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An Analysis of the Legal Obstacles to State Pension Reform

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AN ANALYSIS OF THE LEGAL OBSTACLES TO STATE PENSION REFORM

AN ANALYSIS OF THE LEGAL OBSTACLES TO STATE PENSION REFORM

A dissertation submitted in partial fulfillment
of the requirements for the degree of
Doctor of Philosophy in Education Policy

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ABSTRACT

Public pension systems are underfunded, straining state budgets. Historically, many states have presumed that they can modify pension benefits only as to newly-hired employees, and that they must leave benefit accruals untouched for current workers. More recently, though, states have begun enacting more fundamental pension reform that modifies future accruals or even reduces cost-of-living allowances for retirees. Nearly all such new reforms have been the subject of one or more lawsuits alleging that the federal and/or state constitution bars the legislature from reducing benefits or accrual patterns. This dissertation examines the legal underpinnings for arguments made against pension reform, and suggests that constitutional doctrine ought to allow pension systems to be reformed in ways that protect past benefit accruals while reorganizing future benefit accruals in a way that is fairer to younger and more mobile workers. That theory is consistent with contract law and constitutional principles.

The dissertation then moves to the real challenge, which is how to apply that theory in particular cases, such as contribution increases, cost of living reductions, retirement age increases, or the establishment of a different pension system entirely. In such cases, it is not always immediately obvious what it means to protect past accruals but allow modifications to future accruals. Given that neither state nor federal judges are pension specialists, courts may benefit from a closer examination of a wide variety of pension reforms.

This dissertation is approved for recommendation
to the Graduate Council.

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Thanks to the faculty and staff at the Department of Education Reform. My time there was wonderful.

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I. INTRODUCTION

State pension systems are in financial trouble. According to a 2011 Pew report,¹ state pensions are collectively some \$700 billion short of the funding needed to meet their actuarial liabilities. That figure depends on assuming that pensions' current investments will appreciate at about 8% per year indefinitely.² Under more realistic and less volatile assumptions, the unfunded liabilities rise to as much as \$3 trillion using the state debt interest rate or \$4.4 trillion using the zero-coupon Treasury yield.³

In light of these looming actuarial deficits, numerous states have begun taking steps to reform their pension systems.⁴ While some states' reforms are relatively modest, other states are beginning to enact serious and fundamental pension reform. In Rhode Island, the state treasurer Gina Raimondo spent all of 2011 warning of a looming \$9 billion or so deficit in the pension systems there, a deficit so large that the state would soon be unable to pay what is needed for schools, roads, libraries, and more.⁵ Despite weighty political opposition from the state's

¹ Pew Center on the States, *The Widening Gap: The Great Recession's Impact on State Pension and Retiree Health Care Costs* (2011), available at http://www.pewcenteronthestates.org/uploadedFiles/Pew_pensions_retiree_benefits.pdf.

² *Id.* at 2; see also Josh Barro and Stuart Buck, *Underfunded Teacher Pension Plans: It's Worse Than You Think*, Manhattan Institute Civic Report No. 61 (April 2010), available at http://www.manhattan-institute.org/html/cr_61.htm.

³ Robert Novy-Marx and Joshua D. Rauh, "Public Pension Promises: How Big Are They and What Are They Worth?," *Journal of Finance* 66(4), 2011: 1211-1249.

⁴ See Ronald K. Snell, *Pensions and Retirement Plan Enactments in 2011 State Legislatures*, National Conference of State Legislatures (April 30, 2011), available at <http://www.ncsl.org/?tabid=22763>; Ronald K. Snell, *Pensions and Retirement Plan Enactments in 2010 State Legislatures*, National Conference of State Legislatures (Nov. 17, 2010), available at <http://www.ncsl.org/?tabid=20836>.

⁵ See generally Gina Raimondo, *Truth in Numbers: The Security and Sustainability of Rhode Island's Retirement System* (May 2011), available at <http://www.ricouncil94.org/Portals/0/Uploads/Documents/General%20Treasurer%20Raimondo%20report.pdf>.

powerful labor unions, Rhode Island enacted ground-breaking pension reform in late 2011.

Many states have found that reform legislation is just the beginning of a difficult road. Within the past few years, at least fifteen jurisdictions have faced lawsuits alleging that pension reform is unconstitutional, including Colorado, Minnesota, South Dakota, New Hampshire, New Mexico, Massachusetts, Florida, New Jersey, and Rhode Island.

The most significant claim raised against pension reform legislation is that it violates the federal Contracts Clause or a state constitutional parallel. In both the U.S. and state constitutions, a Contracts Clause provides that the government may not pass laws that abrogate contractual responsibilities. Thus, the argument runs, a pension that has been promised to a state employee is essentially a contract: the state employee offered work in exchange for a compensatory package that included both salary and a pension benefit. When legislation diminishes pension benefits, it alters the terms of the state's contractual obligation to provide the bargained-for remuneration, and is arguably unconstitutional.

A second claim raised against pension reform is that it violates the Takings Clauses of state and federal constitutions. These clauses prevent the government from "taking" away someone's property without just compensation. The argument is that state pension benefits are a promised stream of monetary payments that has present economic value, and therefore arguably constitute an employee's "property." Thus, if the state diminishes that stream of payments without some countervailing compensation, then some of the employee's property has been "taken" away.⁶

The claim that pension rights are contractual is not only plausible but has often succeeded

⁶ In most cases, a takings clause argument appears, if at all, only as a tag-along claim to a contracts argument: as many courts have noted, a takings violation might arise only if the plaintiffs have a contractual right to the stream of payments, which in turn means that a takings claim usually rises or falls along with a contractual claim.

in prior state court lawsuits. As a result, many policymakers have thought that pension reform must be limited to changing the terms applicable to newly-hired employees.

This dissertation will argue, however, that more modest changes to current workers' benefits ought to be allowed consistent with federal and state contracts clauses. In particular, it will contend that it would be more consistent with the underlying considerations of established caselaw for state workers to be presumptively entitled to the pension benefits that they have *actually* accrued for past work, but that changes to future accruals are permissible. (Accrual is a concept that will be discussed further in Chapter II below.)

Consider the case of pension benefit increases. Imagine, for example, that for 29 out of 30 years of a state worker's working life, a statute provided that the cost of living allowance (COLA) for state employees' pensions would be 2.5%, but the statutory COLA was raised to 3% during the last year of that person's career. It is hard to see why that person would now be contractually entitled to a 3% COLA for the rest of his life, possibly another 30 years. Why is that so, given that the worker spent the overwhelming majority of his or her career contributing to a system that, at the time, was designed to allow for a lower COLA? Put more broadly, by what principle of contract law should retirees be guaranteed the highest level of benefit that might ever have momentarily been put in place during their entire working lives?

This standard does not seem a plausible application of principles of contract law. Pensions are merely an alternative way of structuring salary-based compensation, after all: rather than paying a worker's entire salary today, the state government sets aside a portion and invests it so as to be able to pay out a pension after 25 or 30 years. If wages are increased – say, from \$45,000 to \$48,000 – state employees with 28 years of service at the lower wage would not therefore be entitled to receive back-pay that brings all their previous 28 years of salary up to

\$48,000. Those employees bargained for and worked for the lower wage for those 28 years. To be sure, if they continue working under the wage increase, they will receive the higher salary on a going-forward basis, but they are not entitled to have their wages retroactively increased for all the previous years of employment: they never provided consideration for such a wage increase.

By the same reasoning, when pension benefits are increased, it is not plausible to argue that anyone within the system, no matter how near retirement, is then constitutionally entitled to receive that higher pension benefit during his or her *entire* retirement. Pensions are just back-loaded salary. If someone works for 28 years with the expectation of a certain pension benefit, and that benefit is raised on a going-forward basis for the last two years of his or her employment, he or she is contractually entitled to the higher benefit for the last two years, but not for the earlier 28, since the higher benefit is not what he or she bargained for during all of his or her previous years of employment.

Consider then the case of pension benefit decreases. What are employees entitled to? Courts in several states have offered the suggestion, albeit without weighing the full implications thereof, that state workers have a contractual interest in the pension benefits as they exist on the date that a worker begins his or her career. These courts seem driven to such a conclusion out of the fear that employees who contributed to a pension system for, say, 5 or 10 years could then see those already-accrued benefits reduced or eliminated by the time they reached retirement.

Again, though, the prorated solution makes perfect sense: Consider the flip side of my initial analogy: imagine that the pension system includes a 3% COLA for the first year of an employee's 30-year career, but is reduced to a 2.5% COLA for the remaining 29 years of that employee's career. No court has faced exactly such a situation and thereupon held that such an employee would be entitled to the 3% COLA for his or her entire retirement, although several

courts have indeed said that their state constitutions protect pension benefits as of the date of employment.

Such a holding would make little sense. To return to the analogy to regular wages, if the salary for a job is \$30,000 during a worker's first year of work, but then is lowered to \$29,000 in year two and thereafter, no constitutional problem arises. True, if the state attempted to demand a refund of \$1,000 for salary paid during year one, that would be problematic, but it is presumptively constitutional to offer a lower salary on a going-forward basis. If the employee does not wish to work for the new and lower salary, he or she is free to seek employment elsewhere (thus providing a brake on any impulse for the state to lower salaries across the board).

The same logic applies in the pension context. If an employee was promised a 3% COLA only during one year of his career, but worked towards a 2.5% COLA for the overwhelming majority of his or her career, the employee's contractual entitlement is to a prorated COLA that was based on his or her one year of work under the 3%-COLA-system and his 29-year of work under the 2.5%-COLA-system.⁷

By the same token, though, the employee should be presumptively entitled to a prorated portion of whatever higher benefit had been promised for a given period of time. Thus, recent court decisions from Colorado and Minnesota arguably err in suggesting that state governments have the blanket power to reduce the COLA awarded to retirees all the way down to a new and lower level, regardless of any financial emergency and without taking into account how long those employees might have worked towards the previous higher benefit.

I have thus far merely described the default contractual protection that should apply to

⁷ The prorated average would be $[(29 \cdot .025) + (1 \cdot .03)]/30 = .02517$, or 2.517%.

state pensions. But under current constitutional doctrine, even valid state contracts can be abrogated in an emergency situation. Such a situation arguably exists in some states. In Rhode Island, for example, the state faces a \$9 billion underfunding problem, or around \$9,000 for every person in the state. As the state treasurer there has pointed out, the proportion of state taxes devoted to pensions is projected to rise to a stunning 20% in 2018, up from three percent in 2002.⁸ Without serious pension reform, the state of Rhode Island would not have enough money for many other state services, such as police, trash pickup, or schools.

Reducing benefits to retirees obviously upsets the reliance that retirees (most of whom are unfamiliar with actuarial calculations) may justifiably have had towards their pension benefits. At the same time, the constitution is not a suicide pact, as Justice Holmes famously said. State judges will therefore be faced with a difficult choice in times of strapped budgets: either affirm the limitation of benefits that retirees relied on in good faith, or order a state to shortchange schoolchildren and other recipients of state services in order to pay retirees for pensions that neither they nor anyone else ever funded fully.

So, then, the key principle is this: contractual protection ought to be offered to past benefit accruals (at most, and given the lack of a true emergency), but future benefit accruals can be changed in the same manner that future salaries can. The real challenge, however, is how to apply this key principle to actual cases – that is, to actual cases that have been litigated, and to actual reforms as to which the dividing line between past and future accruals is not always as clear as in the case of employee contributions. For example, it is not intuitively obvious how courts should treat raising the retirement age or changing the way that final average salary is calculated. The signal contribution of this dissertation is to examine numerous ways in which a

⁸ Gina Raimondo, *Truth in Numbers: The Security and Sustainability of Rhode Island's Retirement System* (May 2011), at 7.

state legislature could change future accruals or even change the pension system entirely, while still allowing contractual protection to past accruals.

The plan for the remainder of this dissertation is as follows: Chapter II presents the background on how state pensions work. Chapter III discusses the constitutional arguments that have been raised against pension reform and analyzes their merits. It elaborates on the arguments made above that existing caselaw is best and most reasonably interpreted as protecting pension benefits as contracts under state and federal constitutions, but *only* to the extent that a particular form or level of pension accrual was already applied to previous years of service. It also expands on the point that even with such protection in place as the default, courts may still appropriately decide to allow retiree benefits to be limited where these benefits were never fully paid for and where the deficits pose a dire threat to state budgets. Most significantly, several subsections examine in detail how courts should apply the Contracts Clause to several of the more analytically challenging types of pension reforms, such as changing the retirement age or moving to a contributory or hybrid system. Finally, Chapter IV analyzes pension reform legislation in several states and municipalities in more detail, with suggestions as to how to implement the principle of protecting past accruals while changing the terms applicable to future service.

II. BACKGROUND ON PENSIONS

A. *The Structure of Pensions*

In defined contribution plans, such as the 401(k)s that are familiar in the private sector, the employee contributes money to the account, that money is invested, and whatever exists in the account at retirement belongs to the employee – nothing more and nothing less. In a defined benefit plan, however, the system promises to pay a particular benefit during retirement, even if the present value of benefits is out of proportion to what the employee and employer are going to pay into the pension system.

A defined benefit pension is typically calculated as a percentage of final average salary (this can be the final year of work, or the average of some longer period, such as three or more years). The percentage is derived by applying a multiplier to the employee's years of service. Thus, for example, if a state employee retires with 30 years of service, with a final average salary of \$100,000, and with a multiplier in place of 2%, then the yearly pension payment will be 30 years times 2% times \$100,000 – that is, \$60,000 per year for the rest of the employee's life.⁹ The typical pension plan has various age and/or service requirements in order to retire with a full pension; in a given plan, for example, an employee might be able to retire after reaching age 65 with 10+ years of service, or after reaching 30 years of service regardless of age.¹⁰

Most pension plans also include some sort of cost-of-living allowance, or COLA, by which the pension payments paid to retirees increase over time. As we shall see below, some states have set a statutory COLA at a particular number (say, 2% per year), while others base the

⁹ See generally Douglas Fore, *Going Private in the Public Sector: The Transition from Defined Benefit to Defined Contribution Pension Plans*, in OLIVIA S. MITCHELL AND EDWIN C. HUSTEAD, EDS., *PENSIONS IN THE PUBLIC SECTOR* (2001), at 267-68.

¹⁰ See generally Olivia S. Mitchell, David McCarthy, Stanley C. Wisniewski, and Paul Zorn, *Developments in State and Local Pension Plans*, in OLIVIA S. MITCHELL AND EDWIN C. HUSTEAD, EDS., *PENSIONS IN THE PUBLIC SECTOR* (2001) 10, 21-22.

COLA on the rate of inflation, while others base it on inflation but with a cap, while still others have caps and floors on a cumulative adjustment.¹¹ A further distinction is whether the COLA is simple (that is, applied to the original base amount each year) or compounding (that is, applied to whatever the pension payment actually was in the previous year, with all previous COLAs having been applied to that payment as well).

Defined benefit plans are funded as follows: public employers (such as school districts) set aside a certain percentage of their payroll every year, while employees typically set aside a certain percentage of their salaries as well.¹² In many cases, however, the state employer “picks up” the employee contribution, in essence making both the employer and “employee” contribution at once. This is expressly allowed under the federal tax code, which provides that “where the contributions of employing units are designated as employee contributions but where any employing unit picks up the contributions, the contributions so picked up shall be treated as employer contributions.”¹³

This all may seem like a matter of semantics at first glance. If the employer offers a salary of \$45,000 and “picks up” an employee contribution requirement of \$5,000 per year, how is that any different from offering a salary of \$50,000 and demanding an employee contribution of \$5,000 per year? The answer is that when the employee makes a contribution to a defined benefit pension plan and it is defined as an “employee contribution” by the plan itself, income taxes and FICA (Social Security and Medicare) taxes are still owed on the amount contributed.

¹¹ *Id.*

¹² See Karen Steffen, *State Employee Pension Plans*, in OLIVIA S. MITCHELL AND EDWIN C. HUSTEAD, EDS., *PENSIONS IN THE PUBLIC SECTOR* (2001) 41, 43. The distinction between employee and employer contributions is semantic, of course; all of the money at issue comes from state taxes, whether or not it is first delivered to the employee under the heading of “salary.”

¹³ 26 U.S.C. § 414(h)(2).

