compared to 48% nationally)."12 In 2006, sixteen states paid one hundred percent of monthly premiums13 while only five states paid one hundred percent of the monthly premiums for families of state employees.14 "State and local governments continue to offer retiree health benefits at a higher rate than any other industry."15

A number of factors, however, are increasing pressure on public employers to reduce their PRHB costs. There is the impending retirement of the seventy-nine million baby boomers born between 1946 and 1964, which will make it difficult for state and local governments to keep up with the cost of retiree medical

8. Id. at 10. Although two states, Indiana and Nebraska, end health benefits at age sixty-five. Id. The contributions, however, are by no means equal. Id. Wisconsin, for example, only contributes to PHRBs by converting accumulated sick leave into "retiree health insurance credits." Id.; see id. at v. (noting that "[p]ublic employers are typically large employers and large employers generally provide post-employment benefits programs"). Iowa and Mississippi offer little or no PRHBs. Moody's Investor Service, Other Post-Employment Benefits (OPEB), 2005 MOODY'S SPECIAL REPORT No. 93649, at 4 [hereinafter MOODY'S SPECIAL REPORT]. While Wisconsin and Montana offer PRHBs, these states require retirees to pay most of the cost. Id.


10. See National Conference of State Legislatures, State Employee Health Benefits, http://ncsl.org/programs/health/stateemploy.htm (last visited October 4, 2008) (listing various features of each state's health plans and providing a link to the administrative agency responsible for each state's plan) [hereinafter Health Benefits].

11. Id.

12. Id.

13. Id. Monthly premiums ranged from as little as $105 per month in Indiana, to as much as $668 per month in Alaska. MOODY'S SPECIAL REPORT, supra note 8, at 4.

14. Health Benefits, supra note 10. The five states are New Hampshire, New Jersey, North Dakota, Oklahoma, and Oregon. Id.

15. Wisniewski & Wisniewski, supra note 2, at i.
benefits. Moreover, lengthening life expectancies, the smaller number of active employees compared to the growing number of retirees, and increased incentives for public employees to retire earlier, add to the cost of PRHBs. New federal accounting standards in place starting in 2006 will also create financial incentives for public employers to rein in the costs of PRHBs. The rising costs of health insurance is yet another reason public employers are cutting back on retiree benefits. Thirty-seven states’ plans faced double-digit premium growth in 2005, with Wyoming facing the biggest increase of thirty-eight percent. Health care premiums have been rising faster than inflation for many years.

Already a number of cities and states have taken steps to reduce their PRHB liabilities. For example, six states now charge or authorize lower premiums to non-smoking state employees and higher premiums for smokers. Pennsylvania started requiring new retirees to pay one percent of their salary for retiree health benefits, while West Virginia requires retirees to pay twenty

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18. Wisniewski & Wisniewski, supra note 2, at 22.
19. Hous. & Redevelopment Auth. of Chisholm v. Norman, 696 N.W.2d 329, 333 (Minn. 2005) (holding that the main aim of a statutory amendment was to authorize public employers to offer PRHBs to encourage highly compensated employees to retire).
20. GAS 45, supra note 1.
21. See id. (providing a framework to tie future payments for retiree benefits to the accounting period when those benefits accrued rather than simply lumping payments together at the end of an employee’s service in an effort to make employers aware of how much they spend on each employee).
22. Kevin G. Hall, Prices Slam Middle Class, MIAMI HERALD, Jan. 17, 2008, at 3C (noting that the price of health insurance rose by 10.1% in 2007).
25. Health Benefits, supra note 10. The six states that charge smokers a premium are Alabama, Indiana, Georgia, Kentucky, Missouri, and West Virginia. Id.
dollars for specialists and fifty dollars for emergency room visits.\textsuperscript{27} Another cost-saving measure entails raising the number of years of employment required for eligibility for retiree health benefits. For example, in 2006, North Carolina increased from five to twenty years the time that new employees must work to qualify for full benefits.\textsuperscript{28} New Jersey and West Virginia have recently cut education and health programs to fund future PRHBs.\textsuperscript{29} In an effort to save money, Utah changed its practice of providing retirees a month of health insurance for every day of unused sick pay.\textsuperscript{30} Orlando, Florida and Arlington, Texas, have cut costs by scaling back PRHBs for new employees.\textsuperscript{31} While public employers generally avoid shifting higher health costs to employees, some workers have chosen to keep their generous benefits by forgoing wage increases.\textsuperscript{32}

\textbf{B. Comparing PRHBs and Public Retiree Pension Benefits}

Besides PRHBs, all fifty states also offer public employees pension benefits ("PRPBs").\textsuperscript{33} In most states, these two post-employment benefits are generally referred to as retirement benefits, and both programs are commonly administered by the same state agency.\textsuperscript{34} What began historically as a reward for retired military personnel\textsuperscript{35} has, over the course of time, turned into the most prized and costly benefit bestowed by public employers.\textsuperscript{36}

\textsuperscript{27} Id.
\textsuperscript{28} Id.
\textsuperscript{29} Walsh, supra note 3, at C1.
\textsuperscript{30} MOODY'S SPECIAL REPORT, supra note 8, at 3.
\textsuperscript{31} Id.
\textsuperscript{32} Ctr. News Release, supra note 9. One of the drawbacks of generous retiree health benefits, however, is that it decreases labor mobility. \textit{See} Thomas C. Buchmueller & Robert G. Valletta, The Effects of Employer-Provided Health Insurance on Worker Mobility, 49 INDUS. & LAB. REL. REV. 439, 453-54 (1996) (finding, empirically, that health benefits do create lower worker mobility—"job lock"—and noting that the risk of not being insured during the transition period from one job to another is the primary factor).
\textsuperscript{33} Ron Snell, Pension Tension: Very Few States Hold all the Assets they Should for Future Retirement and Health Care Benefits, STATE LEGISLATURES, May 2008, at 12.
\textsuperscript{34} U.S. GOVERNMENT ACCOUNTABILITY OFFICE, GAO-07-1156, STATE AND LOCAL GOVERNMENT RETIREE BENEFITS, 3-4 (2007) [hereinafter GAO RETIREE BENEFITS].
While detailed treatment of public pension law is beyond the scope of this article, it is useful to sketch a few key features of this retirement benefit and describe how it relates, affects, overlaps, and departs from PRHBs before proceeding to a discussion of how PRHBs vest and can be modified. A pension has been defined as a “payment following retirement from service.” By first, both pensions and health insurance benefits were looked upon as gratuities. By the 1930s, however, public pensions at least were considered as a form of deferred compensation. In many states, a public employee’s right to pension benefits vests upon acceptance of employment, subject only to reasonable changes by the legislature. The method of financing pension and PRHBs differs in most states. While all states provide for advance funding of pension benefits, PRHBs are funded on a pay-as-you-go basis in the vast majority of states.

Retirement plans in the United States fall into two groups, defined benefit and defined contribution. Most public employee pension plans are defined benefit plans. Under a defined benefit plan, an eligible retiree receives a fixed percentage of her salary multiplied by the number of years of service. This benefit,
generally paid monthly, is guaranteed for the life of the employee.\textsuperscript{46}

By contrast, a defined contribution plan has a fixed cost.\textsuperscript{47} Under such plans, the employer and employee contribute a set percentage of salary to the retirement fund each pay period.\textsuperscript{48} Upon retirement, the employee is entitled to the total sum in the retirement account.\textsuperscript{49} While defined benefit plans do not set up individual accounts, defined contribution plans do.\textsuperscript{50} If the retiree exhausts the money in the defined contribution account, the retiree’s benefits run out.\textsuperscript{51}

In the 1990s, in light of dramatic stock market growth, a number of states began offering defined contribution alternatives to public employees in lieu of defined benefit plans.\textsuperscript{52} This transition from defined benefit to defined contribution pension plans parallels a similar trend in the private sector. Between 2003 and 2005, 229 Fortune 1000 companies eliminated or froze their defined benefit pension plans and switched to defined contribution plans like 401(k)s.\textsuperscript{53} The financial incentive for both public and private employers to switch to defined contribution plans is that they create a substantial actuarial gain over defined benefit plans, thereby reducing the employer’s liability.\textsuperscript{54} But the bursting of the tech stock bubble in 2000-01 resulted in plunging 401(k) accounts, leading at least one state to abolish its defined contribution system in favor of a return to a defined benefit plan.\textsuperscript{55} Setbacks in the stock market also caused contribution rates for public defined benefit plans to skyrocket.\textsuperscript{56} Alaska reacted to steep contribution

\textsuperscript{46} GAO RETIREE BENEFITS, \textit{supra} 34, at 7.

\textsuperscript{47} Zorn, \textit{supra} note 43, at 25.

\textsuperscript{48} \textit{Id.}

\textsuperscript{49} \textit{Id.}

\textsuperscript{50} \textit{Id.}

\textsuperscript{51} \textit{Id.}


\textsuperscript{54} \textit{Id.}

\textsuperscript{55} 2002 Neb. Laws LB 687.

\textsuperscript{56} See, e.g., \textit{La. Mun. Ass'n v. State}, 893 So. 2d 809, 818-19 (La. 2005) (upholding state legislative act forcing the state to pay whatever contribution was actuarially required to maintain the financial integrity of the retirement system). As a result, the Louisiana Firefighters Retirement System employer
increases by closing its entire public employee retirement system in 2006; all employees hired after July 1, 2006, were forced into defined contribution plans.\footnote{57}{See ALASKA STAT. §§ 14.25.009-12 (2008) (establishing that Alaska’s Teachers’ Defined Benefit Retirement Plan is only available to employees hired before July 1, 2006); ALASKA STAT. § 14.25.320 (2008) (creating a defined contribution plan for hires from Jul. 1, 2006 onward).}

In the 1990s, many public employers started tapping their state pension funds to help pay for PRHBs.\footnote{58}{Mary Williams Walsh, Paying Health Care From Pension Proves Costly, N.Y. TIMES, Dec. 19, 2006, at A1.} With double-digit increases in health care costs, however, some states are regretting the drain.\footnote{59}{Id. at 853 n.122.}

\section*{C. Comparing Sources of Law Governing Private and Public Sector Retiree Health Benefits}