But if the employer “picks up” the employee contribution, the employee owes no income or FICA taxes on the contribution.¹⁴ Further, if the employer pick-up is done for tax purposes and is taken out of the stated salary, the employee is entitled to withdraw it upon early retirement or withdrawal. Indeed, it is a little known fact that federal law does not recognize pre-tax employee contributions at all: even in the case of 401(k) plans, the federal tax code refers only to “employer contributions.”¹⁵

The employer and employee contributions (if any) in a given year do not represent the full dollar value that is expected to be paid out in pensions one day. Instead, the total contributions are typically limited to the “normal cost” of the pension system plus any extra employer contributions that go towards unfunded liabilities. The yearly “normal cost” of the pension system is simply the amount of money that represents the system’s best estimate of 1) what this year’s employees will one day be paid in pensions due to this year’s worth of work; and 2) what smaller amount of money needs to be set aside today in order to compound (via interest or investments) to pay the higher amount in (1).

We thus arrive at the concept of “accrual,” which has at least three different definitions. By the economic definition, as used in Costrell and Podgursky (2010), a year’s accrual refers to the amount by which the present value of pension benefits rises for one employee after one year of work, over and above interest on prior pension wealth and the employee’s own contributions, and based on the assumption that the employee then retires after that year. Prior to retirement eligibility, if an additional year of work at present entitles the employee to another 2% of his final average salary during each year of retirement, and if there is nothing deemed an “employee

¹⁴ See the IRS’s explanation at <http://www.irs.gov/govt/fslg/article/0,,id=181694,00.html> and http://www.irs.gov/publications/p560/ch04.html#en_US_publink10008974.

¹⁵ 26 U.S.C. § 401(k)(2)(B).

contribution,” then that year’s accrual would simply be the discounted value of that increment of 2% of final average salary. A further complication is that an extra year of employment in some cases affects the length of time that the employee will be expected to draw a pension: if the employee is currently eligible to retire, working another year adds to the yearly pension payment but subtracts one year from the amount of time that the employee will be receiving a pension before death, and that accordingly reduces the “accrual” during that year of work. Conversely, if an extra year of service helps the employee move closer to drawing the pension at an earlier age (say, under an early retirement option or a 25-and-out provision), the accrual for that year includes the extra years of pension payments.

There is a second and very different concept of accrual used by actuaries to calculate the normal cost of an employee’s pension. In the actuarial usage, accrual is not directly tied to the extra incremental payment that an employee is actually eligible to receive if he or she retired in any given year of employment. Instead, actuarial accrual is smoothed out such that it represents the normal cost of what should be contributed to the pension system each year so that, assuming the employee works until retirement age, the employee’s pension will be fully funded at that time.

In this dissertation, I rely on yet a third variant of “accrual,” as used by the federal tax code and ERISA. In those federal laws, an “accrued benefit” means one’s pension wealth expressed in the form of what it would cost to purchase an annuity at retirement age, discounted back to present value. This is obviously quite close to the economic concept of accrual used by Constrell and Podgursky, with the main difference being the inclusion of employee contributions in the total value of what is accrued during a given year.

ERISA sets out three alternative schedules for the accrual of benefits under private

defined benefit plans.¹⁶ First, a plan can provide that a worker's accrued benefit each year rises by a 3% increment of what his "normal retirement benefit" would be if he started working at the earliest possible age and worked until 65 or full retirement. Second, a plan can provide that the amount by which retirement benefits accrue in any one year is no more than 1 and 1/3 times the rate in which benefits accrue in any other year of the employee's career. Third, a plan can provide that if a worker leaves employment before retirement age, the plan must divide his actual years of employment by the total years that would have been necessary to reach the normal retirement age; then that fraction is multiplied by the retirement benefit he would have gotten if, at the date of separation, he had actually been completing a full career and retiring normally. In other words, if a worker leaves after 15 years of employment with 15 years left to reach the normal retirement age, his pension benefit would be calculated by pretending that he had actually just completed 30 years of employment ending at that particular salary, and then multiplying by ½ to account for the fact that he had worked only half a career. All of these standards ensure that accrual is fairly even throughout each worker's career. In other words, it is not legal under ERISA to structure a pension plan as are many governmental plans, letting workers accrue little if anything during their first ten or fifteen years of employment but then have a huge accrual bump at some later date.¹⁷

Whereas accrual is about the "*amount* of the benefit to which the employee is entitled," vesting is about "when an employee has a *right* to a pension."¹⁸ Vesting generally refers to giving the employee a guaranteed entitlement to part or all of the accrued benefits arising from

¹⁶ 29 U.S.C. § 1054(b)(1).

¹⁷ Robert M. Costrell and Michael Podgursky, "Distribution of Benefits in Teacher Retirement Systems and Their Implications for Mobility," *Education Finance and Policy* (2010): 519-557.

¹⁸ *Stewart v. National Shopmen Pension Fund*, 730 F.2d 1552, 1562 (D.C. Cir. 1984).

employer contributions. Black's Law Dictionary defines "vested" as "[h]aving become a completed, consummated right for present or future enjoyment; not contingent; unconditional; absolute."¹⁹ Under the federal tax code – which here does not apply to governmental plans²⁰ -- the following standards apply. First, an employee must always have a "nonforfeitable" right to his own contributions.²¹ Second, in the case of a defined benefit plan, one of two vesting standards must be satisfied, by either of which the employee has a right to the accrued benefit arising from employer contributions: 100% at 5 years of service, or a 20%-40%-60%-80%-100% schedule for years three through seven of employment.

In pension jurisprudence, "vesting" is often treated as essentially synonymous with the question whether the pension is "contractual"²² – if a pension benefit is "vested," then it presumptively receives constitutional protection, and vice versa.²³ That said, various state courts have used a quite different sense of "vesting," by which vesting occurs at the time of retirement, not before. For example, one state court has found that "although we find vested rights, we do not find contractual rights," on the theory that for "vesting" to become "mature," the final statutory condition of actually retiring must be met first.²⁴

Any employer and employee contributions become part of the current assets of the pension system, and are invested in any number of ways (stocks, bonds, real estate, hedge funds, etc.), depending on the pension system's choices. The asset base of the pension system is then

¹⁹ Black's Law Dictionary (8th Ed. 2004).

²⁰ 26 U.S.C. § 411(e)(1)(A).

²¹ 26 U.S.C. § 411(a)(1).

²² *Pineman v. Oechslin*, 488 A.2d 803 (Conn. 1985).

²³ *White v. Davis*, 68 P.3d 74, 99 (Cal. 2003) ("Once vested, the right to compensation cannot be eliminated without constitutionally impairing the contract obligation.").

²⁴ *Pierce v. State of New Mexico*, 910 P.2d 288, 302 (N.M. 1995); see also *Robinson v. Taylor*, No. 99-1428 (Ark. 2000).

assumed to grow at some rate of return for the indefinite future. Pension systems have typically assumed a rate of return in the vicinity of 8%, although a few systems have begun to lower that estimate due to the recent economic downturn.

Unfunded liabilities arise when the actuarial liabilities of the system exceed both the future normal contributions and the current actuarial assets. Until fairly recently, the value of the assets used for actuarial purposes has not been the current market value, but the “actuarial value” of the assets, which means average value over a rolling period of three to five or more years depending on the choices made by state law or a pension board. By using a rolling average, the actuarial value does not fluctuate wildly every time the market swings up or down. That said, a new GASB rule will eliminate this type of asset smoothing for purposes of financial reporting.

On the liabilities side, actuaries calculate what the pension system expects to be paying out to retirees over time given whatever benefits have been accrued via past service to date. This is a calculation that involves a huge number of assumptions, such as how many employees will continue in service, when they will retire, what their salaries will be at retirement, what their life expectancies will be, and the like.

Finally, the unfunded actuarial liability is found by comparing the total actuarial liabilities to the expected value that the actuarial assets will have when they are needed to pay out pensions plus the future normal contributions to the pension system.²⁵ If assets plus future contributions will not be enough to pay for pensions as they come due, then the pension system has an unfunded actuarial liability that must be paid down over time. As noted above, state pensions and retiree healthcare systems have a collective \$1.26 trillion in unfunded liabilities as of early 2011, according to the Pew 2011 report.

²⁵ See generally Mitchell et al., *supra* note 10 at 25; 29 U.S.C. § 1002(29) and (30) (defining accrued liability and unfunded accrued liability).

The unfunded liabilities, however one calculates them, do not need to be paid off in one fell swoop, but rather can be paid over a 20- or 30-year amortization period. Even so, this collective underfunding is likely to be a significant financial strain on state budgets in the years ahead. As Novy-Marx and Rauh have pointed out, “Without policy changes, contributions to these systems would have to immediately increase by a factor of 2.5, reaching 14.2% of the total own-revenue generated by state and local governments (taxes, fees and charges). This represents a tax increase of \$1,398 per U.S. household per year, above and beyond revenue generated by expected economic growth.”²⁶

B. Private Pensions vs. Public Pensions

1. Regulatory Treatment

Private and public pension systems are subject to very different regulatory structures under federal law. Private pension plans are governed by the Internal Revenue Code and by ERISA, which often mirror each other. Public pension plans, by contrast, are generally left unregulated by ERISA, and are subject only to parts of the Internal Revenue Code.

The Employment Retirement Income Security Act, or ERISA, was enacted in 1974 out of a desire to address many abuses that occurred in private pension plans.²⁷ Congress specifically found “that despite the enormous growth in such plans many employees with long years of employment are losing anticipated retirement benefits owing to the lack of vesting provisions in such plans; that owing to the inadequacy of current minimum standards, the soundness and stability of plans with respect to adequate funds to pay promised benefits may be endangered; that owing to the termination of plans before requisite funds have been accumulated, employees

²⁶ Robert Novy-Marx and Joshua D. Rauh, *The Revenue Demands of Public Employee Pension Promises*, NBER Working Paper (June 2011), at 1.

²⁷ See generally H.R. Rep. No. 533, 93d Cong., 2d Sess., reprinted in 1974 U.S. Code Cong. & Ad. News 4639.

and their beneficiaries have been deprived of anticipated benefits.”²⁸ Congress specifically exempted “governmental plans” from all of ERISA’s provisions.²⁹

Title I of ERISA³⁰ contains the substantive and procedural requirements that private pension plans must follow. Title II of ERISA is codified in the Internal Revenue Code,³¹ and contains requirements about how pension plans qualify for favorable income tax treatment. Finally, Title III³² contains certain administrative and enforcement provisions, while Title IV³³ establishes the Pension Benefit Guaranty Corporation, which insures pension plans that terminate without enough assets to pay the promised pension benefits.

Title I is the main source of regulatory obligations for private pensions. As for reporting and disclosure obligations, pension plans must provide all participants with a summary plan description,³⁴ file annual and supplemental reports with the Secretary of Labor,³⁵ notify participants if the minimum funding standard is not met,³⁶ provide annual funding reports to participants and to the Pension Benefit Guaranty Corporation,³⁷ provide pension benefit

²⁸ 29 U.S.C. § 1001(a).

²⁹ 29 U.S.C. § 1003(b)(1) (“The provisions of [Title I] shall not apply to any employee benefit plan if—such plan is a governmental plan.”). Instead, ERISA expressly states that Congress wishes to study state and municipal plans in the future, including “(1) the adequacy of existing levels of participation, vesting, and financing arrangements, (2) existing fiduciary standards, and (3) the necessity for Federal legislation and standards with respect to such plans.” 29 U.S.C. § 1231(a).

³⁰ 29 U.S.C. §§ 1001 et seq.

³¹ 26 U.S.C. §§ 401 et seq.

³² 29 U.S.C. §§ 1201 et seq.

³³ 29 U.S.C. §§ 1301 et seq.

³⁴ 29 U.S.C. § 1021(a)(1).

³⁵ *Id.* § 1021(b).

³⁶ *Id.* § 1021(d).

³⁷ *Id.* § 1021(f).

statements to individual participants at least every three years for defined benefit plans (or quarterly for employees who are investing their own accounts),³⁸ and more.

As for participation and vesting obligations, private pension plans have to follow specific guidelines. For example, pension plans must generally be available to all employees who have turned 21 or completed one year of service (or two years, if employees are fully vested at that time).³⁹ Pension plans must protect employees' own contributions as "nonforfeitable,"⁴⁰ and in the case of defined benefit plans, must allow the employees to be 100% vested in the employer's contribution by 5 years of service (or under an alternative vesting schedule in the statute).⁴¹ For employees in a defined benefit plan, the yearly benefits (as a percentage of what the total pension benefit would be at retirement age) have to be accrued at one of three possible rates during the employee's career.⁴² Vested participants in a pension plan must be given certain survivor benefits.⁴³ Finally, as for funding obligations, private employers who offer a defined benefit plan must make the "minimum required contribution" to the plan each year.⁴⁴ This minimum contribution is based on the plan's normal cost (the cost of funding each year's accrued benefits) and any amortization costs for shortfalls.⁴⁵

Turning to the Internal Revenue Code, section 401(a) includes various requirements that private plans must meet in order to receive favorable tax treatment. A plan that meets all of the

³⁸ *Id.* § 1025(a).

³⁹ *Id.* § 1052(a).

⁴⁰ *Id.* § 1053(a)(1).

⁴¹ *Id.* § 1053(a)(2).

⁴² *Id.* § 1054(b).

⁴³ *Id.* § 1055.

⁴⁴ *Id.* § 1082(a)(2).

⁴⁵ *Id.* § 1083(a).

requirements is referred to as a “qualified plan.” The plan must be in writing,⁴⁶ and the assets of the plan must be held in trust.⁴⁷ The Code also provides such plans must follow certain participation standards⁴⁸ and must not discriminate in favor of highly compensated employees.⁴⁹ The Code imposes maximum vesting periods,⁵⁰ and specifies benefit accrual standards that must be followed.⁵¹ There are also dollar amount limits on the contributions to and benefits that can be paid from such plans, as well as the compensation levels that can be taken into account in calculating such amounts.⁵² Benefits offered under such plans are protected against retroactive reductions, as well as from the reach of creditors.⁵³ In addition, the Code provides a complex set of rules addressing both the form and timing of plan benefit distributions.⁵⁴

Governmental plans, however, are specifically exempt from many qualification rules. The main qualification requirements for a governmental plan are that it must be established and maintained by the employer for the exclusive benefit of the employer’s employees or their beneficiaries⁵⁵; provide definitely determinable benefits⁵⁶; satisfy the eligible rollover rules⁵⁷; limit compensation in accordance with section 401(a)(17); comply with required minimum

⁴⁶ I.R.C. § 401(a); Treas. Reg. §1.401-1(a)(2).

⁴⁷ I.R.C. §§ 401(a)(1), (3), (5).

⁴⁸ *Id.* §§ 401(a)(3), 410.

⁴⁹ *Id.* § 401(a)(4).

⁵⁰ *Id.* §§ 401(a)(7), 411(a).

⁵¹ *Id.* §§ 401(a)(7), 401(a)(35), 411(b).

⁵² *Id.* §§ 401(a)(16), (17), (30), 402(g)(1), 404, 415.

⁵³ *Id.* §§ 401(a)(7), 411(d)(6), 401(a)(13).

⁵⁴ *Id.* §§ 401(a)(9), 401(a)(11), 417.

⁵⁵ *Id.* § 401(a).

⁵⁶ *Id.* § 401(a)(25).

⁵⁷ *Id.* § 401(a)(31).

distribution rules⁵⁸; fully vest benefits upon a plan termination⁵⁹; and comply with section 415 benefit limitations.⁶⁰ Notably, governmental plans do not have to comply with the more stringent vesting requirements applicable to private employer plans,⁶¹ nor with nondiscrimination rules⁶² or various benefit protections such as the minimum funding standards.⁶³

Why does federal law so broadly exempt state and municipal plans from these many requirements in ERISA and the tax code? As the Second Circuit has noted,⁶⁴ ERISA's governmental exemption arose for at least three reasons, which also apply to the Tax Code: First, Congress thought that private plans were more likely than public plans to incorporate unduly restrictive and unfriendly provisions towards employees, and hence private sector employees would need more protection in the form of regulating all of the terms and conditions of pension plans.⁶⁵ Second, Congress believed that "the ability of the governmental entities to fulfill their obligations to employees through their taxing power" eliminated much of the need to regulate how governmental pension plans were funded.⁶⁶ Third, Congress worried that imposing minimum funding and similar standards would "entail unacceptable cost implications to governmental entities."⁶⁷

⁵⁸ *Id.* § 401(a)(9).

⁵⁹ *Id.* § 401(a)(10).

⁶⁰ *Id.* § 401(a)(16).

⁶¹ *Id.* § 411(e)(1)(A) (exempting governmental plans from minimum vesting standards).

⁶² *Id.* § 410(c)(1)(A) (exempting governmental plans from participation rules).