Unlike the public sector, where each state creates its own retirement system largely unregulated by federal law, private sector retirement benefits are regulated by the federal Employee Retirement Income Security Act of 1974 ("ERISA")\footnote{60}{29 U.S.C. § 1001 (2006).} and to a lesser extent by the National Labor Relations Act ("NLRA").\footnote{61}{29 U.S.C. § 151 (2006).} Public retirement plans are expressly excluded from the scope of ERISA.\footnote{62}{29 U.S.C. § 1003(b)(1) (2006); Simac v. Health Alliance Med. Plans, Inc., 961 F. Supp. 216, 217-18 (C.D. Ill. 1997) (recognizing the rule that ERISA does not apply to "governmental plans").} While a detailed description of ERISA is beyond the scope of this article, a brief summary of its key features enriches our understanding of PRHBs for at least two reasons: (1) some government plans have been deemed to be private and so fall within ERISA’s orbit;\footnote{63}{E.g., ERISA Op. Ltr No. 79-62A (1979) (advising an Oklahoma teachers’ association that they would be subject to ERISA because they were an employee welfare organization).} and (2) many courts assessing the vesting and modification of PRHBs often look to ERISA and the case law interpreting it for guidance.\footnote{64}{E.g., Davis v. Wilson County, 70 S.W.3d 724, 727 (Tenn. 2002) (analogizing to ERISA, Tennessee Supreme Court ruled that employees do not automatically enjoy a vested interest in PRHBs).}

All employee benefit plans governed by ERISA are subject to minimum standards, such as reporting and disclosure obligations,\footnote{65}{29 U.S.C. § 1001(b) (2006).} fiduciary standards,\footnote{66}{29 U.S.C. § 1104 (2006).} preemption of state law,\footnote{67}{29 U.S.C. § 1144(a) (2006).} and
remedies.68 Pension plans, but not such benefits as health insurance, are also subject to participation, vesting, accrual, and funding regulations.69

Private sector collective bargaining is shaped by the National Labor Relations Act ("NLRA"),70 which expressly exempts public employment.71 Many state statutes framing public sector collective bargaining, however, are modeled on the NLRA on such matters as the exclusivity of union representation,72 and in defining unfair labor practices.73 While the NLRA and case law interpreting it have been highly influential on courts assessing public sector labor relations, there are some noteworthy differences, including one area dealing with retirees that bear on PRHBs.

In Allied Chemical & Alkili Workers, Local No. 1 v. Pittsburgh Plate Glass,74 the Supreme Court ruled that under the NLRA, retiree benefits are not a mandatory subject of bargaining.75 Therefore, a unilateral change in retiree benefits is not an unfair labor practice.76 By contrast, even though Minnesota's public sector labor relations act is largely modeled on the NLRA, it formerly treated public retiree benefits as a mandatory subject of bargaining.77 Whether or not retiree benefits are subject to mandatory bargaining bears on whether public employers may unilaterally modify retiree benefits after an impasse in contract negotiations is reached.78 The lesson to be drawn from these


69. See Curtiss-Wright Corp. v. Schoonejongen, 514 U.S. 73, 78 (1995) (confirming that ERISA does not establish any minimum participation, vesting, or funding requirements for welfare plans, including retiree health benefits, as it does for pension plans).


72. Compare 29 U.S.C. § 159(a) (2006) (establishing the exclusive representation rule under the NLRA), with DEL. CODE ANN. tit. 19, § 1306 (2008) (making it an unfair labor practice in Delaware to refuse to bargain with the employees' exclusive representative); HAW. REV. STAT. § 89-8(a) (2007) (granting the employees' exclusive representative the right to bargain on behalf of employees in Hawaii); MINN. STAT. § 179A.12 (2008) (proscribing that certified employee organizations in Minnesota will be the exclusive representative of their members).


75. Id. at 182.

76. Id. at 185.


78. Id.
examples is to caution courts assessing PRHB issues from over-reliance on analogies drawn from ERISA and the NLRA.

There are three sources of law that bear on public sector PRHBs that have no private-sector counterparts. There is the Contract Clauses found in the United States and most state constitutions, reliance on interest arbitration when parties reach an impasse during negotiations over a collective bargaining agreement ("CBA"), and the "ultra vires" doctrine.

Constitutional Contract Clause analysis, a common legal basis for challenging modifications to PRHBs but unavailable in the private sector, inquires whether legislative action creates a contractual obligation. While there is a strong presumption that statutes do not create contractual rights, "a statute is itself treated as a contract when the language and circumstances evince a legislative intent to create private rights of a contractual nature enforceable against the state." Whether state action modifying PRHBs is prohibited by the Contract Clause turns on whether the impairment is reasonable and necessary to serve an important public purpose.

In the public sector, under binding interest arbitration, the terms of a CBA are forced on the public employer and union by an outsider when the two parties reach an impasse in negotiations. Interest arbitration governs only some public employees, usually


81. See David Broderdorf, Overcoming the First Contract Hurdle: Finding a Role for Mandatory Interest Arbitration in the Private Sector, 23 LAB. LAW. 323, 324 (2008) (explaining that "binding interest arbitration" in the public sector is when a neutral arbitrator resolves a labor dispute by creating a new contractual agreement).

82. Black's Law Dictionary defines "ultra vires" as: "[u]nauthorized; beyond the scope of power allowed or granted by a corporate charter or by law." BLACK'S LAW DICTIONARY 1559 (8th ed. 2004).

83. See U.S. CONST. art. I, § 10, cl. 1 (limiting the prohibition against the impairment of contracts to state actors).

84. See, e.g., Colo. Springs Fire Fighters Ass'n v. Colo. Springs, 784 P.2d 766, 773 (Colo. 1989) (rejecting retired employees' contract claim disputing the capping of health plan contributions because the city ordinance at issue did not create private contractual rights).


87. Id. at 21.

88. Broderdorf, supra note 81, at 324; see, e.g., IOWA CODE § 20.3(7) (2001) (defining impasse as "the failure of a public employer and the employee organization to reach agreement in the course of negotiations").
police officers and firefighters, who are not entitled to strike when impasse is reached.89

The use of interest arbitration to resolve PRHB disputes has been in flux in Minnesota.90 Unlike the private sector governed by the NLRA, where employers may effect unilateral changes,91 Minnesota public employers formerly had to submit PRHB issues to interest arbitration.92 In 1992, however, the Minnesota Supreme Court held that 1988 statutory amendments meant that public employers cannot be forced to submit to binding interest arbitration when they reach an impasse after good faith bargaining.93

An ultra vires contract is one "which is not within the power of a municipal corporation to make under any circumstances or for any purpose."94 A contract that is merely the result of a defective exercise of existing authority is not ultra vires.95 In a New Jersey case, the court held that a public employee retirement system was not estopped from denying retirement eligibility where there is "an absolute and unambiguous statutory declaration which deprives the agency of jurisdictional authority to award pension benefits under the circumstances."96 If a city’s act is ultra vires in the primary sense, the act is void ab initio and cannot be undone by estoppel.97 By contrast, however, if the city’s act is merely an irregular exercise of a basic power, not utterly beyond its jurisdiction, it is ultra vires only in the secondary sense.98 An act ultra vires in the secondary sense is subject to ratification under the doctrine of equitable estoppel.99 Unfortunately, facts do not always neatly line up with primary or secondary forms of ultra vires.100

89. See, e.g., Fairbanks Police Dep’t. Chapter, Alaska Public Employees Ass’n v. City of Fairbanks, 920 P.2d 273, 276 (Alaska 1996) (upholding city’s refusal to pay police officers’ benefits awarded by arbitrator because statute requiring legislative approval of monetary terms applied to CBA’s arising out of binding interest arbitration).
90. Law Enforcement Labor Servs., Inc., 483 N.W.2d at 699.
91. Allied Chem. & Alkili Workers, Local No. 1, 404 U.S. at 182, 185.
92. Law Enforcement Labor Servs., Inc., 483 N.W.2d at 499. The Minnesota Court of Appeals interpreted the 1988 amendments to subject PRHBs disputes to interest arbitration. Id.
93. Law Enforcement Labor Servs., Inc., 483 N.W.2d at 701.
94. 10 MCQUILLIN MUN. CORP. § 29.10 (3d ed. 1999)
95. Id.
98. Id.
99. Id.
100. Id. at 315.
D. Federal Statutes That Govern Both Public and Private Retiree Health Benefits

Federal statutes that bear on retiree health benefits both in the private and public sectors include: the Internal Revenue Code ("IRC"), the Age Discrimination in Employment Act ("ADEA"), the Americans With Disabilities Act ("ADA"), and Medicare. Under §§ 105 and 106 of the IRC, premiums paid by the employer and employee for health insurance benefits are not taxable income.101

Under the ADEA102 and regulations interpreting the ADEA,103 an older employee may not be forced to make greater contributions than a younger worker in support of an employee benefit plan. Despite this provision, an older worker’s share of the premium may rise with age so long as the proportion of the total premium required to be paid by the participants does not increase with age.104

Nationally, there are about twelve million non-federal Medicare beneficiaries receiving retiree health benefits from their former employers.105 A recent controversy involving the intersection of retiree health benefits, the ADEA, and Medicare, was whether the employer could reduce or terminate health benefits for retirees who are eligible for Medicare without violating the ADEA.106 In 2004, the Equal Employment Opportunity Commission ("EEOC"), which enforces the ADEA, voted three to one to approve a rule that would allow employers to coordinate the retiree health benefits with Medicare without violating the ADEA.107 In other words, the new EEOC dispensation allowed employers to give Medicare-eligible retirees fewer health benefits than retirees under age sixty-five without violating the ADEA. Moreover, Medicare bridge plans that provide health benefits to

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101. I.R.C. §§ 105-06 (2006). In his 2007 State of the Union address, President Bush proposed changes to the IRC whereby employer-provided health insurance would be treated as taxable income. Address Before a Joint Session of the Congress on the State of the Union, 43 WEEKLY COMP. PRES. DOC. 57 (Jan. 23, 2007), available at http://www.whitehouse.gov/news/releases/2007/01/20070123-2.html. Instead, a standard deduction would be provided: $15,000 for families; $7,500 for individuals. Id.


106. Id. at 3. In 2003, forty-eight states (all but Indiana and Nebraska) offered PRHBs to Medicare-eligible retirees. Id.

retirees too young for Medicare eligibility were also deemed not to constitute age discrimination.\textsuperscript{108} Similarly, the rule allows unions to negotiate for health benefits that coordinate with Medicare.\textsuperscript{109} In sum, employers may provide supplemental health benefits for Medicare-eligible retirees without having to prove that the benefits are identical to any benefits provided to pre-Medicare retirees.\textsuperscript{110} Absent the EEOC rule, retiree health benefits would become so expensive and complex that employers would likely decide simply to eliminate or reduce the benefits they currently provide. Under the Older Workers Benefit Protection Act ("OWBPA") amendments to the ADEA,\textsuperscript{111} a retiree’s severance payments may be offset by the costs of the retiree’s health benefits. In the wake of federal legislation extending prescription drug coverage under Medicare Part D,\textsuperscript{112} states like Maryland have set up prescription drug benefit plans for Medicare-eligible retirees.\textsuperscript{113}

On June 19, 2008, the Supreme Court decided Kentucky Retirement Systems v. EEOC,\textsuperscript{114} a case involving the intersection of the ADEA and public pension plans. Hazardous duty workers under age fifty-five, the age of retirement eligibility in Kentucky, if forced to retire owing to a disability, are entitled to more generous benefits than disabled hazardous duty workers over age fifty-five.\textsuperscript{115} The Supreme Court held that the ADEA and OWBPA permit differential treatment of fringe benefits when it is not motivated by age.\textsuperscript{116} While strictly speaking the case narrowly involves public pension plans, any decision is likely to influence all public employment retirement benefits, including health benefits that offer different benefits packages for different age groups.