⁶³ *Id.* § 412(e)(2)(C) (exempting governmental plans from funding standards).

⁶⁴ *Rose v. Long Island R.R. Pension Plan*, 828 F.2d 910, 914 (2d Cir. 1987).

⁶⁵ H.R. Rep. No. 533, 1974 U.S. Code Cong. & Ad. News at 4667.

⁶⁶ S. Rep. No. 383, 93d Cong., 2d Sess., reprinted in 1974 U.S. Code Cong. & Ad. News 4890, 4965; H.R. Rep. No. 807, 93d Cong., 2d Sess. reprinted in 1974 U.S. Code Cong. & Ad. News 4670, 4756-57.

⁶⁷ H.R. Rep. No. 807, 1974 U.S. Code Cong. & Ad. News at 4830; *see also* H.R. Rep.

Of course, underlying all of these three reasons was the idea that federal regulation of state pension plans would present federalism concerns. Congress wanted to avoid the intrusion of imposing too much national oversight of state and municipal pension plans⁶⁸ After all, these plans are established and primarily regulated by state legislatures, and Congress does not lightly presume that state legislatures' regulation of such matters needs to be overridden by federal regulation.

2. How Private and Public Pension Plans Are Structured

As of 2008, there are “over 2,500 different public employee retirement systems providing benefits to the over 20 million individuals employed in the public sector.”⁶⁹ The majority of these systems (1,659 of them) are municipal, while 218 exist at the state level.⁷⁰ Although these state pension systems are diverse in some respects, some broad generalities remain true.

With only a handful of exceptions that have traditionally been optional, state pension systems consist of defined benefit plans, not defined contribution plans.⁷¹ In sharp contrast,

No. 533, 1974 U.S. Code Cong. & Ad. News at 4668.

⁶⁸ *Rose v. Long Island R.R. Pension Plan*, 828 F.2d 910, 914 (2d Cir.1987); *see also Roy v. Teachers Insurance and Annuity Ass'n v. College Retirement Equities Fund*, 878 F.2d 47, 50 (2d Cir. 1989) (“We think it clear that the congressional goal of preserving federalism requires that when a pension plan has been established by a governmental entity for its employees and the governmental entity’s status as employer has not changed, the plan must be exempt from ERISA as a governmental plan.”).

⁶⁹ John Beshears, James J. Choi, David Laibson, and Brigitte C. Madrian, *Behavioral Economics Perspectives on Public Sector Pension Plans*, NBER Working Paper No. 16728 (Jan. 2011), at 4 (citing data from the U.S. Census Bureau and the U.S. Bureau of Labor Statistics), available at http://www.nber.org/papers/w16728.pdf?new_window=1.

⁷⁰ See U.S. Census Bureau, Table 5a, “Number and Membership of State and Local Public Employee Retirement Systems by State: Fiscal Year 2008,” available at <http://www.census.gov/govs/retire/2008ret05a.html>.

⁷¹ See the nationwide map here: <http://www.ncsl.org/issues-research/employment-working-families/state-defined-contribution-hybrid-retirement-plans.aspx>; Edwin C. Husted and Olivia S. Mitchell, *Public Sector Pension Plans: Lessons and Challenges for the Twenty-First Century*, in OLIVIA S. MITCHELL AND EDWIN C. HUSTEAD, EDS., *PENSIONS IN THE PUBLIC*

private pension plans, which used to be defined benefit for the most part, have overwhelmingly been transformed or replaced by cash balance or defined contribution plans.

What makes states choose defined benefit plans over defined contribution plans? There are at least three reasons. First, the advantage of a defined benefit plan as currently structured is that it can provide a comfortable living for retirees who spent their entire career working within a single state. The prospect of receiving a defined pension benefit can encourage workers to stay long-term in a particular job, reducing turnover and any associated costs with training new workers. If certain workers benefit from experience such that they become more and more valuable over time, and if such workers might otherwise be tempted to earn more income elsewhere based on that valuable experience, states might rationally wish to give those workers an incentive to remain in state employment for the long-term. This rationale appeals to a traditional view of public service as a lifetime calling, one in which public servants accept lower wages in exchange for having a meaningful pension in their old age.

Second, defined benefit plans have been adopted out of the desire to shift risk. Having a guaranteed benefit is beneficial to many employees, in that it displaces any risk of bad investments or inadequate savings onto the state and ultimately onto the taxpayer. With a defined benefit plan, that is, individual workers typically do not have to worry if the plan is underfunded due to insufficient contributions or poor investment performance, because the government provides a backstop against any losses. By contrast, a defined contribution plan places more risk onto the individual workers, whose pension payments could be reduced if their investments turn out to be less profitable than expected or if their contributions were not sufficient to last for their entire retirement years.

SECTOR(2001), at 3, 4; Beshears et al., *supra* note 69 at 4-5.

Third, a different political element might be at issue as well: public choice theory and the ability of concentrated interest groups to extract money from the public fisc while taxpayers at large have a much more diffuse incentive to oppose such spending. Given overly-optimistic assumptions about how fast the money set aside today will grow, defined benefit plans allow today's legislators to promise an ever-higher level of benefits while leaving the problem of actually paying for the benefits to tomorrow's legislators. One of many examples can be seen in California, which in 1999 passed what became known as the "3% at 50" rule,⁷² which allowed police and fire employees to retire by age 50 with a pension equal to their years of service times 3% of their final salary (the multiplier had previously been 2%). This increased benefit was even made retroactive, such that police or fire employees on the eve of retirement could retire with this new benefit in place, even though neither they nor anyone else had ever set aside nearly enough money to pay for it. This new increased benefit is to blame for driving at least one California city into bankruptcy.⁷³ At the time, however, CalPERS essentially claimed that the rising stock market would make the expansion in benefits cost little or nothing: "CalPERS told legislators that state costs would not rise above the previous year's rate for a decade. Its actuaries actually did forecast that costs could soar if investment earnings fell – but the 17-page brochure CalPERS gave to legislators only reflected the optimistic scenario"⁷⁴

Today's defined benefit plans do harm some employees, however: those who do not spend their entire careers within state government, or who move between states. Consider, for

⁷² See, e.g., <http://www.porac.org/3percent@50.html>.

⁷³ Bobby White, "California Cities Cut Police Budgets," *Wall Street Journal*, 31 Oct. 2008, available at <http://online.wsj.com/article/SB122540831980086085.html>. That article notes, "By 2007, 80% of Vallejo's budget was dedicated to police and firefighters."

⁷⁴ Teri Sforza, "9/11 Legacy: Enormous Public Safety Pensions," *OC Watchdog*, 11 Sept. 2011, available at <http://taxdollars.ocregister.com/2011/09/11/911-legacy-enormous-public-safety-pensions/96425/>.

example, what happens to a new teacher who either changes careers or moves to another state before the vesting period (sometimes five or seven years) has expired. She may be able to get her own contributions back from the pension system, but she loses any right to obtain a pension at retirement, and has to start over somewhere else. Even if she works past the vesting period before moving or quitting – say, for 15 years – she is still relatively harmed. While she may eventually obtain a pension at retirement age based on those 15 years of service, the pension will likely be *much less* than a pro rata portion of a full pension benefit.⁷⁵ If she then participates for 15 years in the teacher pension system in another state, her total pension will be much less than what she would have gotten had she spent the full 30 years in either state.

As economists Costrell and Podgursky have shown by analyzing the pension systems of six states in detail, “teachers who split a thirty-year career between two pension plans often lose over half their net pension wealth compared with teachers who complete a career in a single system.”⁷⁶ Today’s defined benefit plans are therefore disadvantageous to teachers who are more mobile or have worked (or will work) in different careers, and whose participation in the pension system is used to subsidize older workers who stay within the same state for their entire career.

This unfairness to mobile workers is not an *inherent* feature of defined benefit plans, however. Rather, it is due to highly uneven accrual and vesting patterns, whereby the early years of a worker’s career carry little or no entitlement to any pension but the later years of a career provide a huge boost to the pension payment.

One alternative type of defined benefit plan that smooths out the economic accrual

⁷⁵ See Fore, *supra* note 9 at 274-75.

⁷⁶ Robert M. Costrell and Michael Podgursky, “Distribution of Benefits in Teacher Retirement Systems and Their Implications for Mobility,” *Education Finance and Policy* (2010): 519-557.

pattern is known as a “cash balance” plan. In cash balance plans, the state pension system provides each worker with a notional investment account whose value is based on the employee and employer contributions. The state then guarantees the employee a particular rate of return (such as 5%, as is the case for Nebraska’s cash balance plan⁷⁷). Thus, cash balance plans leave the risk of investment loss on the state rather than the worker, but are much more fiscally sustainable than today’s defined benefit plans. That is, because the benefit is ultimately based on the actual contributions made by the employee and/or employer, politicians are less likely to enact a new benefit that is retroactive and wildly in excess of any contributions that have ever been made. At the same time, cash balance plans are still technically “defined benefit” plans under federal law, and are regulated as such.

III. AN ASSESSMENT OF THE CONSTITUTIONAL ARGUMENTS AGAINST REFORM

A. *The Contracts Clause*

The major complaint about pension reform is that it violates the U.S. Constitution’s Contracts Clause, which states that “No State shall . . . pass any . . . Law impairing the Obligation of Contracts.” Federal contracts clause cases revolve around the following inquiry: “(1) Does a contractual relationship exist, (2) does the change in the law impair that contractual relationship, and if so, (3) is the impairment substantial?”⁷⁸ State contracts clauses are usually interpreted and applied in parallel with that of the U.S. Constitution.⁷⁹

⁷⁷ See Andrew Biggs, “Public Sector Pensions in Nebraska: Are Cash Balance Plans the Answer?,” Platte Institute Policy Study (Oct. 2011), available at http://www.platteinstitute.org/docLib/20111212_Public_Sector_Pensions_in_Nebraska.pdf.

⁷⁸ *Koster v. City of Davenport, Iowa*, 183 F.3d 762, 766 (8th Cir. 1999) (quoting *Honeywell, Inc. v. Minn. Life and Health Ins. Guar. Assoc.*, 110 F.3d 547, 551 (8th Cir. 1997) (en banc)).

⁷⁹ See, e.g., *Jacobsen v. Anheuser-Busch, Inc.*, 392 N.W.2d 868, 872 (Minn. 1986) (under state contracts clause, “a court initially considers whether the state law has, in fact, operated as a substantial impairment of a contractual obligation,” and if a substantial impairment is found,

Even if legislation abridges a contractual right, that does not doom the legislation to unconstitutionality. Instead, the court must ask whether “the State, in justification, [has] a significant and legitimate public purpose behind the regulation, such as the remedying of a broad and general social or economic problem.”⁸⁰ This requirement guarantees that “the State is exercising its police power, rather than providing a benefit to special interests.”⁸¹ Even while courts have a presumption against construing a statute so as to create contractual obligations, once a statute has been so construed, courts may then be *more* wary of the state’s justification for changing a contract to which it is a party: “Courts defer to a lesser degree when the State is a party to the contract because the State’s self-interest is at stake.”⁸²

State and federal contracts clauses are the most likely avenue of success for any lawsuit seeking to block pension reform. But as we shall see, judicial opinions are often couched in language that is far overstated compared to the actual situations before the court. Given the financial situation affecting state and municipal pension systems today, state courts should take

“those urging the constitutionality of the legislative act must demonstrate a significant and legitimate public purpose behind the legislation”); *R.I. Bd. of Corr. Officers v. Rhode Island*, 264 F. Supp. 2d 87, 92 (D.R.I. 2003). Even New Hampshire, whose state constitution lacks an express contracts clause, applies the federal test. *See Tuttle v. N.H. Med. Malpractice Joint Underwriting Ass’n*, 159 N.H. 627, 641 (2010).

⁸⁰ *Energy Reserves Group, Inc. v. Kan. Power & Light Co.*, 459 U.S. 400, 411 (1983).

⁸¹ *Id.* at 411-12 (citation omitted); *see also Denning v. Kansas Public Employees Retirement System*, 285 Kan. 1045, 180 P.3d 564, 570 (2008) (“[O]ur precedent has recognized that there may be times when pension system changes are necessary for the greater good, even if an individual employee or retirant may suffer some marginal disadvantage. Changes may be made, for example, to protect the financial integrity of the system or for some other compelling reason. Changes may be necessary to preserve or protect the pension system; to maintain flexibility; to permit necessary adjustments due to changing conditions; to protect the beneficial purpose of the system; to maintain the system on a sound actuarial basis or by reason of administrative necessity.”) (internal quotation marks and citation omitted).

⁸² *United States Trust*, 431 U.S. at 25-26; *Energy Reserves Group*, 452 U.S. at 412 n.14 (“When a State itself enters into a contract, it cannot simply walk away from its financial obligations.”).

the opportunity to reinterpret past precedent consistent with the theory that workers have a constitutional right to the pension benefits that were accrued during their working years – which includes a prorated portion of benefits that were increased in mid-career – *no more and no less*. As the Arkansas Supreme Court once said in a retirement benefit case, “The permissible changes, amendments and alterations provided for by the Legislature can apply only to conditions in the future, and never to the past.”⁸³ This should be the baseline protection, but not a guarantee that stands even in situations of dire economic emergencies.

A substantial question is how prorating would be accomplished as to any given pension reform – COLA reductions, contribution increases, multiplier reductions, retirement age increases, and conversions of defined benefit plans to alternative plans (cash balance, defined contribution, or hybrid plans). That is one of the main questions that this dissertation attempts to answer.

1. Is There a Contract At All?

First questions first: does a contractual relationship exist? That is, are state pension benefits really a “contract” in the first place?⁸⁴

As an initial matter, there is the question of whether state pension laws are really “contracts” at all. After all, in the typical case, public employees and state governments have not literally sat down at a bargaining table and signed a literal contract. Instead, the state legislature

⁸³ Jones v. Cheney, 253 Ark. 926, 933, 489 S.W.2d 785, 789-90 (Ark. 1973).

⁸⁴ An additional preliminary question is whether legislation is at issue or not. It has long been held by federal courts that the contracts clause is aimed only at state legislation, not at “the decisions of its court, or the acts of administrative or executive boards or offices, or the doings of corporations or individuals.” New Orleans Waterworks Co. v. La. Sugar Ref. Co., 125 U.S. 18, 30 (1888). Thus, a court must “first consider whether . . . there is shown on [the] record any act of state legislation.” St. Paul Gaslight Co. v. City of St. Paul, 181 U.S. 142, 147 (1901); see also Skoutelas v. Port Authority of Allegheny County, 2008 U.S. Dist. LEXIS 31704, *9-*10 (W.D. Pa. 2008).

has enacted a pension law creating a pension system with certain terms and conditions. The argument, therefore, is that when people elect to accept public employment given a particular pension law then in existence, that pension law somehow transforms into what is effectively an employment “contract” between the government and the individual.

The U.S. Supreme Court has explained that “absent some clear indication that the legislature intends to bind itself contractually, the presumption is that a law is not intended to create private contractual or vested rights but merely declares a policy to be pursued until the legislature shall ordain otherwise.”⁸⁵ Moreover, the party asserting the existence of a contract bears the burden of overcoming this presumption.⁸⁶ Indeed, “normally state statutory enactments do not of their own force create a contract with those whom the statute benefits” because the potential “constraint on subsequent legislatures” is so significant.⁸⁷

Historically, public pensions were viewed as a gratuity that imposed no legal obligation on the state whatsoever.⁸⁸ Indeed, as recently as 2000, the Arkansas Supreme Court said that a pension funded entirely by the employer, rather than by employee contributions, was “merely a gratuitous allowance.”⁸⁹

Throughout the middle of the 20th century, however, most states had abandoned the old gratuity approach.⁹⁰ Today, most state courts have held that pension laws are effectively

⁸⁵ *National Railroad Passenger Corp. v. Atchison, Topeka & Santa Fe Railway Co.*, 470 U.S. 451, 465-66 (1985).

⁸⁶ *Id.* at 466.

⁸⁷ *Parella v. Ret. Bd. of the Rhode Island Employees’ Ret. Sys.*, 173 F.3d 46, 60 (1st Cir. 1999) (quoting *Hoffman v. City of Warwick*, 909 F.2d 608, 614 (1st Cir. 1990)).

⁸⁸ *See, e.g., Mell v. State of Ohio*, 130 Ohio St. 306, 199 N.E. 72 (1935).

⁸⁹ *Robinson v. Taylor*, 342 Ark. 459, 29 S.W.3d (2000).