\textsuperscript{108} Id.
\textsuperscript{109} Id.
\textsuperscript{110} Id.
\textsuperscript{113} See 90 MD. OP. ATT’Y GEN. 195, 199 (2005) (reporting that the Maryland General Assembly directed the state’s retirement program to include a prescription drug benefit) [hereinafter "MD. ATT’Y GEN."].
\textsuperscript{114} 128 S. Ct. 2361 (2008).
\textsuperscript{115} Id. at 2364.
\textsuperscript{116} Id. at 2369. The Court held that Kentucky’s differential treatment of workers of different ages was motivated by pension status rather than age, rendering the conduct legal under ADEA. Id.
E. Federal Accounting Rules
  Governing Retiree Health Benefits

1. Private Sector: FAS 106

In the 1990s, the federal Financial Accounting Standards Board ("FASB") implemented new accounting rules, specifically Statement 106 ("FAS 106"), which changed dramatically how private employers were required to report the cost of retiree health benefits. Instead of reporting this expense on the basis of costs of benefits in the period in which they are paid, FAS 106 required employers to report the cost of retiree health benefits as they are earned, which entails estimating and accruing both the future costs and current spending for these obligations. FAS 106, together with sharply rising medical costs, made employers aware of the extent of their retiree health benefits liabilities. Private employers worried that implementing FAS 106 would lead to huge drops in "reported corporate income and net worth, with negative implications for shareholder values." Because of FAS 106, increasing numbers of employers began reducing or even eliminating health insurance coverage. In 1993, forty percent of private employers offered retiree health benefits; by 2001, only twenty-three percent did. While some studies question the extent to which FAS 106 prompted employers to cut retiree health benefits, this brief summary of the substance and impact of FAS 106 on private retiree health benefits is instructive in forecasting the effect of equally far-reaching public sector accounting rules to be fully implemented by the end of 2008.

2. Public Sector: GAS 45

The Governmental Accounting Standards Board ("GASB") is a nonprofit agency that sets accounting standards for state and local governments. In 2004, the GASB issued Statement 45 ("GAS 45"), adopting rules that will do in the public sector what FAS 106 did in the private sector. GAS 45 is to be implemented.

118. Wisniewski & Wisniewski, supra note 2, at i.
120. Wisniewski & Wisniewski, supra note 2, at 20.
121. Kemp, supra note 119, at 1.
122. Id.
123. Wisniewski & Wisniewski, supra note 2, at 20.
125. GAS 45, supra note 1.
gradually, ultimately insisting that all state and local governments compile data about their retiree health benefits and report unfunded liabilities that will accrue for retirees in future years. Just as FAS 106 imposed accounting standards for retiree health benefits that were already in place for private pension obligations, GAS 45 will require public employers to report unfunded retiree health benefit liabilities already required for public pension obligations. In sum, GAS 45 imposes no legal obligations on the states with respect to the level or types of health care benefits accorded to retirees or the financing of those benefits.

If the impact of FAS 106 in the private sector is any guide, public employers will have a strong incentive in the wake of GAS 45, though not a legal duty, to set aside funds (known as pre-funding) for PRHBs as they are incurred. Of the forty-one states reporting some contribution to retiree health coverage, thirty states finance PRHBs on a pay-as-you-go basis while only eleven states report some level of pre-funding. Pre-funding, as a tool for financing PRHBs, has its virtues and its drawbacks. On the plus side, states that forgo pre-funding risk Wall Street lowering their credit rating, which makes it far more expensive to borrow money. Pre-funding typically produces higher short-term costs as compared to pay-as-you-go financing but may lower costs in the long run, especially if the state's credit rating is strengthened. Local governments in Michigan, previously deterred from pre-funding PRHBs by state law, were freed to

126. See id. (discussing the three year staggered phase-in of GAS 45). GAS 45 compliance is staggered, with smaller governments afforded more time to comply. Id.
127. GAS 45, supra note 1.
128. MOODY'S SPECIAL REPORT, supra note 8, at 5.
129. Id. The unfunded liability is the amount of extra money that needs to be set aside today and invested to cover the future costs of all promised benefits earned to date by current employees and retirees. Legislative Analyst's Office, Retiree Health Care Frequently Asked Questions, http://www.lao.ca.gov/RetireeHealth/RetFAQ.aspx (last visited October 4, 2008).
130. Wisniewski & Wisniewski, supra note 2, at 11. By the end of 2006, only Arizona, North Dakota, Oregon, Utah, and Wisconsin were on course to be able to fully fund their PRHBs for the next thirty years. Prah, supra note 26. Unfunded retiree health liabilities typically are far greater than governments' unfunded pension liabilities. Legislative Analyst's Office, supra note 129. On the whole, public employers have pre-funded eighty-five percent of pension liabilities but only three percent of PRHBs. Larry Lipman, State's Pension System Healthy, Report Finds, PALM BEACH POST, Dec. 19, 2007, § A, at 8A.
131. Prah, supra note 26. Six states, Delaware, Georgia, Maryland, Missouri, Utah, and Virginia have achieved the top rating for their bonds from all three major rating agencies. MD. ATT'Y GEN., supra note 113, at 210, n.18.
132. Wisniewski & Wisniewski, supra note 2, at 23.
133. MICHIGAN COMMISSION ON PUBLIC PENSION AND RETIREE HEALTH
pre-fund when the law was repealed in 1999.\textsuperscript{134} Pre-funding will also help limit exposure of taxpayers to defaults.\textsuperscript{135}

On the minus side, some public employers fear that pre-funding will change the nature and status of retiree health benefits from unvested to vested.\textsuperscript{136} Another disincentive to pre-funding is the body of tax laws that strongly discourage channeling such funded assets to other employer purposes if the health plans are later discontinued.\textsuperscript{137}

III. VESTING OF PRHBs

A. Framing the Issue

It is instructive to approach the issue of the vesting of retiree benefits by looking at typical phrases found in a CBA: the agreement promises retirees "lifetime health benefits,"\textsuperscript{138} but another contract provision reserves the right of the public employer to "modify or terminate all retiree benefits."\textsuperscript{139} The following seven topics warrant discussion.

First, assuming the CBA expires in three years, under what circumstances does the promise of "lifetime health benefits" survive expiration of the CBA?\textsuperscript{140} Second, is the CBA rendered ambiguous thanks to inclusion of the two seemingly conflicting terms in the preceding paragraph? Third, if the CBA is deemed ambiguous, what types of extrinsic evidence is admissible to determine the survivability issue? Fourth, even if the promise of "lifetime health benefits" survives the CBA's termination, is the public employer free to modify the level of these benefits or is it bound by benefits contained in the CBA? Fifth, even if the promise of "lifetime health benefits" survives, which class of active employees is entitled to them?\textsuperscript{141} Sixth, even if more than one

\textsuperscript{134} Id.

\textsuperscript{135} Id.

\textsuperscript{136} Kemp, supra note 119, at 2.

\textsuperscript{137} Id.

\textsuperscript{138} Id. at 3. Or the contract may promise PRHBs "indefinitely" or "continuously." Id.

\textsuperscript{139} Id.

\textsuperscript{140} Can the promise survive for retirees but expire for active employees? \textit{E.g.,} Poole v. City of Waterbury, 831 A.2d 211, 227-30 (Conn. 2003) (holding that while the promise of continued PRHBs survives for retirees, "[i]t is undisputed that active employees' benefits continue only until the expiration of the agreement").

\textsuperscript{141} Are only those employees who retire during the term of the CBA entitled to the benefits? What about employees who are eligible for retirement during the CBA's term but retire after its expiration?
class of employee is entitled to "lifetime health benefits," will only those employees who retire during the CBA's term be entitled to exactly those benefits contained in the CBA?\textsuperscript{142} Lastly, when do PRHBs vest, upon acceptance of employment,\textsuperscript{143} upon retirement,\textsuperscript{144} or when the employee becomes eligible for retirement?

To be sure, many, if not all of these issues can be resolved by contract language that clearly, explicitly, and unambiguously spells out what is meant by "lifetime health benefit" and whether language in the reservation clause applies to these benefits.\textsuperscript{145} Unfortunately, few contracts are sufficiently unambiguous to aid a reviewing court.\textsuperscript{146}

Even in the absence of the promise of "lifetime health benefits," or a reservation clause in a CBA, courts differ over how to answer questions one through seven above. If a CBA simply promises retiree health benefits, can an inference of survivability be deduced from silence about the duration of this promise?\textsuperscript{147}

In one way or another, all of these questions entail some aspect of what is known as vesting. Unfortunately, the word itself

\textsuperscript{142} Will those who retire after a CBA expires be subject to modifications put in place in succeeding CBA's?

\textsuperscript{143} \textit{E.g.}, Thorning v. Hollister Sch. Dist., 15 Cal. Rptr. 2d 91, 94-95 (Cal. Ct. App. 1992) (holding elected officers of local school board became contractually vested upon acceptance of employment); Duncan v. Retired Pub. Employees of Alaska, Inc., 71 P.3d 882, 886 (Alaska 2003) (finding that the right to PRHBs vested "on employment and enrollment in the system," as opposed to when the employee is eligible to receive those benefits.

\textsuperscript{144} See, \textit{e.g.}, \textit{Chisholm}, 696 N.W. 2d at 338 (holding that former employee's right to PRHBs vested at the time she retired).

\textsuperscript{145} But in the public sector, promises in the CBA of lifetime retiree benefits may be overruled by state constitutional or statutory provisions. \textit{See, \textit{e.g.}}, Mass. Water Res. Auth. v. AFSCME, 856 N.E.2d 884, 889-90 (Mass. App. Ct. 2006) (holding a CBA to be superseded by statute); 90 MD. OP. ATT'Y. GEN., \textit{supra} note 114, at 220-22 (reporting the Md. AG’s opinion that a CBA cannot alter PRHBs unless the state legislature ratifies it).

\textsuperscript{146} \textit{Contra} Maryland's Benefits Handbook outlining retiree benefits states "Membership in the State Health Program does not constitute a contract. The provisions of the program are subject to annual review and modification. Costs may vary each year." 90 MD. OP. ATT'Y. GEN. at 219 (quoting \textit{STATE RETIREMENT AGENCY, BENEFITS HANDBOOK FOR THE EMPLOYEES AND TEACHERS PENSION SYSTEMS} \textit{46} (Rev. July 2004) (providing an example of an unambiguous contract denying PRHB rights).

\textsuperscript{147} \textit{See} Senn v. United Dominion Indus., Inc., 951 F.2d 806, 816 (7th Cir. 1992) (noting that "mere silence" as to vesting of welfare benefits did not render the CBA ambiguous, but rather reflected that the parties did not intend the PRHB's to survive the agreement). Because silence as to duration does not create an ambiguity, resort to extrinsic evidence is improper. \textit{Id.; see generally} Randy E. Barnett, \textit{The Sound of Silence: Default Rules and Contractual Consent}, 78 VA. L. REV. 821 (1992) (surveying default contract rules that fill "gaps" in contracts, with or without the parties' consent).
may refer both to the duration of a promise and whether what is promised may be unilaterally altered or terminated during the retiree's lifetime. What is more, there are other phrases that may or may not be synonyms for the word vesting: "accrued benefits," "contractual obligations," "lifetime benefits," "inviolable contract," "deferred compensation," and a "contractual, quasi-pension benefit." Some or all of these terms may mean that benefits last for the life of the retiree and that those benefits may not be diminished or terminated. Or, these terms may only mean the former, leaving the public employer free to modify the level of these benefits. And even if vested retiree benefits can be reasonably modified but not eliminated, what are the limits of

148. See Poole, 831 A. 2d at 230 (deciding that plaintiffs have a vested right to medical benefits that survived the expiration of their CBA).
149. See id. at 231 (stating the rule that a vested right may not be modified unilaterally).
150. See, e.g., Duncan, 71 P.3d at 887 (explaining that "accrued benefits" encompasses PRHBs, and that they may not be diminished or impaired under Alaska Constitution).
152. See Cole v. ArvinMeritor, Inc., 516 F. Supp. 2d 850, 879 (E.D. Mich. 2005) (ordering an employer to resume health benefits where employees had contracted for the benefit to continue for the "rest of their lives").
153. See Jones v. Bd. of Trs. of Ky. Ret. Sys., 910 S.W.2d 710, 713 (Ky. 1995) (deciding that Kentucky retirement system formed an "inviolable contract" between [system] employees and the state, such that the legislature cannot decrease benefits).
154. See Weiner v. County of Essex, 620 A.2d 1071, 1079-80 (N.J. Super. Ct. Law Div. 1992) (finding public employees had a "property interest" in their benefits). One consequence of labeling PRHBs a "property" right is to trigger the requirement of procedural due process safeguards, such as notice and opportunity to be heard, before retirees' benefits can be impaired. Id.; see also McMinn v. Okla. City, 952 P.2d 517, 523 (Okla. 1997) (upholding retiree's due process right to cross-examine city witness as to how additional retirement benefits were calculated).
155. See Roth v. City of Glendale, 614 N.W.2d 467, 472 (Wis. 2000) (reasoning that employees expect assurances, when trading wages for "deferred compensation" such as retirement benefits, that the benefits will continue).
156. See Colo. Springs Fire Fighters Ass'n, 784 P.2d at 768 (rejecting plaintiffs' claim that their PRHBs had vested because they were provided by a "contractual quasi-pension type benefit").
157. See Md. ATT'Y GEN., supra note 113, at 208 (reporting that "[n]ot all impairments of contractual obligations are unconstitutional; an impairment is constitutional if it is reasonable and necessary to serve an important public purpose." (citing U.S. Trust Co., 431 U.S. at 25)). The Md. AG concluded that there was no contractual right to PRHBS that would be impaired if the legislature amended the statute to alter benefits. Id. at 210.
158. Id.
reasonableness? In a nutshell, there is no consensus among the states whether PRHBs are a vested or contractual right.

Another complicating factor found in the public sector that is largely absent under ERISA-governed welfare benefits is that states may authorize, prohibit, or even require CBA's to vest PRHBs. ERISA merely leaves the issue of PRHB vesting to the contracting parties, unlike pensions where ERISA clearly dictates vesting rules. But in the public sector, what if a statute forbids the vesting of PRHBs but the contract includes a promise of lifetime retiree benefits? What about the reverse situation? Can a city council resolution vest PRHBs, even absent a CBA?

In sorting out these vesting issues, the courts rely on an array of analytical tools and doctrines: contract law, the creating of presumptions in favor or against vesting, promises contained in employee handbooks, promissory or equitable estoppel, the role of interest arbitration, pre-funding, and, arguably, the law governing fiduciaries. Some courts look to ERISA and the

159. See, e.g., Bernstein v. Pennsylvania, 617 A.2d 55, 58-59 (Pa. Commw. Ct. 1992) (interpreting the statutory language to mean that retirees could enroll in state's health plan if they elected to do so, but did not give them contractual rights to a specific plan); MD. ATT'Y GEN., supra note 113, at 221 (reporting the Maryland Attorney General's opinion that PRHBs can be a subject of collective bargaining under Maryland's state collective bargaining law); Chisholm, 696 N.W.2d at 334-35 (stating that statute authorized public employer to pay PRHBs indefinitely beyond the term of the CBA).

160. See Nat'l R.R. Passenger Corp., 470 U.S. at 465-66 (repeating the longstanding presumption that, absent clear intent to the contrary, laws do not create "private contractual or vested rights"); Fraternal Order of Police Lodge No. 2, 8 S.W.3d at 264 (denying vested rights to public pensioners because there was no contractual obligation, only "a gratuitous allowance, terminable at the will of the grantor"); see supra note 146 (providing an example of an unambiguous teacher contract denying PHRB vesting or contractual rights).

161. See supra Part II.C (providing a brief overview of ERISA).


163. See infra Part III.B (examining whether PRHBs vest under contract law).

164. See infra Part III.D (exploring presumption in favor of and against PRHB vesting in ambiguous CBA's).

165. See Bernstein, 617 A.2d at 61 (rejecting the employees' argument that promises in the employee handbook created vested contractual rights to health benefits).

166. See infra Part III.F (analyzing the use of equitable or promissory estoppel to vest retiree benefits).

167. See infra Part III.G (reviewing the vesting of PRHBs through interest arbitration).

168. See infra Part III.H (reporting on the vesting of PHRBs through pre-funding).

169. See infra Part III.I ( theorizing about the availability of breach of fiduciary duty claims in disputes over the vesting of PHRBs).
NLRA for guidance—sometimes wisely—sometimes unwisely.\(^{170}\) Since vesting of PRHBs may derive from a state constitution or statute or from interest arbitration, all these sources must be assessed alongside contract doctrines. In addition, a public employer's long-standing practice of providing retirees with specific benefits must be factored in.\(^{171}\)

Part III aims to answer only the durational aspect of vesting; when do PRHBs last for the life of retirees? Part IV then addresses an equally vexing aspect of vesting; when may even vested retiree benefits be modified or terminated?

**B. Vesting under Contract Law**

The weight of authority makes clear that contractual obligations usually do not survive expiration of the CBA.\(^{172}\) The best public sector case applying contract principles in addressing the vesting of retiree benefits is *Poole v. City of Waterbury*\(^ {173} \):

A contract must be construed to effectuate the intent of the parties, which is determined from the language used interpreted in the light of the situation of the parties and the circumstances connected with the transaction. . . . The intent of the parties is to be ascertained by a fair and reasonable construction of the written words and . . . the language used must be accorded its common, natural, and ordinary meaning and usage where it can be sensibly applied to the subject matter of the contract. . . . Where the language of the contract is clear and unambiguous, the contract is to be given effect according to its terms. A court will not torture words to import ambiguity where the ordinary meaning leaves no room for ambiguity. . . . Similarly, any ambiguity in a contract must emanate from the language used in the contract rather than from one party's subjective perception of the terms.\(^ {174} \)

Applying these principles, the Supreme Court of Connecticut concluded that the language in the contract providing that the city "shall continue in full force and effect the [medical] benefits for each . . . employee who retires . . . after [the execution of this agreement]" created an ambiguity over the duration of PRHBs.\(^ {175} \)

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\(^{170}\) E.g., *Davis*, 70 S.W.3d at 727 (drawing upon ERISA to hold that the PRHBs did not vest); *Colo. Springs Fire Fighters Ass'n*, 784 P.2d at 772 (drawing upon ERISA to conclude that PRHBs did not vest).

\(^{171}\) E.g., *Poole*, 831 A.2d at 230 (finding that the prior practice of continuing benefits for retirees beyond expiration of their CBA constituted the intent to create a vested right to PRHBs on retirement).


\(^{173}\) 831 A.2d at 211.

\(^{174}\) Id. at 224 (quoting Niehaus v. Cowles Bus. Media, Inc., 819 A.2d 765, 771 (Conn. 2003)).

\(^{175}\) Id. at 227.
Ambiguity in a contract permits the court to consider extrinsic evidence to clear up the ambiguity.\textsuperscript{176} In Poole, extrinsic evidence revealed that the city had been continuing to provide PRHBs to retirees beyond the expiration of their CBA.\textsuperscript{177} While conceding that this practice "could have as easily been a result of intent as inertia," the court affirmed the trial court's conclusion that the retirees had a vested right to PRHBs that survived expiration of the CBA.\textsuperscript{178}

When a contract lacks the magic phrases "lifetime benefits," "vested rights," or "contractual obligation," some courts have analogized to ERISA to conclude that retirees do not have a vested right to PRHBs.\textsuperscript{179} The Tennessee Supreme Court insisted there must be "clear and express language" indicating an intent to confer a vested benefit.\textsuperscript{180}

\textbf{C. Vesting under State Constitutions, Statutes, and City Ordinances}

Unlike the private sector where ERISA governs welfare benefits nationwide, in the public sector each state decides for itself whether PRHBs vest under a state constitution, a state statute, or a city ordinance, even absent a contract.\textsuperscript{181} Kentucky is an example of a state where PRHBs vest under a provision of the state's constitution.\textsuperscript{182} States like Alaska and Michigan have state constitutional provisions that protect accrued benefits of retirees.\textsuperscript{183} But while the Alaska Supreme Court concluded that PRHBs fell within this protected category,\textsuperscript{184} the Michigan Supreme Court held that the same phrase excluded PRHBs.\textsuperscript{185}