⁹⁰ Note, “Public Employee Pensions in Times of Fiscal Distress,” 90 HARV. L. REV. 992, 994-1003 (1977).

contracts on the theory that government has offered compensation, and the individual has accepted that compensation in exchange for his or her work. Such an arrangement basically mimics an employment contract, even if the terms are printed in a collection of statutes rather than in a separate “contractual” document. Indeed, several state constitutions, including in Michigan and New York, have been amended to expressly designate public pensions as a contract.⁹¹

Other states’ contractual protection arises from state court rulings or state statutes. For example, the Massachusetts “retirement system” has been held to “create[] a contractual relationship between its members and the State.”⁹² By statute, most pension provisions (including the definition of “wages”) “shall be deemed to establish . . . a contractual relationship under which members who are or may be retired . . . are entitled to contractual rights and benefits, and no amendments or alterations shall be made that will be deprive any such member or any group of such members of their pension rights or benefits provided for thereunder.”⁹³ The Massachusetts Supreme Judicial Court has explained that the term “contract” is best understood “in a special, somewhat relaxed sense,” *i.e.*, “as meaning that the retirement scheme has generated material expectations on the part of employees and those expectations should in substance be respected.”⁹⁴

As for the specific states that have recently been sued, courts have taken both sides as to whether state pension systems create a contractual benefit or not. Massachusetts has already

⁹¹ *See, e.g.*, Alaska Const. art. XII, § 7; Hawaii Const. art. XVI, § 2; Ill. Const. art 13, § 5; Mich. Const. art. IX, § 24; N.Y. Const. art. V, § 7.

⁹² *Madden v. Contributory Retirement Appeal Bd.*, 431 Mass. 697, 720 N.E.2d 1095, 1098 (2000).

⁹³ Mass. General Laws, chapter 32, § 25.

⁹⁴ *Opinion of the Justices*, 364 Mass. 847, 861-862, 303 N.E.2d 320 (1973).

recognized contractual protection for its state pension system, as noted above. The Colorado Supreme Court has found that “rights which accrue under a pension plan are contractual obligations which are protected under article II, section 11, of the Colorado Constitution.”⁹⁵ The South Dakota Supreme Court has likewise held that pensions are considered a form of contract.⁹⁶

Only a few states have said that their pension benefits are not contractual, at least not for constitutional purposes. The reasoning usually starts from the premise, long acknowledged in federal constitutional cases, that a statutory enactment is generally presumed not to create “contractual or vested rights but merely declares a policy to be pursued until the legislature shall ordain otherwise. . . . Policies, unlike contracts, are inherently subject to revision and repeal, and to construe laws as contracts when the obligation is not clearly and unequivocally expressed would be to limit drastically the essential powers of a legislative body.”⁹⁷ As the First Circuit has noted, “Finding a public contractual obligation has considerable effect. It means that a subsequent legislature is not free to significantly impair that obligation for merely rational reasons. Because of this constraint on subsequent legislatures, and thus on subsequent decisions by those who represent the public, there is, for the purposes of the Contract Clause, a higher burden to establish that a contractual obligation has been created.”⁹⁸

Thus, in Maine, the state supreme court has held that while retirement benefits may be a form of property that cannot be taken away without due process, they nonetheless fall short of a

⁹⁵ Colorado Springs Fire Fighters Ass’n, Local 5 v. City of Colorado Springs, 784 P.2d 766, 770 (Colo. 1989) (en banc).

⁹⁶ Tait v. Freeman, 74 S.D. 620, 57 N.W.2d 520 (1953).

⁹⁷ National R.R. Passenger Corp. v. Atchison, Topeka & Sante Fe Ry, 470 U.S. 451, 456-66 (1985) (quoting Dodge v. Board of Educ. , 302 U.S. 74, 79 (1937)); *see also* Koster v. City of Davenport, 183 F.3d 762, 766-67 (8th Cir. 1999) (finding no contractual right to an Iowa pension plan).

⁹⁸ Parella v. Retirement Bd. of Rhode Island Employees’ Retirement System, 173 F.3d 46, 60 (1st Cir. 1999).

full contractual right: “[t]o rule otherwise would prohibit the State from amending its retirement plan without giving many years of notice and would unduly restrict the power of the legislature.”⁹⁹ The Connecticut Supreme Court has said that “[i]f that reasoning were carried to its logical conclusion, the state would be powerless to reduce the pay or shorten the tenure of any state employee without posing a possible contract clause violation.”¹⁰⁰

As an example of how exactingly courts might look for a clear statement of contractual liability, consider the First Circuit’s ruling in *Parker v. Wakelin*.¹⁰¹ Maine had revised its teachers’ pension system by, among other things, requiring vested members to contribute at a higher rate, capping salary increases that would be used to calculate teachers’ pensions, and delaying the first COLA by 6 months for future retirees.¹⁰² At the time, Maine law provided that “no amendment . . . may cause any reduction in the amount of benefits which would be due a member . . . on the date immediately preceding the effective date of the amendment.” In the First Circuit’s view, the word “due” could easily have meant payments that were *immediately due* to a retiree, not the *mere prospect* of future payments. Thus, the Maine statute had not “unmistakably” given current workers a contractual right to avoid any increased contributions or other changes to their future pensions.¹⁰³

The above analysis, however, seems to miss the boat in a significant way: the First Circuit seemed to assume that allowing “contract rights” at all would prevent Maine from raising

⁹⁹ *Spiller v. State of Maine*, 627 A.2d 513, 517 & n.12 (Me. 1993); *see also Parker v. Wakelin*, 123 F.3d 1, 7-9 (1st Cir. 1997) (finding no contractual right to the benefits of Maine’s pension plan).

¹⁰⁰ *Pineman v. Oechslin*, 488 A.2d 803, 809-10 (Conn. 1985).

¹⁰¹ 123 F.3d 1 (1st Cir. 1997).

¹⁰² *Id.* at 3.

¹⁰³ *Id.* at 8-9.

the contribution rate for future payments into the system; since the court viewed an increase in contribution rates as a reasonable policy that had not been forsworn by the state, it rejected “contract rights.” But treating pension plans as providing a contractual guarantee need not mean that pension benefits are set in stone forever. Rather, it would merely mean that pension benefits *already accrued* by a given employee cannot be taken away (barring a financial emergency). Even if pensions are treated as contracts in that sense, states would retain the right to raise contribution rates or otherwise amend the pension benefit scheme on a going-forward basis, just as the state can amend the wage schedule or the health insurance package or any other aspect of employment as long as it does not take away past benefits. But given the First Circuit’s cramped view of what “contract rights” would mean, it ended up using language that would allow the state to take away past and already-accrued benefits.

In any event, the vast majority of states treat pension laws as creating a contractual entitlement to *something*. As seen in the next section, the real question is what that *something* is.

2. What Does the Contract Actually Protect?

Even if pension benefits in a given state are a form of contractual obligation, that is only the beginning of the analysis. A much more important question is *what* the contract actually protects. As the U.S. Supreme Court has noted, “we begin by identifying the precise contractual right that has been impaired and the nature of the statutory impairment.”¹⁰⁴

In a number of states, including New York, courts have actually suggested that public employees have a contractual right to the pension terms in existence *as of the date of employment*.¹⁰⁵ For example, in one case, the California Supreme Court held that “[a] public

¹⁰⁴ *Keystone Bituminous Coal Ass’n v. DeBenedictis*, 480 U.S. 470, 504 (1987).

¹⁰⁵ *See, e.g., Calabro v. City of Omaha*, 531 N.W.2d 541, 551 (Neb. 1995) (“We now adopt the California rule as the rule in Nebraska and hold that a public employee’s

employee's pension constitutes an element of compensation, and a vested contractual right to pension benefits accrues upon acceptance of employment. Such a pension right may not be destroyed, once vested, without impairing a contractual obligation of the employing public entity."¹⁰⁶ In another case, the Arizona Supreme Court held that "[o]ther states, and we believe those having the better rationale, have reached the same conclusion that the right to a pension becomes vested upon acceptance of employment."¹⁰⁷ In yet another case, the Oregon Supreme Court held that "[a]n employee's contract right to pension benefits becomes vested at the time of his or her acceptance of employment. . . . On vesting, an employee's contractual interest in a pension plan may not be substantially impaired by subsequent legislation."¹⁰⁸

Other state courts have held that pension rights become contractual at some point later than the beginning of employment, although the exact period is usually undefined. For example, in one case, the Kansas Supreme Court held that a public employee has a contractual right in the state pension system after "continued employment over a reasonable period of time during which substantial services are furnished to the employer, plan membership is maintained, and regular

constitutionally protected right in his or her pension vests upon the acceptance and commencement of employment, subject to reasonable or equitable unilateral changes by the Legislature."); *Ballentine v. Koch*, 674 N.E.2d 292, 294 (N.Y. Ct. App. 1996) ("Article V, § 7 of the NY Constitution protects as 'a contractual relationship' the benefits of membership in a public pension or retirement system against diminishment and impairment. The provision fix[es] the rights of the employees at the time of commencement of membership in [a pension or retirement] system, rather than as previously at retirement.") (internal quotation marks omitted); *Pub. Employees Fed'n, AFL-CIO v. Cuomo*, 62 N.Y.2d 450, 459-60, 467 N.E.2d 236, 239 (N.Y. 1984) (noting that the purpose of the New York Pension Clause "was to fix the rights of the employee at the time he became a member of [a pension] system" and "[i]f changes were applied retroactively to prior members of a public retirement system, they were held unconstitutional on the theory that a member's rights were frozen as of the date of the employment and that any changes lessening benefits must be made prospectively.")

¹⁰⁶ *Betts v. Board of Administrators of Public Employees Retirement Sys.*, 21 Cal. 3d 859, 582 P.2d 614, 617 (Cal. 1978).

¹⁰⁷ *Yeazell v. Copins*, 402 P.2d 541, 545 (Ariz. 1965).

¹⁰⁸ *Hughes v. State of Oregon*, 838 P.2d 1018 (Ore. 1992).

contributions into the fund are made.”¹⁰⁹ As the Tennessee Supreme Court said, “While we agree with the implicit holding of the courts below that a public employer may from time to time offer additional benefits which employees may accept expressly or by acquiescence, nevertheless we are not convinced that a plan is ‘frozen’ against detrimental changes or modifications the moment an employee begins to participate in it, where such changes are necessary to preserve the fiscal and actuarial integrity of the plan as a whole. It seems to us that public policy demands that there be a right on the part of the public employer to make reasonable modifications in an existing plan if necessary to create or safeguard actuarial stability, provided that no then accrued or vested rights of members or beneficiaries are thereby impaired.”¹¹⁰

Still other states have suggested that pension rights become contractual at the time of retirement or eligibility for retirement. For example, the Oklahoma Supreme Court has said, “We hold that under Oklahoma law the right to the retirement pension benefits provided to firefighters and police officers under our state statutory schemes becomes absolute at the time those benefits become payable to those eligible.”¹¹¹ Or as the Nevada Supreme Court held, “Until an employee has earned his retirement pay, or until the time arrives when he may retire, his retirement pay is but an inchoate right; but when the conditions are satisfied, at that time retirement pay becomes a vested right of which the person entitled thereto cannot be deprived; it has ripened into a full contractual obligation.”¹¹²

¹⁰⁹ *Singer v. City of Topeka*, 227 Kan. 356, 607 P.2d 467, 474 (Kan. 1980).

¹¹⁰ *Blackwell v. Quarterly County Court of Shelby County, Tennessee*, 622 S.W.2d 535, 541 (Tenn. 1981).

¹¹¹ *Baker v. Oklahoma Firefighters Pension & Retirement Sys.*, 718 P.2d 348, 353 (Okla. 1986).

¹¹² *Nicholas v. State of Nevada*, 992 P.2d 262, 264 (Nev. 2000).

In *Sylvestre v. Minnesota*,¹¹³ for example, the Minnesota Supreme Court considered a judicial pension system in which retired judges had been promised a pension of half the salary *currently* allotted to judges (even if that salary increased after a given judge had retired), but the pension law had been revised to hold judicial pensions to half of the actual salary the judge had been receiving at the time of retirement or as of July 1, 1967 (whichever was greater).¹¹⁴ Retired judges sued, saying that their pension rights had been unlawfully diminished by no longer tying the pension to the current salary of working judges. The Minnesota Supreme Court agreed with the judges, saying “Here, a judge gives up the right to continue in the only field of endeavor in which he has been educated and is experienced in order to accept a position, often for a much smaller financial reward, anticipating that upon retirement the state will continue to pay him part of his salary. Inflation affects retired judges the same as it does anyone else; and a judge’s reliance upon the state’s offer to pay, upon his retirement, a part of the salary allotted to his office surely is one of the significant considerations that induces the judge to remain in office during the required period of time and until the age permitting retirement.”¹¹⁵ Then in *Christensen v. Minneapolis Municipal Employees Ret. Board*,¹¹⁶ an employee had retired from the city of Minneapolis at age 38 after 10 years of service, but his pension was later suspended when the retirement age was raised to age 60.¹¹⁷ The Minnesota Supreme Court found that raising the retirement age retroactively was an “unconstitutional impairment of contractual obligations to the extent that it purports to apply to elected city officials, . . . already retired at the

¹¹³ 214 N.W.2d 658 (Minn. 1973).

¹¹⁴ *Id.* at 660.

¹¹⁵ *Id.* at 666.

¹¹⁶ 331 N.W.2d 740 (Minn. 1983).

¹¹⁷ *Id.* at 742-43.

time of its enactment.”¹¹⁸ Moreover, there is federal caselaw to the effect that pensions are contractual promises that become enforceable when the employee completes the required term of service.¹¹⁹

In the classic case of *Police Pension and Relief Bd. of City and County of Denver v. McPhail*,¹²⁰ the Colorado Supreme Court seemed to indicate that pension rights are fully protected only at the time of eligibility to retire: “Until the employee has earned his retirement pay, or until the time arrives when he may retire, his retirement pay is but an inchoate right but when his retirement pay becomes a vested right of which the pension entitled thereof cannot be deprived, it has ripened into a full contractual obligation.”¹²¹ But later Colorado cases have indicated, as noted above, that pension amendments prior to retirement need to be balanced so that they do not pose an overall detriment to workers.

What are we to make of all this disagreement over the timing of when pension benefits receive contractual protection? It may seem counterintuitive – given the disparity between saying that contractual protection arises on the first day of employment versus at the time of retirement – but there ought not be as much disagreement as meets the eye. One can see a common theme emerging from the caselaw, no matter what the putative holding: employees have a right to

¹¹⁸ *Id.* at 752.

¹¹⁹ *Hoefel v. Atlas Tack Corp.*, 581 F.2d 1, 4-5 (1st Cir. 1978) (explaining that “the promise of a pension constitutes an offer which, upon performance of the required service by the employee[,] becomes a binding obligation”); *Pratt v. Petroleum Prod. Mgmt., Inc. Employee Sav. Plan & Trust*, 920 F.2d 651, 661 (10th Cir. 1990) (stating that a “pension plan is a unilateral contract which creates a vested right in those employees who accept the offer it contains by continuing in employment for the requisite number of years”).

¹²⁰ 139 Colo. 330 (1959).

¹²¹ *Id.* at 342 (quoting *Retirement Board of Allegheny County v. McGovern*, 174 A. 400 (Pa. 1934)); *see also* *Police Pension and Relief Bd. of City and County of Denver v. Bills*, 148 Colo. 383, 38 (1961) (“retirement rights [at eligibility to retire] thereupon become a vested contractual obligation, not subject to a unilateral change of any type whatsoever.”).

pension benefits that they have already accrued, but not necessarily to the accrual of *future* benefits. Courts should more explicitly recognize this principle in current and future lawsuits.

In most of the previous cases suggesting that pensions are contractually protected from the outset of employment, the actual situation before the court was one in which the employees had worked for a number of years, or even their entire careers, with a particular level of expected pension benefits that were then lowered *as to the employee's entire career*. What motivates these courts is evidently the fear that states might try to take away pension benefits that were accrued in year 1, year 2, and so forth. But in most of these cases, the court did *not* consider the question of whether employees have a right not just to the benefits they accrued in previous years but a right to block any changes made on a forward-looking basis only as to future accruals.

Take, for example, the much-cited California case of *Kern v. City of Long Beach*.¹²² That case found that an employee had “pension rights as soon as he has performed substantial services for his employer.”¹²³ This would seem to indicate maximal protection, starting very early in an employee’s career (if not on the first day of employment). But the actual situation before the court was one of gross unfairness, in which Kern had worked for nearly 20 years as a fireman, but the city *completely* repealed its pension plan just 32 days before he finished the 20-year eligibility period. As a result, he would have gotten no pension at all despite having contributed to the pension system for many years.¹²⁴ Whatever language the court might have used about the timing of when pensions are somehow locked in place, the factual situation before the court was not remotely akin to a state that reduces *forward*-looking accrual after a year or two of employment while protecting *past* accruals.