\textsuperscript{176} Id. at 229.
\textsuperscript{177} Id. at 229-30.
\textsuperscript{178} Id.
\textsuperscript{179} See Colo. Springs Fire Fighters Ass'n, 784 P.2d at 772 (drawing upon ERISA to conclude that PRHBS did not vest); Davis, 70 S.W.3d at 727 (drawing upon ERISA to hold that the PRHBs did not vest).
\textsuperscript{180} Id. at 727-28.
\textsuperscript{181} See supra notes 61-70 and accompanying text (providing a brief overview of ERISA's national standards).
\textsuperscript{182} Jones, 910 S.W. 2d at 712 (citing KRS 61.692, the Kentucky statute creating KERS, the Kentucky Employees Retirement System).
\textsuperscript{183} See ALASKA CONST. art. XII, § 7 (defining membership in public retirement systems as a contractual right, prohibiting impairment of accrued benefits); MiCH. CONST. art. IX, § 24 (imposing a contractual obligation on the state not to impair "the accrued financial benefits" of state retirement plans).
\textsuperscript{184} Duncan, 71 P.3d at 888.
Similarly, states differ over whether the term "retirement benefit" merely refers to pension benefits or also encompasses PHRBs. 186

In Maryland, a CBA can vest PRHBs, but only if adopted by the legislature. 187 An opinion by Maryland's attorney general states the general rule that a "strong presumption" exists against statutes creating contractual rights. 188 A statute itself is treated like a contract, however, "when the language and circumstances evince a legislative intent to create private rights of a contractual nature enforceable against the state." 189 The Maryland attorney general concluded that the state statute that extended health benefits to certain classes of retirees did not "expressly create a contractual right." 190

In Colorado Springs Fire Fighters Ass'n v. City of Colorado Springs, 191 the Colorado Supreme Court ruled that a municipal ordinance did not vest PRHBs because it did not address the level of benefits. 192 A Pennsylvania court relied on statutory language affording retirees an option to elect PRHBs to conclude that such benefits had not vested. 193

In Massachusetts Water Resources Authority v. American Federation of State, County and Municipal Employees, Council 93, 194 a Massachusetts appellate court held that a CBA that tried to regulate a public employer's contribution toward retiree health insurance premiums was superseded by a state statute that established the public employer's contribution rate. 195

In New York, when the source of vested PRHBs stem from statute rather than from a contract, retirees need not file a notice of claim before challenging any reduction in such benefits. 196

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186. See, e.g., McMinn, 952 P.2d at 521, (defining "retirement benefits" to encompass much more than just pensions, including "insurance coverage and profit sharing").
187. MD. AT'TY GEN., supra note 113, at 220.
188. Id. at 207 (quoting Nat'l R.R. Passenger Corp., 470 U.S. at 465-66).
190. MD. AT'TY GEN., supra note 113, at 209.
191. 784 P.2d. 766.
192. Id. at 773. This logic illustrates how the question of vesting and whether vested benefits may be modified overlap or may be interdependent. For example, under the Colorado Supreme Court's logic, if a CBA says retirees are entitled to $500 per year for health benefits, benefits vest and cannot be modified. If the CBA says the employer will contribute an unspecified amount for PRHBs, then there is no vesting and benefits can be modified or withdrawn.
195. Id. at 889-90
I. Vesting Presumptions in the Private Sector Governed by ERISA

a. Presumption in Favor of Vesting

The leading private sector case finding a rebuttable presumption in favor of retiree health benefits vesting when the CBA is silent or ambiguous is the 1983 Sixth Circuit ruling in UAW v. Yard-Man.197 Finding the CBA ambiguous over whether retiree health benefits survive expiration of the CBA,198 the court created an inference that the parties intended such benefits to vest based in part on the theory that conditions in the workplace create employee expectations of lifetime benefits.199 With retiree health benefits "typically understood as a form of delayed compensation or reward for past services," the court found that retirees agreed to lower wages in exchange for lifetime retiree health benefits.200 Without a presumption in favor of vesting, a union, owing no duty to retirees, could negotiate these benefits away after the employees retired.201 The Yard-Man presumption in favor of vested retiree health benefits in the face of ambiguous contract language has been embraced by the Fourth202 and Eleventh Circuits.203

197. 716 F.2d 1476 (6th Cir. 1983).
198. Id. at 1480.
200. Yard-Man, 716 F.2d at 1482.
201. Id.
202. See Keffer v. H.K. Porter Co., 872 F.2d 60, 64 (4th Cir. 1989) (calling it an "understanding of the context in which retiree benefits arise," rather than a presumption or an inference; finding this "understanding" to support PRHB vesting).
203. See United Steelworkers v. Connors Steel Co., 855 F.2d 1499, 1505 (11th cir. 1988) (citing Yard-Man with approval while holding the PRHBs to have survived the CBA; does not expressly endorse the Yard-Man presumption).
b. Presumption Against Vesting

Six other circuits, the First,204 Third,205 Second,206 Seventh,207 Eighth208 and Ninth209 Circuit Courts of Appeal reject the Yard-Man inference, refusing to weigh employee expectations in resolving ambiguous contract language over whether retiree health benefits have vested. In support of this position, the Eighth Circuit pointed to the fact that ERISA exempts welfare benefits from its vesting rules.210 **Anderson v. Alpha Portland Industries** held that because Congress had remained neutral on the issue of presumptions, it is consistent with federal labor policy to insist that plaintiffs prove their cases “without the aid of gratuitous inferences.”211 The Seventh Circuit rejected a presumption either for or against vesting, turning to extrinsic evidence when the CBA is ambiguous, but stressing the “limitation of liabilities that is implicit in the negotiation of a written contract having a definite expiration date.”212 In rejecting the use of a Yard-Man inference, the Third Circuit relied, in part, on the fact that retirees who worry that the union will not represent them adequately should have made certain while they were active employees that the CBA guaranteed lifetime benefits.213 The Fifth Circuit remains neutral on the question whether there should be a presumption in favor of vesting, preferring to decide the issue on a case-by-case basis.214

204. See Allen v. Adage, Inc., 967 F.2d 695, 698 (1st Cir. 1992) (rejecting the use of vesting presumptions implicitly by ignoring the topic).
205. See UAW v. Skinner Engine Co., 188 F.3d 130, 139-140 (3d Cir. 1999) (disapproving of the Yard-Man presumption explicitly).
206. See Joyce v. Curtiss-Wright Corp., 171 F.3d 130, 135 (2d Cir. 1999) (refusing to infer vesting without language in the CBA that “itself reasonably supports that interpretation”).
207. See Bidlack v. Wheelabrator Corp., 993 F.2d 603, 608-09 (7th Cir. 1993) (agreeing that extrinsic evidence is proper in resolving ambiguous CBA’s while expressly rejecting the use of presumptions both for and against vesting).
208. See Anderson v. Alpha Portland Indus., 836 F.2d 1512, 1517 (8th Cir. 1988) (disagreeing with the Yard-Man presumption in favor of vesting because it would be illogical in light of Congress’ exempting PRHBs from ERISA vesting requirements).
210. Alpha Portland Indus., 836 F.2d. at 1516.
211. Id. at 1517.
212. Bidlack, 993 F.2d at 608.
213. See Skinner Engine, 188 F.3d at 141 (admonishing those fearing union abandonment to make sure that “specific vesting language” is inserted into the CBA).
2. Vesting Presumptions in the Public Sector

a. Presumption in Favor of Vesting

The key public sector case embracing a presumption in favor of vesting of PRHBs is *Roth v. City of Glendale*. The Wisconsin Supreme Court made clear that a presumption in favor of vesting is in accord with a broader understanding “of the context in which retiree benefits arise” because it satisfies employees’ “legitimate expectations” that their bargained for benefits would continue. *Roth* characterized these bargained for benefits as “deferred compensation” for past services rendered, and not gratuities from the employer. When employees give up current wages for later retirement benefits, they do not anticipate that the benefits they earned will be “whittled away,” or exposed to the “contingencies of future negotiations.” A no-vest presumption creates the risk that deferred compensation for past services will come to be seen as a mere gratuity.

The *Roth* court stressed that an employer cannot promise retiree health benefits as an “inducement to employment” and then eliminate this benefit after an employee has retired, having fulfilled all conditions for receiving these benefits. Moreover, since the union does not represent retirees (and could have a conflict of interest if it did), *Roth* viewed a vesting presumption as a means to protect the “voiceless” worker in case the union chose to sacrifice retirees’ benefits in favor of active employees’ benefits.

Another argument in favor of a presumption that PRHBs vest is that resort to presumptions only arises in cases where the contract language is ambiguous. Under canons of contract interpretation, if terms in a contract are ambiguous, it must be construed against the drafter.

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215. 614 N.W.2d at 472.
216. Id. at 472.
217. Id.
218. Id.
219. Id.
220. Id.
221. Id. at 473.
222. But see United Steelworkers, 855 F.2d at 1504 (endorsing the *Yard-Man* presumption in favor of vesting despite finding the CBA unambiguous); *Yard-Man*, 716 F.2d at 1480 (moving on to the presumption issue only after finding the CBA ambiguous).
223. See Graham v. Goodman, 850 S.W.2d 351, 355 (Mo. 1993) (stating the canon as a “last-resort” when the contract is open to two interpretations); *McMinn*, 952 P.2d at 521-22 (interpreting retirement benefits to include PRHBs, noting that ambiguities go against the city that drafted the CBA).
b. Presumption Against Vesting

Both Tennessee and Rhode Island have staked a position contrary to Wisconsin's presumption in favor of vesting. In *Davis v. Wilson County*,224 the Tennessee Supreme Court favored a presumption against vesting, in part, by relying on the distinction in the private sector under ERISA between pension benefits which vest automatically and welfare benefits that do not.225 The court left no doubt that the retiree bears the burden of establishing that the employer expressly intended the benefits to vest.226

In *Anderson v. Town of Smithfield*,227 a Rhode Island court supported its presumption against vesting by arguing that it is sound public policy not to impose lifetime obligations on employers without clear language expressing their intent to vest benefits.228 The continued availability of health insurance, moreover, depends on the insurer, a third party not bound by the CBA.229 The insurer could terminate coverage of public employees or terminate the particular plan.230 The insurer could increase costs to the point that the city became unable to afford insurance at all.231 At that point the defense of impossibility of performing the contract would be available, absolving the city of any obligation, and leaving the retirees with no health insurance.232 Finally, the *Anderson* court cited other "uncertain variables," such as inflation, changing medical technology, and rising cost of treatment in support of its presumption against vesting.233

c. Deciding Vesting Question without Either Presumption

The leading public sector case rejecting a presumption either for or against vesting when the CBA is silent or ambiguous is *Poole v. City of Waterbury*.234 In *Poole*, a city provided medical benefits to retired city firefighters even absent a CBA.235 Eventually, however, CBA's negotiated between the city and union included promises of PRHBs.236 While the city and union were negotiating a new CBA, the state legislature intervened and accused the city of gross fiscal mismanagement for, among other

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224. 70 S.W.3d at 727.
225. Id.
226. Id.
228. Id.
229. Id. at *20 (quoting Poole, 831 A.2d. at 233).
230. Id.
231. Id.
232. Id.
233. Id. at *21.
234. 831 A.2d at 224.
235. Id. at 216.
236. Id.
things, paying health care benefits out of the city general fund.\textsuperscript{237} The city's bond rating had been downgraded as a result.\textsuperscript{238} The state legislature responded by establishing an oversight board authorized to disregard CBA's and to arbitrate labor disputes.\textsuperscript{239} An oversight board arbitration award aimed at altering retirees' medical benefits was challenged as: 1) a breach of contract; 2) an ultra vires act; 3) a taking under the state and federal constitutions; and 4) an impairment of contract rights in violation of the federal constitution.\textsuperscript{240} Ultimately, the Supreme Court of Connecticut ruled that the trial court properly determined that PRHBs survived expiration of the CBA's.\textsuperscript{241} In reaching this conclusion, \textit{Poole} reviewed the arguments in favor of and against vesting of retiree benefits when the CBA is ambiguous and found the rationales for either presumption unpersuasive.\textsuperscript{242} It found the presumption in favor of vesting (or "burden shifting") to conflict with the principle that contractual obligations ordinarily cease at the expiration of a CBA.\textsuperscript{243} \textit{Poole} also concluded that both presumptions fail to adequately account for the conflicting and important policy considerations involved.\textsuperscript{244} Taking the employer's point of view, \textit{Poole} cautioned courts to not lightly find indefinite benefit obligations, especially when, unlike with pension plans, the employer cannot predict or control health care costs.\textsuperscript{245} At the same time, from the employee's perspective, the promise of retiree health benefits is a significant inducement in determining employment.\textsuperscript{246} Essentially, the employer and employee interests cancel each other out, leaving the court to conclude that the best course is to apply general principles of contract interpretation on a case-by-case basis.\textsuperscript{247} Here, the court found the contract ambiguous, looked to extrinsic evidence and the conduct of the parties and concluded that the PRHBs vested and survived expiration of the CBA's without resort to either presumption.\textsuperscript{248}

\textsuperscript{237} Id. at 217.
\textsuperscript{238} Id.
\textsuperscript{239} Id.
\textsuperscript{240} Id. at 218.
\textsuperscript{241} Id. at 230.
\textsuperscript{242} Id. at 222.
\textsuperscript{243} Id. at 223 (citing Litton Fin. Printing Div. v. NLRB, 501 U.S. 190, 207 (U.S. 1991)).
\textsuperscript{244} Id.
\textsuperscript{245} Id.
\textsuperscript{246} Id. at 224.
\textsuperscript{247} Id.
\textsuperscript{248} Id. at 230.
E. Use of Extrinsic Evidence to Resolve Ambiguities Over whether Retiree Benefits Vest

Extrinsic evidence is admissible when contract language is ambiguous. A contract is ambiguous if it is susceptible to more than one interpretation based on its language alone. In the face of contract language promising retirees “lifetime” health benefits and a clause reserving to the employer the right to alter or terminate retiree benefits, most courts would consider the CBA ambiguous. The court would then entertain extrinsic evidence to aid in assessing whether the PRHB vests and whether the obligation survives CBA’s expiration. By contrast, if contract language is unambiguous, extrinsic evidence is inadmissible to create an ambiguity.

Once allowed, courts differ over what forms of extrinsic evidence may be used to resolve vesting ambiguities. Take the example of representations in employee handbooks that PRHBs are for the lifetime of the retiree. In one Pennsylvania case, employees argued that the offer in a handbook of fully paid state coverage of health benefits induced them to continue working. Relying on precedent, the court stated that employee handbooks are not “legislative action,” and do not confer contractual property rights unless the legislature expressly provides a contractual obligation. The weight of authority holds that an employer’s unilateral act of publishing its policies in a handbook does not constitute a “meeting of the minds” necessary for a contract. Since representations in handbooks are not bargained for by the

249. See, e.g., id. at 225 (discussing the basics of contract law, including the admissibility of extrinsic evidence to interpret ambiguities).
250. Id.; Chisholm, 696 N.W.2d at 337.
251. Compare Jensen v. Sipco, Inc, 38 F.3d 945, 952 (8th Cir. 1994) (finding a CBA with both a lifetime benefit promise and a clause reserving the employer’s right to modify to be ambiguous), with In re Unisys Corp. Retiree Med. Benefit ERISA Litig., 58 F.3d 896, 903-04 (3d Cir. 1995) (deciding that a CBA was not ambiguous where it contained a promise of lifetime PRHBs while reserving the right to terminate those benefits).
252. See Poole, 831 A.2d at 225; Chisholm, 696 N.W.2d at 337; Bidlack, 993 F.2d at 608; (employing extrinsic evidence in each case to determine whether the PRHBs vest where the CBA is ambiguous).
254. Bernstein, 617 A.2d at 59.
255. Id. at 60 (quoting Pivarnik v. Pa. Dep’t of Transp., 474 A.2d 732, 734 (Pa. Commw. Ct. 1984)).
parties, promises are merely gratuities.\textsuperscript{257} New Jersey draws a legal distinction between a duly enacted and published formal Attorney General's opinion which is admissible,\textsuperscript{258} and an informal opinion which is inadmissible as hearsay.\textsuperscript{259}

Conduct of the parties is yet another example of extrinsic evidence the court may admit as evidence that promises of lifetime PRHBs survive expiration of the CBA. For example, evidence that the public employer continued paying for PRHBs even after the contract ended was admissible to show that the benefits outlive the CBA.\textsuperscript{260}

The use of extrinsic evidence overlaps the doctrines of ultra vires and estoppel. For example, whether representations by a human resources manager that PRHBs are for retirees' lifetime may be admissible as extrinsic evidence or as part of an estoppel claim for benefits may turn on whether the manager's representations were ultra vires in a primary sense (i.e., void)\textsuperscript{261} or in a secondary sense (i.e., enforceable by estoppel).\textsuperscript{262}

\textbf{F. Use of Equitable or Promissory Estoppel to Vest Retiree Benefits}

Promissory estoppel may be invoked to vest retiree health benefits only for agreements "implied in law" where there is no actual contract in fact.\textsuperscript{263} The New Jersey Supreme Court explained estoppel as the principal that "one may, by voluntary conduct, be precluded from taking a course of action that would work injustice and wrong to one who with good reason and in good faith has relied upon such conduct."\textsuperscript{264} In Wood v. Borough of Wildwood Crest,\textsuperscript{265} a police officer with twenty-two and a half years of actual service purchased two and a half years of service credit to enable him to receive PRHBs.\textsuperscript{266} He discussed the legality of this move with the acting Chief of Police and with

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257. & Richardson, 466 A.2d at 1085. & \\
259. & See id. (concluding that a letter of the deputy attorney general stating that the county was obligated to continue paying post-retirement medical benefits was inadmissible hearsay). & \\
260. & See, e.g., Anderson, 2005 R.I. Super. LEXIS 181, at *3-5 (determining that in this case the public employer continued paying for PRHBs, even after the contract had come to an end). & \\
261. & See Wood, 726 A.2d at 313-14 (describing ultra vires in the primary sense). & \\
262. & See id. (describing ultra vires in the secondary sense). & \\
263. & Chisholm, 696 N.W.2d at 337. & \\
264. & Summer Cottagers' Ass'n of Cape May v. City of Cape May, 117 A.2d 585, 590 (N.J. 1955). & \\
265. & 726 A.2d at 311. & \\
266. & Id. & \\
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several other city officials who all assured him that he would be eligible for retiree health benefits.\textsuperscript{267} For three years, the city paid the retiree's medical benefits before discovering that an amended statute required twenty-five years of actual service for a retiree to be eligible for medical benefits.\textsuperscript{268} When the city stopped paying those benefits, the retiree sued to restore them.\textsuperscript{269}

The court made clear that while equitable estoppel is rarely invoked against a public employer, its use is permissible "where the interests of justice, morality and common fairness clearly dictate that course."\textsuperscript{270} So long as the city's act is not utterly beyond the city's jurisdiction, equitable estoppel may be invoked to prevent injustice.\textsuperscript{271} In \textit{Wood}, the court concluded the city was estopped from terminating the retiree's medical benefits since no essential public function was compromised by vesting the benefits.\textsuperscript{272}

The Minnesota Supreme Court has ruled that public employees become entitled to their pension benefits at the time of retirement and their employers are estopped from denying a promise that has been made to provide those benefits.\textsuperscript{273} Besides showing reasonable reliance, plaintiff must also show that "enforcement of the promise is the only means of avoiding injustice."\textsuperscript{274}

In \textit{Martin v. City of Ottumwa},\textsuperscript{275} another "years of service" estoppel case, the retiree had worked for the city for twelve years.\textsuperscript{276} Although the city council had enacted a "years of service" requirement, Martin was assured by the city's human resources manager that the new rule did not apply to him.\textsuperscript{277} Several months after Martin retired the city discovered its mistake (he did not meet their service requirements) and discontinued his retiree health benefits.\textsuperscript{278} The Iowa court refused to invoke equitable estoppel because the city did not take "unfair advantage" of the plaintiff.\textsuperscript{279} Even though the retiree relied on the human
resources manager's promise, the court was unable to find any exceptional circumstances to justify invoking equitable estoppel.\textsuperscript{280}

At the federal level, a panel of the Federal Circuit Court of Appeals first ruled that the government owed free lifetime medical care to some veterans because recruiters promised them such care if they served in the military for at least twenty years.\textsuperscript{281} Upon rehearing en banc, however, the full Federal Circuit reversed the panel and refused to find an implied contract because the recruiters had lacked the authority to promise lifetime health care.\textsuperscript{282}

\textbf{G. Vesting Through Interest Arbitration}

Many states' public employment labor relations acts deny certain public employees, like police officers and firefighters who perform essential duties, the right to strike.\textsuperscript{283} As a quid pro quo, such essential employees may invoke a special procedure for resolving labor disputes known as binding interest arbitration.\textsuperscript{284} Interest arbitration is to be distinguished from grievance arbitration in that the latter is invoked during the term of the contract to resolve disputes arising under it,\textsuperscript{285} while the former comes into play only after the employer and union reach an impasse in negotiating a new CBA.\textsuperscript{286} Whether the employer must submit to interest arbitration depends on whether the issue in dispute is a mandatory or permissive subject of bargaining.\textsuperscript{287}

\textsuperscript{280} Id.
\textsuperscript{281} Schism v. United States, 239 F.3d 1280, 1291 (Fed. Cir. 2001), rev'd en banc, 316 F.3d 1259 (Fed. Cir. 2002); Robert Pear, \textit{Court Says 2 Veterans Are Owed Lifetime Care}, N.Y. TIMES, Feb. 21, 2001, at A12.
\textsuperscript{282} Schism, 316 F.3d at 1299.
\textsuperscript{283} See, \textit{e.g.}, MINN. STAT. § 179A.18, subd. 1 (2008) (prohibiting "essential employees" from striking); MINN. STAT. § 179A.03, subd. 7 (2008) (defining essential employees as including, among others, firefighters and peace officers).
\textsuperscript{284} See MINN. STAT. § 179A.16, subd. 2-8 (2008) (providing procedure for essential employees to petition for interest arbitration); see also Broderdorf, supra note 81, at 324 (recognizing that the right to invoke interest arbitration exists for public employees prohibited from striking).
\textsuperscript{285} Black's Law Dictionary defines "grievance arbitration" as: "[a]rbitration that involves the violation or interpretation of an existing contract." BLACK'S LAW DICTIONARY 112 (8th ed. 2004); see also Broderdorf, supra note 81, at 338 (stating that grievance arbitration looks to the existing agreement).
\textsuperscript{286} Black's Law Dictionary defines "interest arbitration" as "[a]rbitration that involves settling the terms of a contract being negotiated between the parties; esp., in labor law, arbitration of a dispute concerning what provisions will be included in a new collective- bargaining agreement." BLACK'S LAW DICTIONARY 113 (8th ed. 2004); see also Broderdorf, supra note 81, at 324 (reporting that interest arbitration is most often used in public labor disputes when the parties cannot agree to the terms of a new CBA).
many states, the subject of PRHBs has moved in and out of these two categories. If mandatory, the employer must submit to interest arbitration; if permissive, the employer may refuse and instead, unilaterally change the level of benefits.