¹²² 29 Cal. 2d 848 (1947).

¹²³ *Id.* at 855.

¹²⁴ *Id.* at 850-52.

Consider as well *Police Pension and Relief Board of City and County of Denver v. Bills*,¹²⁵ a prominent Colorado Supreme Court case in which the court held that after a public employee begins working, but before he attains retirement eligibility, the terms of his pension benefit can be modified only “if these changes strengthen or better it, or if they are actuarially necessary.”¹²⁶ As in other states, the Colorado Supreme Court seemed to hold that it is illicit to alter pension benefits even on a going-forward basis, except certain limited circumstances. But as with the other cases discussed above, *Bills* did not concern plaintiffs who had merely begun working and whose benefits were altered on a forward-looking basis at some point after Day One. To the contrary, the plaintiffs had already retired from the Denver Police Department at a time when the city charter provided that pensions would rise at half the rate of increases to the salaries of current police officers. After the plaintiffs retired, the city charter was amended to repeal this so-called “escalator clause,” and the court said that the amendment could not be applied retroactively to workers who were retired or eligible to retire.¹²⁷

Similarly, in *Betts*, the plaintiff had worked from 1959 to 1967, and wanted to avoid a reduction in benefits passed in 1974.¹²⁸ In the Arizona case, the plaintiff had worked from 1942 to 1962, and wished to have the benefit of the pension benefit promised before a 1952 amendment to the plan. In other words, he had worked for ten years under the old benefit.¹²⁹ And

¹²⁵ 148 Colo. 383 (1961).

¹²⁶ *Id.* at 390.

¹²⁷ *Knuckey v. Public Employees’ Retirement Association*, 851 P.2d 178, 180 (Colo. App. 1992) (“[T]here can be a limited vesting of pension rights prior to actual retirement and also even prior to eligibility to retire. . . . Until benefits fully vest, a pension plan can be changed; but any adverse change must be balanced by a corresponding change of a beneficial nature, a change that is actuarially necessary, or a change that strengthens or improves the pension plan.”).

¹²⁸ *Betts v. Board of Administrators of Public Employees Retirement Sys.*, 21 Cal. 3d 859, 582 P.2d 614, 616 (Cal. 1978).

¹²⁹ *Yeazell v. Copins*, 402 P.2d 541, 542 (Ariz. 1965).

in the Oregon case, the court merely held that a 1991 pension reform law subjecting pensions to taxation was “a nullity as it relates to PERS retirement benefits accrued or accruing for work performed before the effective date of that 1991 legislation.”¹³⁰

As for cases finding contractual protection at some mid-career point, the usual point of such cases is to *acknowledge* the state’s ability to change pension accrual on a forward-looking basis. In a Delaware case, for example, the state supreme court held, “Because in 1964 the period for vesting of pensions was 30 years, Petras, who had only completed two years service before the free credit provision was changed, had no vested right in that provision or, for that matter, in the plan as a whole. The General Assembly’s modification of the pension plan, therefore, did not violate any contractual right.”¹³¹ As the West Virginia Supreme Court said, “[C]hanges can be made with regard to employees with so few years of service that they cannot be said to have relied to their detriment. Line drawing in this latter regard must be made on a case-by-case basis, but after ten years of state service detrimental reliance is presumed.”¹³²

Finally, as for cases finding contractual protection at the time of retirement or thereabouts, the purpose once again is to preserve the state’s ability to make forward-looking changes to the pension system. As the Louisiana Supreme Court said, “As in the area of retirement benefits, where courts have consistently held that a public employee’s right to retirement benefits does not ‘vest’ until eligibility for retirement is attained, reemployment benefits for retirees likewise do not vest until eligibility as to age and service is attained. Prior to the achievement of eligibility, courts have deemed the right to be inchoate and the details of a contributory retirement system, such as rate of contribution, benefits, length of service, and age

¹³⁰ Hughes v. State of Oregon, 838 P.2d 1020 (Ore. 1992).

¹³¹ Petras v. State Bd. of Pension Trustees, 464 A.2d 894, 896 (Del. 1983).

¹³² Booth v. Sims, 456 S.E.2d 167, ¶ 15 (W.Va. 1994) (syllabus by the court).

requirements could be modified to the prejudice of the employee.”¹³³

As a federal district court in Oregon pointed out, “The Contract Clause does not prohibit legislation that operates prospectively,”¹³⁴ and “[i]f the State of Oregon is to be bound to provide employees a set level of benefits in perpetuity, such a legislative intent must be clear.”¹³⁵ That court found that Oregon statutes had not given employees a contractual right “not only to what was in their accounts, but also to the terms in existence at the time of their employment for future service.”¹³⁶ Another federal district court has held that “an immutable, unalterable pension plan as to future benefits to be earned pro rata by future employment service” would be “*void ab initio* as a surrender of an essential element of the State’s sovereignty.”¹³⁷

In short, whatever the court says about the *timing* of contractual protection, a consistent theme arguably emerges: employees ought to have a right to pension benefits that they have already accrued, but the state should still have the flexibility to modify the pension system going forward. It is just that in the most employee-protective cases, the legislature had *not* modified the pension system going forward, but had tried to take away pension benefits earned years before. In such circumstances, it is not surprising that a court might have used language suggesting that the employees were entitled to pension benefits when earned (that is, starting in those early years of employment). But such holdings do not really address the question of whether employees

¹³³ *Smith v. Board of Trustees of Louisiana State Employees’ Retirement System*, 851 So. 2d 1100, 1107 (La. 2003).

¹³⁴ *Robertson v. Kulongoski*, 359 F. Supp. 2d 1094, 1100 (D. Ore. 2004); *see also* *United States Trust*, 431 U.S. at 18 n. 15 (“States undoubtedly [have] the power to repeal the covenant prospectively.”) (citing *Ogden v. Saunders*, 25 U.S. (12 Wheat) 213, 6 L. Ed. 606 (1827)).

¹³⁵ *Id.*

¹³⁶ *Id.* at 1101; *see also* *Olson v. Cory*, 93 Cal. App. 3d 942, 156 Cal. Rptr. 127, 135 (Cal. Ct. Appl. 2d, 1979) (construing previous California case as holding that “the thwarting of expectation of future accrual of an increased pension does not infringe present vested right.”).

¹³⁷ *Maryland State Teachers Ass’n v. Hughes*, 594 F. Supp. 1353, 1364 (D. Md. 1984).

have a right not just to past accruals but to keep accruing pension benefits at the same or higher rate in the future.

Indeed, what would we make of a seemingly employee-protective rule giving employees the right to block forward-looking modifications to how pension benefits were to be accrued in future years of service? Such a holding would be curious, given that state governments retain the power to control salaries and jobs.¹³⁸ That is, I am unaware of any court holding that state governments are constitutionally forbidden from implementing, on a going forward basis, an across-the-board salary reduction or diminishment in the workforce.¹³⁹ Thus, it would be odd for a court to suggest that state workers are, from day one, contractually entitled to receive a particular pension formula, when that formula itself is based on salaries and employment that the state *can* alter.

To take a hypothetical example, imagine that a state pension system offers a pension that is based on a 2% multiplier: if an employee retires with 30 years of service, his pension would then be 60% (or 30 years times 2%) of his final average salary. Under the hypothetical right to block future modifications, someone who started working today would be entitled to a 2% multiplier 30 years from now.

But suppose that after 15 years of a particular worker's career, the state pension system tries to decrease the benefit to a 1.5% multiplier. We can distinguish at least two ways that the state might go about this change. First, suppose the state literally tries to abolish the 2%

¹³⁸ *Newton v. Commissioners*, 100 U.S. 548, 559 (1879) (“[T]he legislative power of a State, except so far as restrained by its own constitution, is at all times absolute with respect to all offices within its reach. It may at pleasure create or abolish them, or modify their duties. It may also shorten or lengthen the term of service.”).

¹³⁹ Nor is it likely that judges would attempt to create such a constitutional constraint in an era of decreased tax receipts, tight state budgets, and cutbacks made pursuant to balanced budget requirements.

multiplier forever, such that the employee can no longer count on a 2% multiplier *at all* when he retires 15 years down the road. That change would seem unfair, because the employee had already worked for 15 years under a compensation package that was based on a particular current salary plus a particular pension (including the 2% multiplier) later – that package was what he had bargained for. So it does seem intuitively wrong for the state to attempt to deny him any portion of the 2% multiplier at any point.

However, suppose that the state merely changes the pension multiplier going forward to 1.5%, while allowing current and former employees to receive a prorated multiplier based on their years of service. In the case of the 15-year employee who is planning on retiring after another 15 years, he would have worked half his career while planning on a 2% multiplier and half his career while planning on a 1.5% multiplier. Thus, at retirement, he is given a multiplier that splits the difference: 1.75%. Indeed, Rhode Island did something very similar in its 2011 reform package (*i.e.*, it changed the multiplier for future years of service to 1%, as part of a hybrid plan). Does the worker have any contractual claim to anything more than that?

By the normative theory presented in this dissertation, he does not. Not only does he have no contractual right to anything more than that, if a court holds that he does, then what is to stop the state from freezing or reducing his salary, such that his pension in retirement equals whatever it would have been with a lower multiplier? For that matter, what is to stop the state from laying off the worker at 20 years of service, thus lessening the pension that he is ever eligible to receive?

State employees have no constitutional right to perpetual employment, after all; even if they have a property right to their jobs (as is the case with academic tenure, for example), they can be fired after due process is afforded them. It could still be the case that an employee should

be treated in some cases as having a constitutional right to a particular level of pension, but it is an odd constitutional right that can so easily and legitimately be extinguished.

Recall why we think that pension benefits are contractual in the first place: because pension benefits “represent a form of deferred compensation for services rendered.”¹⁴⁰ As the West Virginia Supreme Court pointed out, “By promising pension benefits, the State entices employees to remain in the government’s employ, and it is the enticement that is at the heart of employees’ constitutionally protected contract right after substantial reliance not to have their own pension plan detrimentally altered.”¹⁴¹ Or as the Washington Supreme Court put it, “[W]here an employer has a pension plan and the employees know of it, continued employment constitutes consideration for the promise to pay the pension. . . . A retirement pension is pay withheld to induce continued faithful service. It amounts to delayed compensation for services rendered.”¹⁴²

If pension benefits are akin to deferred *salary*, then it follows that pension benefits, just like wages themselves, are (or ought to be) tied to specific periods of service. If I work for one year at a given salary plus a given level of pension benefits that are promised for some future date, then the salary plus pension represents the total compensation package that I bargained for in that year of service. If I then work for a second year at a *higher* salary plus the *same* pension benefit, that package represents the total compensation that I bargained for in that second year of service. If I then work for the *same* salary but a *higher* pension benefit for a third year, that compensation package represents what I bargained for in that third year of service.

All of this may seem needlessly rudimentary, of course. But it leads to an important

¹⁴⁰ In re Marriage of Gallo, 752 P.2d 47, 51 (Colo. 1988).

¹⁴¹ Booth v. Sims, 456 S.E.2d 167 (W.Va. 1994) (syllabus by the court).

¹⁴² Jacoby v. Grays Harbor Chair & Mfg. Co., 468 P.2d 666 (Wash. 1970).

point: if I work for Salary X in years one through ten, and then for Salary X+\$10,000 in years eleven through twenty, *my rights have not been harmed at all by the fact that the salary was lower in years one through ten*. During the first ten years, I was willing to work for Salary X. The mere fact that the salary was raised in later years cannot possibly cause me to be injured, such that I could then sue the employer to demand that the salary in years one through ten be retroactively raised to X+\$10,000.

The same logic should apply to pensions. At the extreme case, imagine that I accrue pension benefits that include a 2% COLA during 29 years and 364 days of employment, and then that COLA is raised to 3% on my last day of employment. Thus, the contractual bargain that I struck during all but one day of my employment was for a 2% COLA. If I start receiving the 3% COLA during retirement – let's say for the first five years of retirement – and that COLA is then lowered to 2%, have I been injured at all? The opposite seems the case: given that I worked for nearly all my career while planning on a 2% COLA, it seems that the 3% COLA was an undeserved windfall.

This reasoning can then be extended. If I accrue a particular level of pension benefits during years one through fifteen of employment, and then accrue a higher level of pension benefits during years sixteen through thirty, it would seem odd if I am then able to claim a legal right to receive only the higher level of pension benefits for the *entirety* of my retirement years. After all, didn't I spend half my career working for the lower level of retirement benefits? How can it be that I have a right to receive only the higher level of retirement benefits, any more than I have the right to receive backpay for the years during which I worked at a lower wage?

The *Lyon* case from California sets forth this principle.¹⁴³ In that case, a legislator retired

¹⁴³ *Lyon v. Flournoy*, 271 Cal. App. 2d 774 (1969).

and began receiving a pension that, by the law at the time, was tied to the salaries of current legislators. For more than ten years, he received no adjustments, as legislative pay remained stuck at \$500 per month.¹⁴⁴ In 1963, the California legislature adopted a COLA for retired legislators, and then in 1966, the California Constitution was amended to raise legislative salaries to \$16,000 per year while prohibiting any pensions from being adjusted upwards based on the new higher salary.¹⁴⁵ Lyon's widow sued to obtain a higher benefit tied to current legislative salaries, but the California appellate court disagreed. That court held that the purpose of tying pensions to current salaries was to mimic a cost-of-living allowance, but the large increase to \$16,000 a year had nothing to do with an increase in the cost of living. Given the new statutory COLA in place, Lyon's widow had no reasonable expectation of getting a cost-of-living increase based on the fact that legislative salaries more than doubled in a single year, particularly given that Lyon himself had contributed to the pension system based on the old lower salary. To let Lyon's widow have such a huge COLA would amount to a "windfall."¹⁴⁶

For federal law purposes, employers can modify pension plans prospectively, or even terminate such plans, as long as past accrued benefits are protected.¹⁴⁷ The theory I have outlined was essentially followed by one federal district court in *Howell v. Anne Arundel Cnty.*¹⁴⁸ In *Howell*, the plan at issue had changed its calculation of COLAs, with pre-amendment service still accruing a COLA under the old formula but new service accruing a COLA under the new

¹⁴⁴ *Id.* at 784-85.

¹⁴⁵ *Id.* at 777-78.

¹⁴⁶ *Id.* at 783-86.

¹⁴⁷ *Lockheed Corp. v. Spink*, 417 U.S. 882, 890-91 (1996).

¹⁴⁸ 14 F. Supp. 2d 752 (D. Md. 1998).

formula.¹⁴⁹ In other words, the COLA amendment applied only “prospectively to benefits not yet earned by an employee on its effective date.”¹⁵⁰ The court held that as no Supreme Court case had ever struck down a state law “with only prospective effect under the Contract Clause,” neither would the Maryland law be struck down.¹⁵¹ “The County’s prospective reduction in the rate of increase of future pension benefits which had not yet vested does not constitute an ‘impairment’ that entitles an employee to obtain judicial relief.”¹⁵²

3. Literature Review on the Contracts Clause and Pensions

To date, few legal scholars have written about how the Contracts Clause applies to pension reform. Two exceptions are Paul Secunda and Amy Monahan.

Secunda’s article¹⁵³ considers pension reform specific to Wisconsin, in which Governor Walker successfully proposed to cut back on public employees’ collective bargaining rights. His article reviews the basics of the Contracts Clause and a few recent pension cases. His main substantive point is that Wisconsin may have gone too far in proposing that Wisconsin public employers can no longer “pick up” any required employee contributions. Secunda argues that this new law would unduly interfere with current arrangements without making much financial difference to the state’s budget, and hence is likely unconstitutional.

In Monahan’s first foray into this area,¹⁵⁴ she provided a fairly exhaustive overview of pension jurisprudence in dozens of states. Marshalling all of this jurisprudence, she contends that

¹⁴⁹ *Id.* at 753.

¹⁵⁰ *Id.* at 756.

¹⁵¹ *Id.*

¹⁵² *Id.* at 755.

¹⁵³ Paul Secunda, “Constitutional Contracts Clause Challenges in Public Pension Litigation,” *Hofstra Labor & Employment Law Journal* 28 no. 2 (2011): 263-300.