In City of Pittsburgh v. Fraternal Order of Police, the issue of PRHBs was submitted to interest arbitration. The arbitration award allowed the city to modify its contribution toward premium costs for PRHBs. On appeal, the retirees argued that the award violated the Contract Clauses of the United States and state constitutions. Rejecting this argument, the court ruled that the Contract Clauses only barred unilateral changes in contractual benefits, not modifications reached by interest arbitration. The City of Pittsburgh ruling, however, only allowed the city to modify its PRHBs through interest arbitration for active employees. The Pennsylvania Supreme Court had earlier ruled that benefits statutorily set could be altered by an interest arbitration award.

In Anderson v. Town of Smithfield, a PRHB vesting dispute was submitted to interest arbitration in Rhode Island. The arbitration award allowed the city to increase retirees' prescription co-payments. The retirees sued, arguing the arbitration could not apply to them since their interests were not represented during the arbitration process. The court ruled that the retirees' only vested right is to receive health care insurance from their former employer, and "not the substantive health care

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288. See Allied Chem. & Alkali Workers, Local No. 1, 404 U.S. at 185 (deciding that "a 'modification' is a prohibited unfair labor practice only when it changes a term that is a mandatory rather than a permissive subject of bargaining"); Oklahoma Oncology & Hematology P.C. v. US Oncology, Inc., 160 P.3d 936, 948 (Okla. 2007) (reporting the rule that only mandatory subjects of collective bargaining are enforceable with interest arbitration clauses).

289. Iowa State Educ. Ass'n, 369 N.W.2d at 797.

290. See Law Enforcement Labor Servs., Inc. v. County of Mower, 469 N.W.2d 496, 501 (Minn. Ct. App. 1991), rev’d, 483 N.W.2d 696 (Minn. 2002) (highlighting the change in Minnesota from the appellate court’s holding that PRHBs were a mandatory subject of bargaining, to the Supreme Court’s reversal).


292. Id. at 651-52.

293. Id. at 652.

294. Id.

295. Id. at 653.

296. Id.


299. Id. at *5.

300. Id.

301. Id. at *8.
benefits.” Since no vested right was affected by the arbitration award, the retirees' participation in the arbitration was not necessary.

H. Vesting Through Pre-Funding Retiree Health Benefits

The law is unclear whether the vesting of PRHBs may occur once a state decides on pre-funding as a means of financing PRHBs. Pre-funding is increasingly likely in light of GAS 45, as opposed to the currently common pay-as-you-go method of financing PRHBs. At any rate, if pre-funding consists in part of employee contributions, “there may be a stronger argument that the state has undertaken to devote the funds in the trust to retiree health care benefits.” In other words, the act of pre-funding may create a contractual obligation on the part of the state, which could subject any change in benefits to challenge as an unlawful impairment under the federal and state contract clauses. The Supreme Court of Colorado rejected former city employees' claims that a city ordinance created a vested quasi-pension-type benefit for PRHBs, in part because city employees were not required to contribute a percentage of their salary to pre-fund PRHBs and participation in the program was wholly optional. Such reasoning lends credence to employer wariness toward pre-funding of PRHBs, fearful that such financing schemes strengthen retirees' claims that such benefits are vested.

I. Breach of Fiduciary Duty

While research has turned up no public sector case where public employees have invoked breach of fiduciary duty as a tool for supporting a claim that PRHBs have vested, it seems clear that such a cause of action should lie, especially since it is available under ERISA. Moreover, in Varity Corporation v. Howe, the Supreme Court ruled than an employer acts as a fiduciary when it communicates about benefits to its employees and thus owes a fiduciary duty not to misrepresent plan benefits.

302. Id. at *23.
303. Id.
304. See GAS 45, supra note 1 (creating new accounting rules that will require public employers to report unfunded PRHB liabilities).
305. See Wisniewski & Wisniewski, supra note 2, at 11 (reporting that as of 2004, thirty states funded PRHBs on a pay-as-you-go basis).
308. See Kemp, supra note 119, at 5 (citing Metro. Life Ins. Co. v. Taylor, 481 U.S. 58, 62-63 (1987)) (reporting that breach of fiduciary duty claims are actionable under ERISA).
310. Id. at 503.
311. Id. at 506.
IV. MODIFYING OR TERMINATING VESTED PRHBs

As the preceding Part makes clear, if retiree health benefits have not vested, they may be modified or terminated at will.312 This Part, by contrast, presupposes that PRHBs have vested in the sense that they survive expiration of the CBA. Now attention shifts to the knotty question of whether and to what extent even vested PRHBs may be modified or terminated by the public employer. The modification cases fall not so neatly into the following three categories: (a) with consent; (b) if reasonable; and (c) if substantially equal.

A. Vested PRHBs Cannot be Modified or Terminated without Consent of Retirees Absent Unanticipated Circumstances

An example of this extreme view is found in a decision of the Minnesota Supreme Court in *Housing & Redevelopment Authority Of Chisholm*,313 where the court ruled that vested PRHBs survived expiration of the CBA and consequently the public employer could not unilaterally terminate those benefits.314

B. Modification of Vested PRHBs is Subject to the Reasonableness Test Under the Contract Clauses of the United States and State Constitutions

On one level it would seem that all vested PRHBs are ipso facto subject to the Contract Clauses of the United States and/or state constitutions, but not all cases address this issue when it comes to what types of modifications constitute impairments. States differ over what kinds of modifications to PRHBs pass constitutional muster. As a general rule, vested PRHBs may be modified without violating the Contract Clause if reasonable and necessary to serve an important public purpose.315 For example, the attorney general of Maryland found that protecting the soundness of a retirement system amounted to an important and legitimate public purpose.316 The Supreme Court of Georgia ruled that switching retirees from a PPO plan to HMOs did not violate the impairment clause of the state constitution,317 while conceding that these retirees enjoyed vested benefits at whatever level they

312. E.g., *Davis*, 70 S.W.3d at 728 (holding PRHBs did not automatically vest and could be altered or terminated by employer at any time); MD. ATT’Y GEN., supra note 113, at 224 (stating that the statute did not create a contractual obligation to provide PRHBs).
313. 696 N.W.2d at 337-38.
314. Id.
317. Unified Gov’t of Athens-Clarke County v. McCrary, 635 S.E.2d 150, 153 (Ga. 2006)
had when they retired. The change in coverage did not violate their vested rights because the retirees were only guaranteed cost-free coverage, not a specific type of coverage. Similarly, the Supreme Court of Kentucky ruled that a change in the valuation method for PRHBs from book value to modified market value for calculating retirement benefits did not constitute a substantial impairment under the Contract Clause.

The Supreme Court of Alaska ruled that when assessing whether modifications to PRHBs were reasonable under the Contract Clause, a comparative analysis of disadvantages and compensating advantages of changes to PRHBs must be undertaken by focusing on the entire group of employees rather than from an individual retiree's perspective. In this regard, equivalent value must be proven by comparison of benefits provided, not merely by comparing old and new premium costs. Many cases assessing what constitutes an unconstitutional impairment of vested PRHBs under the Contract Clause have looked to cases involving changes to vested pension benefits for guidance.

The Supreme Court of Connecticut made clear that the burden is on retirees to prove that modifications to PRHBs diminished their benefits "below a level reasonably commensurate with the coverage they enjoyed before." This "reasonably commensurate" test is borrowed from the law governing when vested pension benefits can be modified. For example, a Maryland court concluded that a public employer may unilaterally change pension benefits so long as any modifications "do not adversely alter the benefits," or if the change in benefits is adverse, they are "replaced with comparable benefits."

318. Id.
319. Id.
320. Bd. of Trustees of Ky. Ret. Sys.'s, 910 S.W.2d at 715 (Ky. 1995).
321. Duncan, 71 P.3d at 892.
322. Id.
323. E.g., Bd. of Trustees of Ky. Ret. Sys.'s, 910 S.W.2d at 715 (discussing cases from jurisdictions assessing whether changes to pension plans violate the Contract Clause).
324. Poole, 831 A.2d at 233-34.
325. Zielinski v. Pabst Brewing Co., 463 F.3d 615, 619 (7th Cir. 2006).
C. Modifications to Vested PRHBs are Permissible so Long as Retiree Benefits are Substantially Equal to Benefits for Active or Current Employees

Allowing changes to PRHBs so long as retiree and active employee benefits remain substantially the same is an ingenious way to sidestep the potential conflict of interest a public union faces whenever it feels tempted to reduce retiree health benefits in order to enhance benefits for active employees. Usually, this standard is imposed by state statute. For example, in State ex rel. City of Wheeling Retirees Ass'n, Inc. v. City of Wheeling, the court interpreted a West Virginia state labor statute as mandating the same PRHBs level for retirees as for active employees. Similarly, in Ventura County Retired Employees Ass'n, Inc. v. County of Ventura, a state statute required California public employers to give preference to health insurance plans that provided retirees with the same benefits as active employees, at no increased cost. Finally, in Jones v. Board of Education of the Watertown City School District, the court concluded New York state law barred any reduction in PRHBs unless a corresponding diminution of benefits or contributions was applicable to active employees.

V. FINANCING PRHBs IN LIGHT OF NEW ACCOUNTING RULES

A. How States Currently Finance PRHBs

1. Pay-As-You-Go States

As mentioned earlier, thirty states finance PRHBs on a pay-as-you-go basis, much like how Social Security benefits are financed. In other words, current workers are paying for current retirees. While nothing in the new accounting rules

328. Id. at 387-88.
330. Id. at 678. The California statute at issue did not mandate equal health care benefits between retirees and active employees, however, only that preference be given to such plans. Id.
332. Id. at 970.
333. See Wisniewski & Wisniewski, supra note 2, at 11 (reporting states that pre-fund PRHBs).
335. Id.
forces states to switch from pay-as-you-go financing, several factors will exert pressure on states to increasingly pre-fund PRHBs: (1) failure to pre-fund may result in a downgrading of a state's creditworthiness, making it more expensive to borrow money;\(^3\) (2) the decreasing ratio between the numbers of active employees to retirees will increase the cost of PRHBs;\(^3\) (3) the aging workforce\(^3\) and financial incentives to retire at younger ages\(^3\) will increase the cost of PRHBs; and (4) if recent trends in the development of medical technology continue, the costs of healthcare will continue to outstrip inflation for the foreseeable future.\(^3\) Florida, for example, while generously pre-funding pension obligations, has set aside virtually no money for PRHBs estimated to cost $3.6 billion over the next thirty years.\(^3\) While states have set aside sufficient funds to cover eighty-five percent of pension liabilities, only three percent of future PRHBs costs have been pre-funded.\(^3\) None of the five largest states, California, Texas, New York, Florida, or Illinois has put aside any money for PRHBs.\(^3\) Several states partially finance PRHBs on a pay-as-you-go basis and partially through pre-funding financing. For example, Idaho finances its state retirement health care subsidy on a pay-as-you-go basis, but sick leave insurance conversion is pre-funded by employer contributions.\(^3\) The same hybrid financing is in place in New Hampshire.\(^3\) No PRHBs financing is necessary in Mississippi because health insurance premiums are fully paid for by retirees.\(^3\) In an about-face, New Jersey switched from pre-funding financing back to pay-as-you-go in 1994 as a result of a severe budgetary shortfall.\(^3\)

2. Pre-Funding States

Thirteen states have set up irrevocable trusts to pay for PRHBs under which none of the funds can be diverted to other uses.\(^3\) Several states like Arizona\(^3\) and Florida\(^3\) only offer

\(^336\). Prah, supra note 26.
\(^337\). Wisniewski & Wisniewski, supra note 2, at 22.
\(^338\). Health Benefits, supra note 10.
\(^339\). See Chisholm, 696 N.W.2d at 333 (holding that the main aim of a statutory amendment was to authorize public employers to offer PRHBs to encourage highly compensated employees to retire).
\(^340\). Wisniewski & Wisniewski, supra note 2, at 11.
\(^341\). Lipman, supra note 130, at 8A.
\(^342\). Id.
\(^343\). Id.
\(^345\). Id. at app. B at 95 tbl. B2.
\(^347\). Id. at app. B at 95 tbl. B2.
\(^348\). Prah, supra note 26.
\(^349\). Id. at app. B at 90 tbl. B2.
\(^350\). Id. at app. B at 91 tbl. B2.
retirees a healthcare subsidy which is pre-funded by employer contributions as a percentage of payroll for all active employees. Seven states: Kentucky, North Dakota, Ohio, Virginia, Michigan and Montana finance PRHBs through a wide array of legal devices. Montana has set up a voluntary employee benefit association (VEBA) to finance PRHBs and will be discussed later. Most of the other pre-funding states do so through employer contributions. Wisconsin is unique in that its only retiree health benefit is a program that converts accumulated sick leave into a lump sum award to retirees which is pre-funded based on an actuarially determined percentage of payroll. Some states have issued bonds, much like bonds issued to finance pension liabilities. This approach is risky if investment returns are weak, however, because it leaves the public employer duty-bound to pay for benefits as well as servicing the debt on the bonds.

Between 1985 and 1991, Michigan financed PRHBs through pre-funding. In 1991, however, owing to budgetary problems, the state reverted to a pay-as-you-go financing system at the Governor's request. Current employees and retirees brought suit, alleging the state's failure to pre-fund violated the state constitution which requires that "financial benefits arising on account of service rendered in each fiscal year shall be financed during that year and such funding shall not be used for financing unfunded accrued liabilities." In *Musselman v. Governor* (*Musselman I*), the Michigan Supreme Court ruled that PRHBs were "financial benefits" under the state constitution, and consequently must be pre-funded just as pension benefits are pre-

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351. See Standard & Poor's, *U.S. States Are Quantifying OPEB Liabilities And Developing Funding Strategies As The GASB Deadline Nears*, Nov. 12, 2007, at 3-9 available at www.nasra.org/resources/medical/SandPOPEB0711.pdf (reporting how each state is currently funding its PRHBs).

352. In 1992, Kentucky was one of only six states that undertook to pre-fund PRHBs. *Bd. of Trustees of Ky. Ret. Sys.*'s, 910 S.W.2d at 714.

353. Ohio is one of the few states beginning to manage its PRHBs and accumulate assets to fund the liability, with about $12 billion in accumulated assets. Standard & Poor's, *supra* note 351, at 8.


355. See *infra* note 388 (describing Montana's VEBA).


358. GAO RETIREE BENEFITS, *supra* note 34, at 33.

359. *Id.* at 34.


361. *Id.*

362. *Id.* at 239.

363. *Id.* at 240; MICH. CONST., art. 9, § 24 (1963).
funded.”

Not until the year 2000 did the Michigan Legislature authorize the pre-funding of PRHBs. The Michigan Supreme Court settled any confusion left over from Musselman II when it held in 2005 that PRHBs were not constitutionally protected “financial benefits.”

In 2005, Utah changed its practice of paying retirees a month of health insurance for every day of unused sick leave. Instead, wages for each day of unused sick leave will be deposited in retiree health savings accounts, which retirees can dip into to buy their own health coverage.

B. Innovative Financing Tools

Public employers may seek to address large, unfunded PRHBs liabilities through the issuance of taxable bonds much like pension-obligation bonds. For example, the city of Gainesville, Florida, issued bonds to finance a $306 million liability in its self-insured Retiree Healthcare Plan. Some public employers finance PRHBs through pooled programs known as cost-sharing, multiple employer plans.

Two financing options that are available in both the public and private sectors are known as Voluntary Employees Beneficiary Associations (VEBA) and Internal Revenue Code section 401(h) Accounts. These two financing vehicles share the following features: (1) both are devices for financing PRHBs; (2) both permit employer contributions to be made on a tax-free basis; (3) both are trust accounts where assets are administered in a fiduciary manner and invested to accrue tax-free earnings;

364. Id. at 242. As a remedy, however, the Musselman I court made clear that it lacked the power to force the legislature to appropriate funds. Id. at 245. On rehearing, however, Chief Justice Brickley changed his vote and decided the case without interpreting the Michigan constitution to include PRHBs as “financial benefits.” Musselman v. Governor (Musselman II), 545 N.W.2d 346, 346-47 (Mich. 1996).

365. MICHIGAN COMMISSION ON PUBLIC PENSION AND RETIREE HEALTH BENEFITS 13, supra note 133.

366. Studier, 698 N.W.2d at 360.

367. MOODY'S SPECIAL REPORT, supra note 8, at 3.

368. Id.


370. MOODY'S SPECIAL REPORT, supra note 8, at 3.

371. Id.

372. Id. at 4.

373. Heffelfinger, supra note 369, at 2-4.

374. Id. at 2.

375. Id.

376. Id.
and (4) both pay PRHBs that are not taxable. Key differences between these two financing devices are discussed below.

1. Voluntary Employees Beneficiary Associations (VEBA)

VEBAs are created under § 501(c)(9) of the Internal Revenue Code. Neither the VEBA trust nor the board of trustees may be under the thumb of an employer or a union and VEBA funds must be dispersed exclusively for the benefit of eligible VEBA members. VEBAs may be set up either as a defined benefit plan or as a defined contribution plan whose benefits may be paid to active employees, retirees and their families. Finally, VEBAs are portable.

Washington State set up a VEBA Medical Expense Plan for public employees in 1983. A trust fund was established that provides its members with tax-free reimbursement of any medical expense that is tax-deductible under IRS laws. The plan is structured as a defined contribution plan with individual member accounts. Employees manage their individual account investments and at retirement, unused sick leave is contributed tax-free to the VEBA trust fund. The plan is entirely portable. In 2001, Montana set up a VEBA plan under § 501(c)(9) as well, and its contours largely follow its counterpart in Washington.

2. Internal Revenue Code section 401(h) Accounts

An Internal Revenue Code section 401(h) account is a qualified annuity plan set up as a defined benefit plan (it is unclear whether 401(h) plans can be set up as a defined contribution plan) that may be tapped to pay PRHBs. Employer contributions are paid into the account tax-free (but it is unclear if employees may make contributions with pre-tax

377. Id.
379. Heffelfinger, supra note 369, at 3.
380. Id. at 3-4.
381. Id. at 4.
382. Id. at 5.
383. Id.
384. Id.
385. Id. at 5-6.
386. Id. at 5.
387. See Montana VEBA, http://www.montanaveba.org (providing information on the VEBA program for various Montana state employees) (last visited October 4, 2008); MONT. CODE ANN. 2-18-1302 (2007) (declaring that the VEBA is being formed to provide a tax-free trust to assist public employees in paying for health care expenses).
390. Id.
dollars). Section 401(h) funds must be separate from pension funds and its assets may not be used for any other purpose. Unlike VEBAs, 401(h) benefits may only go to retirees, not active employees. Notably, if a 401(h) plan does not meet IRS qualification standards, the tax-qualified status of the pension plan would also fail. Finally, it is unclear whether the pension plan must be fully funded before a 401(h) plan can be funded.

VI. CONCLUSION

The advent of new accounting rules will highlight the magnitude of unfunded liabilities facing state and local governments over the costs of retiree health benefits for current and former employees. To be sure, other demographic factors are applying pressure on public employers either to cut back all retiree benefits or to frame new financing schemes to maintain a strong credit rating essential for reducing the cost of borrowing money. An aging population, a decline in the ratio of active workers to retirees, incentives for highly compensated public employees to retire early and the rising costs of healthcare generally will produce a financial nightmare for state and local governments down the not-to-distant road.

As this article makes clear, efforts to back pedal on promises of lifetime health care face daunting hurdles where vested benefits are at stake. Clearly, public employers can reduce or eliminate retirement benefits for new employees but this will make public employment less attractive especially if states continue to finance these benefits on a pay-as-you-go basis. This is so because new employees will be funding generous benefits for current retirees fully aware that they will be denied similar benefits when their turn to retire comes around. Perhaps a new president with the political will, clout, and skill to enact universal health care will relieve public employers of some measure of these growing unfunded liabilities.

391. Id.
392. Id. at 7.
393. Id.
394. Id.
395. Id.