¹⁵⁴ Amy Monahan, Public Pension Plan Reform: The Legal Framework, 5 *Education Finance and Policy* 617 (2010).

pension benefits can be protected to the extent they are “already accrued,” but that on a forward-looking basis, the state “may change employment conditions such as salary or benefits, and the employee may choose whether or not to accept such changes by either continuing to work for the state or electing instead to seek employment elsewhere.” What is important, in Monahan’s view, is that “courts are precise about the duration of the contract” – i.e., that it extends backward and protects work already performed, but does not extend indefinitely as to future accruals.

In Monahan’s next foray,¹⁵⁵ she squarely critiques all of the thirteen states (most notably California) that have held “not only that state retirement statutes create contracts, but that they do so as of the first day of employment,” the result being that “pension benefits for current employees cannot be detrimentally changed, even if the changes are purely prospective.” She criticizes this legal rule on several grounds. First, it contradicts the standard legal presumption that statutes do not create certain contractual rights unless there is unmistakable evidence that the legislature intended to bind itself into the future. But there is no evidence that state pension statutes are written with a specific and unmistakable guarantee that the rate of accrual can never be changed for any employee within the system. Second, protecting even the rate of future accrual against changes is contrary to all the federal Contracts Clause jurisprudence holding that prospective changes to a contract are constitutional. Third, we should not set in stone merely one aspect of employee compensation (pension accrual rates) even while states “can terminate employees, lower their salaries, and change their fringe benefits.” Employees may well prefer to have a compensation package that is structured differently, and it inhibits labor market efficiency to lock pension benefits in place. Moreover, Monahan points out, the benefit of such strong constitutional protection for pension accrual is “illusory,” given that the only option left to a state

¹⁵⁵ Amy Monahan, “Statutes as Contracts? The ‘California Rule’ and Its Impact on Public Pension Reform,” *97 Iowa Law Review* 1029 (2012).

employer with budgetary trouble is to lay off employees or freeze salaries.

This dissertation adds to the legal literature by explaining for the first time the specifics of how it is possible to change the rate of future accrual and protect past accruals as to a wide variety of pension reforms and in a wide variety of recent legal cases.

4. Specific Types of Pension Reform

The question in this section is central to the dissertation: how legislatures can take the principle of protecting past accruals while allowing future accruals to change, and apply it to *particular* types of pension reform, so that these reforms are best positioned to be defensible in the inevitable court challenges. The section will begin with the easiest cases and move to the most difficult ones (i.e., changing to a different pension system entirely).

i. Contribution Increases

Several states have recently increased the required employee contribution. At the same time, several state courts have held that increasing the required employee contribution is an unconstitutional violation of the Contracts Clause.¹⁵⁶ For example, the Kansas Supreme Court held that legislation raising the contribution rate from 3% to 7% was unconstitutional, and that the state can make reasonable modifications to the pension plan, but only if disadvantages are

¹⁵⁶ Ass'n of Pennsylvania State and Univ. Faculties v. State System of Higher Ed., 479 A.2d 962 (Pa. 1984); Allen v. City of Long Beach, 287 P.2d 765, 768 (Cal. 1955); Valdes v. Cory, 139 Cal. App. 3d 773, 780 (Cal. Ct. App. 1983); McDermott v. Regan, 82 N.Y.2d 354, 624 N.E.2d 985, 604 N.Y.S.2d 890 (1993); Florida Sheriffs' Ass'n v. Dept. of Admin., 408 So.2d 1033 (Fla. 1981); Oregon State Police Officers' Ass'n v. Oregon, 918 P.2d 765, 775 n.18 (Ore. 1996) ("Cases from other jurisdictions that follow a contractual view of public pensions likewise have concluded that legislative enactments that increased the level of public employee contributions, without providing offsetting benefits, violated either the state or federal contract clauses."); Booth v. Sims, 456 S.E.2d 167, 185 (W. Va. 1995) ("[T]he legislature cannot . . . raise the contribution level without giving the employee sufficient money to pay the higher contributions."); Marvel v. Dannemann, 490 F. Supp. 170, 176-77 (D. Del. 1980).

offset by other advantages.¹⁵⁷ Similarly, the Massachusetts Supreme Judicial Court held that “legislation which would materially increase present members’ contributions without any increase of the allowances fairly payable to those members or any other adjustments carrying advantages to them, appears to be presumptively invalid.”¹⁵⁸ The Pennsylvania Supreme Court held it unconstitutional to raise the contribution rate from 5.25% to 6.25%, because to do so devalued the pension benefits.¹⁵⁹

The rationale for such a holding is that increasing the contribution rate “alters the state’s contractual obligation . . . by increasing plaintiffs’ cost of retirement benefits for services that, absent a lawful separation of employment they will provide in the future. That consequence, if approved, would permit the state to retain the benefit of plaintiffs’ labor, but relieve the state of the burden of paying plaintiffs what it promised for that labor.”¹⁶⁰

But a few other courts have disagreed. In *AFSCME Councils 6, 14, 65 & 96 v. Sundquist*,¹⁶¹ the Minnesota Supreme Court held that “because . . . appellants have failed to establish a right, based either on conventional contract or promissory estoppels theories, to a fixed level of employee pension contributions, we need not address the issue of whether the Act operates to unconstitutionally impair such a right,”¹⁶² and given the long history of varied contribution levels, “an expectation that contribution rates would remain fixed is patently

¹⁵⁷ *Singer v. Topeka*, 607 P.2d 467, 476 (Kan. 1980).

¹⁵⁸ *Opinion of the Justices to the House of Representatives*, 303 N.E.2d 847, 864 (Mass. 1974).

¹⁵⁹ *Pennsylvania Federation of Teachers v. School Dist. of Philadelphia*, 484 A.2d 751, 753 (Penn. 1984).

¹⁶⁰ *Oregon State Police Officers’ Association v. State of Oregon*, 918 P.2d 765, 775 (Ore. 1996).

¹⁶¹ 338 N.W.2d 560 (Minn. 1983).

¹⁶² *Id.* at 566.

unreasonable.”¹⁶³

Similarly, a Pennsylvania pension system started requiring an employee contribution for the first time, and employees sued for a violation of the Contracts Clause. But the plan language itself stated that the “Board shall have the power, at any time and from time to time, . . . to modify, alter or amend the Plan and/or Master Trust in any manner which it deems desirable provided that no amendment . . . may affect the rights, duties or responsibilities of the Trustee without its prior written consent.”¹⁶⁴ The Third Circuit held that this reservation of rights could not be ignored, and that under basic principles of contract law, “the rule vesting unilateral contract rights at the beginning of performance ‘is designed to protect the offeree in justifiable reliance on the offeror’s promise, and the rule yields to a manifestation of intention which makes reliance unjustified. A reservation of power to revoke after performance has begun means that as yet there is no promise and no offer.’”¹⁶⁵

How should we think about the contribution issue? Under the framework I have laid out, asking employees to make greater contributions in future years should be presumptively constitutional, as much so as asking employees to take a salary freeze. Increased contributions are inherently forward-looking, after all. That is, unlike multipliers or some other benefit calculation, contribution rates are *inherently* changed on a pro rata basis. If the multiplier is lowered from 3% to 2%, the legislature would need to make it explicit that the 2% multiplier was to be applied only to future service and that the final pension payment would be calculated by

¹⁶³ *Id.* at 569; *see also* Redden v. Board of Tr., Public Employees Retirement System, 2008 WL 612244, at *3 (N.J. Super. Ct. Mar. 7, 2008); Ass’n of Professional & Technical Employees v. City of Detroit, 398 N.W. 2d 436, 438-39 (Mich. Ct. App. 1987).

¹⁶⁴ Transport Workers Union of America, Local 290 v. Southeastern Pennsylvania Transportation Authority, 145 F.3d 619, 621 (3d Cir. 1998).

¹⁶⁵ *Id.* at 624 (quoting Restatement of Contracts (Second) § 45, Comment (b)).

averaging the 2% multiplier for certain years with a 3% multiplier for previous years. With a contribution rate, however, the future years' contribution rate *inherently* applies only to future years, and if one wants to know the overall contribution rate that a given employee paid during his career, averaging together on a pro rata basis is the default way to do it.

Moreover, a higher contribution rate is the functional equivalent of a salary freeze: if, say, Florida teachers are asked to contribute 3% to their pensions¹⁶⁶ (they had previously contributed nothing at all), the result to their take-home pay is the same as if they had foregone a 3% pay raise. Yet no one thinks that employees generally have a constitutional right to get pay raises every year: a new year brings with it new financial conditions, and given that an employee has not yet performed any work within that new year, the employee is free to take or leave the new conditions in his or her discretion.

Indeed, courts have held that the Contracts Clause does not protect state employees from having their salaries frozen or reduced; such matters are seen as within legislative discretion.¹⁶⁷ In one case, San Diego changed its pension system by reducing salaries for deferred retirement employees and reducing the employer "pickup" of the employees' contributions. The Ninth Circuit held that, based on numerous California state court holdings, these changes did not violate the Contracts Clause or the Takings Clause: "as California courts have noted, '[i]t is well established that public employees have no vested rights to particular levels of compensation and salaries may be modified or reduced by the proper statutory authority.'¹⁶⁸ Thus, "indirect effects

¹⁶⁶ See *Florida Teachers Sue over 3 Percent Contribution*, First Coast News, June 20, 2011, available at <http://www.firstcoastnews.com/news/article/208234/4/Florida-Teachers-Sue-over-3-Percent-Pension-Contribution>.

¹⁶⁷ See, e.g., *Perry v. Rhode Island*, 975 F. Supp. 418 (D. R.I. 1997).

¹⁶⁸ *San Diego Police Officers' Ass'n v. San Diego City Employees' Retirement System*, 568 F.3d 725, 737 (9th Cir. 2009) (quoting *Tirapelle v. Davis*, 26 Cal. Rptr. 666, 678, 19 Cal. App. 4th 1298, 1319 (Cal. Ct. App. 1993)).

on pension entitlements do not convert an otherwise unvested benefit into one that is constitutionally protected.”¹⁶⁹

Similarly, in a California Supreme Court case – and remember that California purports to protect pension accruals as of the first date of employment – a public employee alleged that reducing the retirement age from 70 to 67 prevented him from accumulating as many years of service, and thereby lowered his pension in violation of the Contracts Clause. The California Supreme Court held that “it is well settled in California that public employment is not held by contract but by statute and that, insofar as the duration of such employment is concerned, no employee has a vested contractual right to continue in employment beyond the time or contrary to the terms and conditions fixed by law. . . . Nor is any vested contractual right conferred on the public employee because he occupies a civil service position since it is equally well settled that ‘[the] terms and conditions of civil service employment are fixed by statute and not by contract.’”¹⁷⁰ The court added that “[t]he fact that a pension right is vested will not, of course, prevent its loss upon the occurrence of a condition subsequent such as lawful termination of employment before completion of the period of service designated in the pension plan.”¹⁷¹ The court clarified that it is the “advantage or disadvantage to the particular employees whose own contractual pension rights, *already earned*, are involved which are the criteria by which modifications to pension plans must be measured.”¹⁷²

These same results should apply in cases involving an increased employee contribution rate. (No state of which I am aware has attempted to increase contribution rates *retroactively*,

¹⁶⁹ *Id.* at 738.

¹⁷⁰ *Miller v. State of California*, 18 Cal. 3d 808, 557 P.2d 970, 973 (1977).

¹⁷¹ *Id.* at 975 (internal quotation marks omitted).

¹⁷² *Id.* at 975 (internal quotation marks omitted, emphasis added).

which would present quite a different question, more akin to demanding a refund of wages from past years.) On a going-forward basis, states should have the legislative prerogative to decide that a higher employee contribution will be needed to fully fund the promised pension benefits on a going-forward basis.

ii. COLA Reductions

In most previous cases where a state pension system attempted to change the COLAs given to retirees, the retirees were likely to win in court. For example, in *United Firefighters of Los Angeles City v. City of Los Angeles*,¹⁷³ the court held that where firefighters' rights to pension benefits had vested under a pension statute that provided uncapped post-retirement COLAs, the later imposition of a 3% cap on the COLAs violated the Contract Clause.¹⁷⁴ Similarly, in *Booth v. Sims*,¹⁷⁵ the West Virginia Supreme Court struck down a law reducing the pension COLAs from 3.75% to 2% for active State Troopers whose benefits had previously vested and who were eligible for retirement.¹⁷⁶ And in *Arena v. City of Providence*,¹⁷⁷ the Rhode Island Supreme Court struck down a COLA reduction that had been applied to firefighters who retired under a city pension plan.

Despite these previous cases, the logic of pro-rating accruals over the span of a worker's career makes sense as to COLAs. Consider the Colorado pension reform bill that is currently the subject of a lawsuit. From 1994 to 2000, the COLA for retirees was based on a formula that resulted in COLAs ranging from 1.34% to 2.91% per year. The COLA was raised to a flat 3.5%

¹⁷³ 210 Cal.App.3d 1095 (1984).

¹⁷⁴ *Id.* at 1108.

¹⁷⁵ 456 S.E.2d 167 (W.Va. 1995).

¹⁷⁶ *Id.* at 187 (“Requiring the petitioners to protect the future solvency of the pension system is an unconstitutional shifting of the state’s own burden.”).

¹⁷⁷ 919 A.2d 379 (R.I. 2007).

in 2001, and then most recently was downgraded to 2%. Given that the lawsuit purports to represent anyone who retired between 1994 and 2010, there are likely plaintiffs in the class who worked for almost their entire careers with no expectation of a COLA at all, and who retired in 1994 after the first official COLA was adopted.

It is hard to see why such plaintiffs were not being given a windfall for the past 17 years. The same logic applies to people who retired in Colorado between 2001 and 2010. Even though they retired after the 3.5% COLA was in place, most of these employees would have begun their careers before 2001, at a time when COLAs was as low as 1.34% (depending on the formula) or even at a time when COLAs were not offered at all.¹⁷⁸ So for some or most of these individuals' careers, they were working and contributing to a pension system that offered a lower or no COLA. By the logic outlined above, it is difficult to see why individuals should be guaranteed a lifetime right to the highest pension benefit that was ever put in place during their working life, any more than they have a right to have the highest salary *retroactively* applied to their entire working life.

Even if pension decreases have to be accompanied by countervailing increases, as many courts have held, the question remains as to what exactly counts as a decrease in the first place. It is at least arguable, if not obvious, that hardly any relevant decrease has taken place if someone works for 19 years with no COLA, works for 10 years with a variable COLA, and then is given a 3.5% COLA the month before retiring. If that person spent the overwhelming majority of his career contracting for a pension that had either no COLA or a variable COLA that was never more than 2.91%, why is he entitled to a 3.5% COLA for 20 or 30 years of retirement? If he gets

¹⁷⁸ Retirees in Colorado can retire at age 65 with 5 years of service, or at age 60 with 5 years of service and reduced benefits, but typically must work at least 20 years even to get reduced benefits. See <https://www.copera.org/PDF/5/5-57.pdf>. It seems safe to assume that many retirees worked for a number of years under a system with no guaranteed COLA at that time.

a 3.5% COLA for 10 years of retirement, and then the 3.5% COLA is reduced, what increase would be needed to balance out the windfall he has already received?

To be sure, COLAs in the real world are often not simple percentages set in statute (indeed, it makes little sense that such percentages are ever written into law), but consist of formulas that are tied to inflation, or that include some sort of cap and/or floor. What then? The answer is that such COLAs can still be pro-rated for retirees in a fairly straightforward manner. For example, consider a hypothetical worker whose 30-year career saw the following COLAs in place: years 1 through 10 had a variable COLA set at the legislature's discretion; years 11 through 20 had a COLA set based on any given year's CPI but with a 3% cap; and years 21 through 30 had a statutory 3% compounding COLAs.

Here is the simplest view of what that worker should then receive in each year of retirement: First, find the average COLA that was actually implemented in years 1 through 10 at the legislature's discretion (say this average is 2%). Second, apply the statutory formula from years 11 through 20 to the particular year of retirement (say that in the retirement year under consideration, this amounts to 2.5%). Third, take the 3% statutory level from years 21 through 30. Finally, average all of these together weighted by years of service. In this case, since each COLA was earned during an equal 1/3 of the worker's career, this would mean averaging 2%, 2.5%, and 3%, for a final 2.5% COLA in that particular year of retirement. Alternatively, if the COLA promised in some or all years was compounding, the geometric average could be used as a more accurate way to average growth rates that compound over time.

Alternatively, we could imagine a more sophisticated way to calculate a prorated COLA. Imagine that at retirement, an employee receives a baseline annuity (call it P_0) that is multiplied by an annuity factor (AF) that is based on age, discount rate, and COLA. Thus, pension wealth at

retirement is $P0 * AF(\text{age, rate, COLA})$, where “age” is age at retirement, rate is the discount rate, and where the COLA is determined according to whatever parameters (rate, simple vs. compounding, caps, etc.) are in place. One common measure of accrual is to apportion $P0$ to each year of service – that is, $P0 = \text{years of service} \times \text{multiplier} \times \text{final average salary}$. Thus, if 1/3 of one’s career is spent with COLA 1 and 2/3 with COLA 2, a way to determine pension wealth at retirement would be this:

$1/3 * P0 * AF(\text{age, rate, COLA1}) + 2/3 * P0 * AF(\text{age, rate, COLA2})$. Then, one could determine a blended COLA as follows: $AF(\text{age, rate, COLA-blended}) = 1/3 * AF(\text{age, rate, COLA1}) + 2/3 * AF(\text{age, rate, COLA2})$.

Alternatively, one could also apply a blended COLA this way: divide the initial annuity $P0$ into two parts, applying COLA 1 to the first part and COLA 2 to the second part. Thus, if $P0$ was \$60,000, one would have a \$20,000 portion and a \$40,000 portion, and each would have its separate COLA applied year after year (this would work for any COLA terms that might exist).

There is not a strong case that any one of these alternatives should be legally mandated as opposed to the others. Still, it makes sense for legislatures to use one of these in manipulating COLAs, and for courts to approve such legislation.

iii. Changing the Multiplier

Changing a multiplier applied to the final average salary is also one of the more straightforward applications of the prorating principle. If a 3% multiplier was in place for years 1 to 15 but a 1% multiplier was in place for years 16 to 30, then the final multiplier would be 2% (the average of 3% and 1%).

This is exactly what was done in Rhode Island’s 2011 pension reform: Section 36-10-10 of the Rhode Island pension law already had prorated multipliers in place for employees eligible

to retire before September 30, 2009 (1.7% for years 1 to 10, 1.9% for years 11 to 20, 3% for years 21 to 34, and 2% thereafter), and for employees eligible to retire after Oct. 1, 2009 (1.6% for years 1 to 10, 1.8% for years 11 to 20, 2% for years 21 to 25, 2.25% for years 26 to 30, 2.5% for years 31 to 37, and 2.25% thereafter). Then, the 2011 pension reform law restricted those multipliers to any years of service prior to July 1, 2012. For all service after July 1, 2012, the multiplier will now be 1% for the defined benefit portion of the now-hybrid plan.

Clearly, then, the Rhode Island defined benefit pension plan now involves prorating the multiplier according to years of service, and it reduces the multiplier only a forward-looking basis while preserving the higher prorated multipliers in effect for years of service before July 1, 2012. This sort of prorating should be presumptively constitutional, just as much as any other salary or benefit terms that a government chooses to offer for service in a particular year. On the other hand, it would arguably be reducing accrued benefits if a state reduced the multiplier outright, including for all previous years of employment.

iv. Changing What Components of Compensation Are Included

Recall that the typical defined benefit pension is calculated by multiplying a percentage factor for each year of employment times some final average salary. But states differ on what exactly is included in calculating the final average salary itself. For example, a pension could include base wages and nothing else, or it could add allowances for clothing, travel, housing, or other extras, health insurance subsidies, extra money made from moonlighting part-time or from working overtime, extra pay from filling in for a supervisor, or anything else that might somehow boost whatever is paid. Given that a boost to the final average salary will then boost the actual pension payment for the rest of a retiree's life – which could be as much as another 30 years or more – it makes significant difference what is included in that final average salary.

Hence, states may wish to reform a pension system by cutting back on any extras that were allowed and limiting final average salary to base wages alone.

How is prorating to be done here so as to protect accrued benefits while restricting future accruals? In fact, prorating may not be as difficult as one might imagine. Say that final average salary included three extra components during 15 years of a worker's career, but that it was limited to base wages for the next 15 years. What should that worker get on retirement? The answer is to look at how much his final average salary *really was* boosted above base wages during that final year or two or three (in other words, how much overtime did he really work, or how much did he really get in clothing allowances, etc.). Then prorate that addition to base wages based on how many years of his career were spent with those components being included in final average salary.

A further complication, however, is what to do about incremental boosts to wages that are actually eliminated entirely. Suppose, for example, that after year 15 of a worker's career, the police force not only stops including clothing allowances in final average salary but stops having clothing allowances altogether. Then what prorating occurs obviously cannot be based on whatever clothing allowance a police officer received during the final years of his career. One possible answer would be to consider how much historically was paid in clothing allowances (on average) during the first 15 years of his career, including any upwards or downwards trend, and then extrapolate to what a given police officer would have earned in clothing allowances during his final average salary given the historical trend. Prorating would then be done based on that extrapolated figure. This is obviously a far from perfect way of determining pension benefits, but it is preferable to a judicial holding that clothing allowances (or any other extra add-on) can never be altered except for new employees.

v. Changing Years of Final Salary Averaging

One way to clamp down on artificial attempts to boost the final salary by extending the averaging period to three years, five years, or perhaps even further. A pension would then be based on whatever the final average salary was for a lengthier time period.

An initial question, of course, would be whether lengthening the averaging period reduces any previously accrued benefit at all. The argument that a plaintiff might make would run as follows: Salaries generally increase on a yearly basis. If my salary at age 64 is expected to be higher than the yearly average salary I will receive from ages 60-64, then perforce a pension based on the age-64 salary would be higher than a pension based on the yearly average salary from ages 60-64. That being the case, the yearly accrual that I earned at, say, age 30 was based on the then-present value of a higher age-64 salary, but that accrual has now been *retroactively reduced* so that it was really based on the then-present value of a lower final average salary. The same is true for all previous years of employment: the present value of any accrual in any previous year is going to be retroactively reduced when the final average salary is reduced.

Strictly on economic terms, this plaintiff's argument is fairly sound. How then would the prorating idea be applied here?

The answer is that prorating could be done along with any prorating of the multiplier itself. Here is an example. Suppose that John Smith works for 15 years with the promise of a pension based on 3% times years of service times final year's salary. Then, for the next 15 years, he works with the promise of a pension based on 2% times years of services times the 5-year final average salary. Suppose that his final year's salary is \$60,000 but that his final 5-year average salary is \$58,000. What would his pension be, just based on these terms alone? The answer is as follows: $[15 * .03 * \$60,000] + [15 * .02 * \$58,000]$, or \$44,400.

To put this in the economic terms used in discussing COLAs, we might say that pension wealth at retirement is a function of P0 (initial annuity) times actuarial factors (AF), and that P0 is a function of years of service times a multiplier times final salary (itself a function of components, averaging, any caps, etc.). Thus, pension wealth = years of service * multiplier * final salary (components) * AF. So if a third of one's career is spent with one final average salary formula and two-thirds with another, we now have: pension wealth = 1/3 * YOS * multiplier * FAS1(...) * AF + 2/3 * YOS * multiplier * FAS2(...) * AF, which is the same result we reach if we just define P0 itself as YOS * multiplier * [1/3 * FAS1 + 2/3 * FAS2].

To be sure, changing final average salary calculations is not likely to change the pension system's liabilities substantially. In the previous example, changing the final average salary term by itself saved only \$600 per year. Nonetheless, final average salary calculations are a component of many modern pension reform bills, and it is important for courts and legislatures to be aware that prorating is possible so as to protect past accruals while allowing forward-looking changes.

vi. Changing the Retirement Age

Raising the retirement age means both that employees work and contribute to the pension system longer, and that they retire at an age when they are closer to death (which leads to lower average payouts).

But when the retirement age is raised for current employees rather than merely new hires, an obvious question of fairness arises. At the extreme, it would seem unfair and a contractual violation if someone on the literal eve of retirement were suddenly told that he had to work an extra three years to be eligible to retire. Such a last minute change would upset all of the plans that he had been making in reliance on the expectation of a pension payment starting soon, rather

than three years from now. At the other extreme, a 22-year-old who has worked for one day could hardly be said to have a substantial reliance interest in retiring at age 62 rather than 65, and if a three-year addition to the retirement age is intolerable, he has many years in which to find employment that better suits his wish to retire at 62.

How, then, could retirement age be raised for current employees in a manner that would be most fair? Prorating turns out to be possible here as well. Rhode Island's 2011 pension reform raised the retirement age in a way that was prorated based on previous years of service. As an initial matter, the retirement age increase applies only to employees who were not already eligible to retire as of July 1, 2012. This provision is to protect the interests of workers who, as mentioned above, might already be literally on the eve of retiring. Then, as a general matter, employees who have fewer than five years of service on June 30, 2012 have to work until the Social Security retirement age to retire. This provision is similar to what I mentioned above – i.e., the fairly young employees who do not yet have a substantial interest in retiring at some earlier age.

Next is where the prorating comes in: for all of the in-between employees (i.e., those who *do* have more than five years of service but are not already eligible to retire), the retirement age is “adjusted downward in proportion to the amount of service the member has earned as of June 30, 2012,” subject to a lower bound of age 59. The specifics of the calculation are as follows: First, divide the total service by June 30, 2012, by the projected service at the retirement age in effect on June 30, 2012. For example, if an employee had worked 10 years but was 15 years away from the pre-existing retirement age, the fraction would be $10/25$ or $2/5$. Then determine how much the retirement age as of June 30, 2012, differed from Social Security retirement age. For example, if an employee's retirement age was 60 prior to the pension reform but 65 under

Social Security, the difference would be five years. Then, multiply the two figures together: $2/5$ times five years, for a total of two years. At that point, the retirement age for the employee is simply the Social Security retirement age (65) minus those two years.

For another example, if an employee had worked 24 out of 25 years toward the previous retirement age of 60, the new retirement age would now be $[65 \text{ minus } (24/25 * 5)]$, or 60.2 years; the retirement age for this employee would have been raised by a mere 2.4 months.

In other words, the formula in Rhode Island now prorates any increase in retirement age in *inverse* proportion to how many years the employee had already worked towards the previous retirement age.

How should a court think of this prorated formula? Does it properly protect prior accruals while affecting only future accruals? That is a conceptually more difficult question. Just as with changing the final salary averaging period, a plaintiff could argue that an increase in the retirement age during one's working life inherently reduces the present value of all past accruals, because that present value would have to have been calculated by discounting for a longer period. In other words, if I am 35 and now have to work to age 64 rather than age 62, the *then*-present value of what I earned at age 25, 26, 27, etc., would all have been determined by discounting back from age 64 rather than 62, and with any discount rate above zero, that will automatically make the present value of those accruals lower.

There is not as easy an answer to this. Prorating the retirement age by itself (as in Rhode Island) does not solve the problem. This is because even if the retirement age increase is prorated, *any* increase whatsoever could be thought of as having retroactively reduced the present value of previous accruals.

That said, there is a way that prorating could be done so as to preserve the present value

of previous accruals even while raising the retirement age. Say that the retirement age is raised from 62 to 65, including any prorating as in Rhode Island. Then, for any given worker, establish the amount that was accrued (taking into account all of the applicable terms, such as the multiplier) as of the effective date of the legislation. Fast forward that amount with interest to age 62, when that worker would previously have been eligible to retire. At that point, pretend that the worker was presently eligible for an annuity that equals the age-62 present value of all the accruals that the worker had accumulated up to the effective date of the legislation. In other words, if John Smith is 40 in 2012, but pension legislation is passed raising the retirement age from 62, figure out his accruals as of 2012, and establish what that total would be as of 2034, when he would formerly have been able to retire at age 62.

Then, carry that annuity forward up to the worker's *actual* retirement age, *using the same interest rate that is otherwise used as a discount rate* (and in the meanwhile, the worker is still working and accruing more benefits at whatever rate is currently in place). In the John Smith example, figure out what his total accruals as of 2012 would be worth in 2034, and then start imputing interest to that amount for another three years to age 65. At the new actual retirement age, the worker retires with a pension based on the sum of: 1) all the new accruals after the legislation's effective date, plus 2) all the accruals prior to the legislation's effective date, except with interest applied during whatever gap existed between the old retirement age and the new retirement age.

In the same terms used previously, supposing that the retirement age is raised from 62 to 65 one third of the way through someone's career: Pension wealth at 65 should then equal $[1/3 * YOS * multiplier * final\ average\ salary\ at\ age\ 62 * AF(62)] * (1 + r)^3 + [2/3 * YOS * multiplier * final\ average\ salary\ (at\ age\ 65) * AF(65)]$.

Given such a calculation, there will have been no retroactive impairment of the present value of prior accruals. That is, because all prior accruals are now going to effectively receive interest *equal to the discount rate* during any increase in the retirement age, then it automatically follows that discounting the retirement benefit at the new retirement age back to all of those prior years of employment would result in the *exact same present value*. Thus, no prior accruals would have been touched, but the retirement age would have been increased nonetheless.

To be sure, I am not suggesting that such a system is necessary: given the financial emergency in Rhode Island, that state probably hit upon the fairest way to raise the retirement age in a way that was more effective at reducing unfunded liabilities. But what I have outlined here would be perhaps the safest way for a legislature to implement the principle of protecting prior accruals while changing future accruals.

vii. Converting to a Different Pension System Entirely

Converting a traditional defined benefit plan to a completely different structure might seem at first create the most challenging difficulties about how to protect past accruals while changing future accrual patterns. Even so, this dissertation argues that there are clear solutions that should allow legislatures a way forward.

Cash Balance Plans

A cash balance plan is a type of defined benefit plan that promises a particular benefit to participants. Still, it resembles a defined contribution plan insofar as the ultimate benefit consists of a promised rate of return on the contributions actually made on behalf of a given employee. Because the rate of return is inherently fixed to the amount of contributions, pension benefits can no longer exceed contributions by more than the fixed amount. On the other hand, workers' contributions are not subject to all of the riskiness of market fluctuations, which can undermine

retirement security for some defined contribution plans.

The difficulty in constitutional terms arises because the accrual pattern in a cash balance plan differs so dramatically from the accrual pattern in a typical defined benefit plan. As noted above, a cash balance plan involves a steady accrual pattern throughout each worker's career, rather than backloading benefit accrual to the later years of one's employment. This graph from Costrell and Podgursky (2010) shows how the accrual patterns might differ over an employee's working lifetime¹⁷⁹

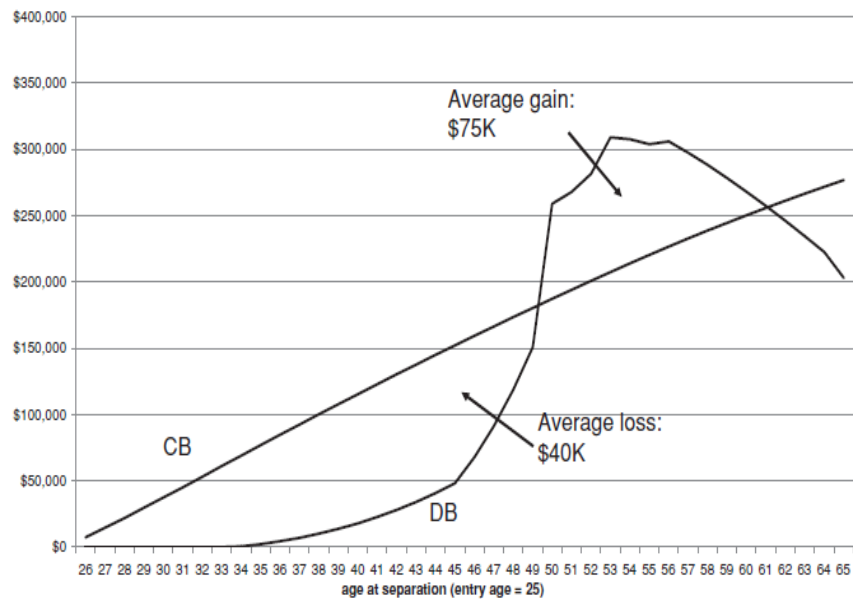


Figure 6. Present Value at Entry of Future Net Pension Wealth, MO. 46% of Net Pension Wealth Is Redistributed

Although no state has done so yet, a state could convert a defined benefit plan to a cash

¹⁷⁹ Robert M. Costrell and Michael Podgursky, "Distribution of Benefits in Teacher Retirement Systems and Their Implications for Mobility," *Education Finance and Policy* (2010): 519-557.

balance plan.¹⁸⁰ Because no state has done so for its current employees, no court has yet considered any of the legal challenges that would probably arise. Consider the graph from Costrell and Podgursky. If the goal was to allow workers early on in their careers to be able to leave with more money in their “account,” but to do so without the state having to spend extra money on the pension system, it would be unavoidably necessary to reduce the future accruals earned by older employees for roughly a 10 year period towards the end of their careers.

To be sure, a state could always keep the older employees happy by keeping their higher accruals while raising the accruals of younger employees – thus creating a smooth accrual curve with a higher intercept than is depicted in the graph above. But that sort of transition to a cash balance system would result in considerably higher expenditures potentially for decades (until all of the older employees died). Assuming that states do not have the resources to raise benefits substantially for younger workers while leaving older workers to collect outsized benefits, states would have to transition to a cash balance plan by raising the accrual of younger workers and lowering the accrual of older workers.

Thus, if a transition to a cash balance system involved reductions in the pension paid to older workers who retired during the “bump” that Costrell and Podgursky identify, one would expect older workers to file a lawsuit claiming that the old system entitled them to a particular level of benefits, and that the switch to a cash balance plan had deprived them of contractually guaranteed rights. Given that this sort of legal challenge would be new, it is difficult to predict what any court would do. Nonetheless, there are good arguments that a fiscally neutral transition to a cash balance plan should be a viable option under federal and state constitutions.

¹⁸⁰ Nebraska’s cash balance plan arose from a (rare) governmental defined contribution plan, and therefore does not raise the same issue of uneven accrual patterns being converted to even accrual patterns.

Before getting to the constitutional question, though, it is necessary to take a short detour through the caselaw regarding the legality of private companies' decisions to switch from defined benefit plans to cash balance plans. Such private decisions obviously do not implicate the Contracts Clause, which applies only to legislatively-imposed contractual changes. Instead, the legal challenges involved claims of age discrimination. These cases are still relevant here, because the underlying premise of either an age discrimination claim or a Contracts Clause claim is that the pension plan has been changed in a way that disfavors the older employees who were expecting a larger pension payment.

The most well-known such case is *Cooper v. IBM Personal Pension Plan*.¹⁸¹ In that case, IBM had switched from a traditional defined benefit plan to a cash balance plan, but was sued for age discrimination. The basis for this argument was that the 5% interest credit was applied to younger workers' accounts for a longer period of time, thus making their yearly accruals greater in value. The district court had noted that under ERISA, an "accrued benefit" is defined as an amount "expressed in the form of an annual benefit commencing at normal retirement age."¹⁸² But someone who "leaves IBM at age 50, after 20 years of service, will have a larger annual benefit at 65 than someone whose 20 years of service conclude with retirement at age 65." This pattern of accruals therefore favored younger employees, according to the district court.

The Seventh Circuit disagreed, however, noting that the time value of money is not the same thing as age discrimination. As long as the contributions to workers' accounts are equal without regard to age, and as long as the interest awarded to accounts each year is the same, it is not employer discrimination against older people merely because they are not leaving their

¹⁸¹ 457 F.3d 636 (7th Cir. 2006). A similar case is *Register v. PNC Financial Services Group*, 477 F.3d 56 (3d Cir. 2007).

¹⁸² 29 U.S.C. § 1002(23)(A).

money in the accounts for as long a period of time. Even worse, the district court's analysis had left out a crucial component: while the court had used the power of compound interest to treat younger workers' accruals as worth "more" at retirement age, it left out the power of the discount rate to discount that value at retirement age back to the present value.

Notably, the Seventh Circuit included a passage addressing whether the shift in pension systems had worked to "diminish vested interests." The Seventh Circuit concluded that it did not, because IBM gave its employees the following: "the greater of the present value of their pension entitlements as of the transition date or the account balance that they would have had if IBM had a cash-balance plan in effect since the employee came to work." Just as notably, the Seventh Circuit said that this shift did not "diminish vested interests" even though it "disappointed expectations." In other words, giving older employees the present value of their pension entitlements earned to date might have still frustrated those older employees (if they were expecting a still-higher payout after another year of work), but such a change was not enough to harm the vested interests already earned. That, in the Seventh Circuit's analysis, was the key point: protecting the past accrued benefits, while allowing IBM to shift to a new system of accrual for future benefits.

In light of what the Seventh Circuit said here, one obvious way to convert a traditional defined benefit plan to a cash balance plan would be to freeze workers' accrued benefits at current levels, while changing how benefits are accrued going forward. Under such a reform, workers in their early 50s might currently be in the period when the former plan entitled them to unduly large pension wealth, and hence they would receive unduly large opening cash balances; conversely, younger or newer workers at the lower point of the pension wealth curve would receive unduly low cash balances. Nonetheless, it may all balance out in the end, as the newer

workers would see their cash balance accounts increase more sharply in value over time with a more even accrual pattern.

Setting opening cash balances based on the present value of the accrued pension wealth is lawful under ERISA when a private company converts from a traditional defined benefit plan to a cash balance plan. As noted above, ERISA protects past accruals while allowing changes to or even the elimination of future accruals altogether. In at least one federal appellate case, the question arose whether a company had sufficiently protected past accruals when it eliminated a traditional defined benefit plan and offered its employees a starting “cash balance” representing the current value of their prior accruals. What the company did – and this was upheld by the Eighth Circuit – was this: ignoring any possible future accruals, determine what it would cost to purchase an annuity at the workers’ normal retirement date that would pay them a monthly pension based on what they had accrued as of the switch in pension plans, and then discount that annuitized value back to the present value using the same discount/interest rate that the cash balance plan itself was going to use (in the Eighth Circuit case, this was a generous 8%). The plaintiffs had argued that a lower discount rate (one that the IRS periodically sets to determine how to calculate lump sum distributions) should have been used, but the Eighth Circuit held that setting an initial cash balance is not the same as a lump sum distribution and there is no statutory obligation to use a lower discount rate here.¹⁸³

Similarly, the Department of Labor has this explanation and example of what must occur when a private company switches pension plans:

In addition, while employers may amend their plans to cease future benefits or reduce the rate at which future benefits are earned, they generally are prohibited from reducing the benefits that participants have already earned. . . . For example, assume that a plan’s benefit formula provides a monthly pension at age 65 equal

¹⁸³ *Sunder v. U.S. Bancorp Pension Plan*, 586 F.3d 593 (8th Cir. 2009).

to 1.5 percent for each year of service multiplied by the monthly average of a participant's highest three years of compensation, and that the plan is amended to change the benefit formula. If a participant has completed 10 years of service at the time of the amendment, the participant will have the right to receive a monthly pension at age 65 equal to 15 percent of the monthly average of the participant's highest three years of compensation when the plan amendment is effective.¹⁸⁴

Obviously, the Department of Labor here is merely explaining how ERISA rules apply to private pension plans; its analysis does not apply to constitutional regulation of governmental plans. Still, ERISA is useful for analogical purposes. After all, ERISA regulates private pension plans extensively based on the presumption that workers need special statutory protection of their accrued pension benefits. If even ERISA, as an employee-protective contractual framework, allows forward-looking changes while guiding how past accruals are to be protected, then by analogy one could argue that it would be odd to interpret the federal or state constitutions so as to provide far greater contractual protection.

Older workers might still complain that they had struck a contractual deal whereby they paid too much into the system earlier in their careers in exchange for the right to withdraw outsized amounts if they stuck around long enough to retire at the right time. Thus, their argument might continue, to change the pattern of accruals mid-stream – even on a forward-looking basis – would upset the expectations that the state pension system originally set in place precisely to encourage longevity in its workforce.

Legislature and courts, however, should reject this argument. Even if older workers' pension accrual is reduced looking forward, that is only because they are currently in a position to get a windfall at the expense of more mobile workers. To the extent that the uneven curve in Figure 1 differs from a smooth line, it is because more mobile workers are paying too much into

¹⁸⁴ U.S. Department of Labor, "Frequently Asked Questions About Cash Balance Pension Plans," at http://www.dol.gov/ebsa/FAQs/faq_consumer_cashbalanceplans.html.

the system compared to the benefits that they themselves receive if they moved or changed jobs, because that money is being transferred to older workers. In a certain respect, traditional defined benefit plans resemble a Ponzi scheme, in that the fiscal viability of the oversized accruals given to some older workers depends on consistently finding more and more new recruits who can be convinced to pay too much money into the system. It is therefore unclear that the basic fairness issue normally raised as to pension changes would weigh in older workers' favor.

A second consideration is that it arguably makes more sense to view each worker's interest as a comprehensive lifetime whole, rather than as a slice of time late in one's career. One might say to an older worker, "Yes, you have been told that at age 55, you can retire with more benefits than were ever paid in on your behalf. But that is only because your own pension wealth five years ago was too low, and will be too low again if you work for until age 60. With a cash balance plan, you can keep working to a normal retirement age, and have even more pension wealth than you have today, in addition to the ability to leave that wealth to your descendants." In other words, over a particular worker's lifetime, the worker will be advantaged *overall* from not having nearly as many time periods when his pension wealth is unfairly low, even if his *excess* pension wealth no longer spikes to an all-time high during one relatively short time period.

On a lifetime view, then, a cash balance plan is not any worse for workers than the traditional defined benefit plan, and there is no reason to think that workers on average would be better off with an outsized benefit during a particular 5- or 10-year window rather than a *fair* benefit at *all* times during their working lives. As Judge Easterbrook said in the *Cooper* case, "removing a feature that gave extra benefits to the old differs from discriminating against them," and "replacing a plan that discriminates against the young with one that is age-neutral does not

discriminate against the old.”

Hybrid plans

Rhode Island is the most prominent recent example of a state that moved its current employees from a strict defined benefit plan to a hybrid defined benefit/defined contribution plan. What does this mean? The defined benefit plan already in existence still remains, but has been scaled back by, as discussed above, lowering the multiplier for future service to 1% from 2% or more, raising the retirement age, and more. Then, in a separate move, the Rhode Island legislation creates a new defined contribution plan that starts as of July 1, 2012. The terms of the defined contribution are mostly drawn straight from 26 U.S.C. § 401(a), which sets out terms that any pension plan must be to be tax-exempt under the United States Tax Code. The employee/employer contribution rates are set by statute at a total of 6% (divided into 5% and 1% respectively) for employees who are also in Social Security, and a total of 10% (5% from employers) for employees who are not in Social Security. In other words, the predominant source of retirement benefits is being shifted towards the new defined contribution plan and away from the traditional defined benefit plan. The main sense in which this is a “hybrid” plan, then, is just that two basically separate plans now exist side-by-side.

Obviously, the rate and everything else about future accruals has been changed. How should such a new hybrid plan protect prior accruals? As noted above, all one needs to do is take the annuitized value of the defined benefit pension wealth at the time of the pension shift, for each employee. Then let that annuitized value continue to earn imputed “interest” each year until a given employee actually retires. Thus, any pension wealth accumulated in the old defined benefit plan will continue to retain all of the present value that it had, with no previous accruals having been lowered retrospectively. And in the meantime, new accruals can occur according to

the terms of the new plan (whether that is a hybrid plan or a completely different plan altogether).

5. What about Emergency Exceptions?

As noted above, even state legislation that substantially impairs contractual rights can be permissible if, in the end, the state justifies its action by a showing of financial necessity or need. Court holdings on the necessity exception tend to veer in different directions. On one hand, some cases suggest that states cannot rely on the mere desire to lower their own financial expenditures as a justification for breaking contractual obligations. The U.S. Supreme Court has explained that “[a] governmental entity can always find a use for extra money, especially when taxes do not have to be raised. If a State could reduce its financial obligations whenever it wanted to spend the money for what it regarded as an important public purpose, the Contracts Clause would provide no protection at all.”¹⁸⁵ Thus, in *AFSCME v. City of Benton, Arkansas*,¹⁸⁶ a city had sought to stop paying retiree health insurance premiums on grounds of economic need, but the Eighth Circuit was skeptical: “Although economic concerns can give rise to the City’s legitimate use of the police power, such concerns must be related to ‘unprecedented emergencies,’ such as mass foreclosures caused by the Great Depression. . . . Further, to survive a challenge under the Contract Clause, any law addressing such concerns must deal with a broad, generalized economic or social problem.”¹⁸⁷

By contrast, in *Baltimore Teachers Union v. Mayor and City Council of Baltimore*,¹⁸⁸ the Fourth Circuit held that Baltimore’s salary reduction plan, adopted because of budget problems,

¹⁸⁵ *U.S. Trust Co.*, 431 U.S. at 26 (footnote omitted).

¹⁸⁶ 513 F.3d 874 (8th Cir. 2008).

¹⁸⁷ *Id.* at 882.

¹⁸⁸ 6 F.3d 1012, 1015 (4th Cir. 1993).

did not violate the Contracts Clause. In explaining why it was reversing the district court's opinion striking down the legislation, the court explained that a real emergency existed and that Baltimore had already tried other means of addressing the financial shortfall.¹⁸⁹

As for the states that recently enacted pension reform, consider Colorado. In *Peterson v. Fire and Police Pension Association*,¹⁹⁰ the Colorado Supreme Court found that while police officers had a limited vesting of survivor pension benefits in a city plan, those pension benefits could be altered (as was the case by the city plan's replacement with a statewide plan). The court held that "[h]ad the General Assembly not changed the funding scheme for death and disability pensions, the City and County of Denver eventually would have exhausted its pension funds. We conclude that ensuring that the individual petitioners receive survivor benefits as long as they remain eligible offsets the harm the petitioners are suffering due to their lower monthly benefit payments. . . . In order to avoid bankrupting the Denver system and others throughout the state, it was necessary to reduce the benefits for the group as a whole. Ensuring that the statewide pension system is actuarially sound justifies any corresponding detriments to the group."¹⁹¹

Suppose that a state's financial emergency does seem to require lowering pension payments that have been accrued in previous years. How can such restrictions be enacted most fairly, given that retirees have relied on the pension promises made to them? Imagine dividing a pension payment into the following categories: 1) the amount that is due to new increases enacted during the worker's career, but that was not paid for at all by increased contributions (this category would obviously include those pension increases that are made retroactive to previous years of employment); 2) the amount that is due to new increases during a worker's career, and

¹⁸⁹ *Id.* at 1020-21.

¹⁹⁰ 759 P.2d 720 (Colo. 1988).

¹⁹¹ *Id.* at 725-26.

that was paid for in part via contributions, albeit at a contribution rate lower than would be necessary to pay for a full lifetime pension; 3) the amount that was promised to the employee for his or her entire career but that is in excess of what contributions could have paid for given accurate actuarial assumptions; 4) the amount that was promised to the employee for his or her entire career and that was fully paid for via contributions.

Category 4 is the easiest: these amounts of money were fully paid for via contributions at the time, and therefore cannot be part of any unfunded liability. They should therefore be fully protected by the Contracts Clause, even in the case of financial emergency. The other categories should receive less protection, culminating in category 1 (which should receive the least protection of all). Category 3 was not fully paid for at the time, but was promised to the employee for his or her entire career, and the employees therefore have a strong reliance interest in obtaining a pension of that amount. Category 2 was neither fully paid for, nor was it promised for an employee's entire career; there is therefore less of a claim on the employee's part to have relied on the promise or to have paid for the benefit in question. And finally, Category 1 was never paid for at all, and includes increases that were made retroactive. Hence, no one could have relied on that pension promise during those retroactive years; after all, if I go to work for a state agency in 1985 and am promised a pension of \$X, and if the pension is increased retroactively in 2005, I could not possibly have spent the years between 1985 and 2004 justifiably relying on the hope that a retroactive pension increase would someday be enacted.

Thus, if benefits must be cut to current retirees, the state should calculate (this can easily be done with spreadsheets) what amounts of money fall into what categories for each employee. Then any cuts should affect category 1 for all retirees first – that is, the state should first cut (if at all) payments that were promised retroactively but never paid for. These payments do not

represent anything that the employee bargained for or gave consideration for in the first place. If cuts to category 1 are not enough, the state should proceed to category 2, making cuts proportionate to the amount of a worker's career that was spent making contributions towards the increased benefit. And so forth.

This may not be a perfect system, but it allows the state to urge that it is attempting to be fair by cutting first (and hopefully only) those benefits that were closest to a gratuity.

B. The Takings Clause

In some of the lawsuits currently before state courts, plaintiffs have raised the argument that pension reform is a violation of state or federal Takings Clauses: if state employees do not receive the pension benefits to which they are entitled, their property right to the money at issue has been violated.

The U.S. Constitution provides that private property shall not be “taken for public use, without just compensation.” Just as with the Contracts Clause, state courts overwhelmingly tend to construe their own state constitutions’ Takings Clause in parallel with the U.S. Constitution.¹⁹²

The question is whether and how this might apply to state legislation that “takes” away pension rights. As the plaintiffs in Minnesota argued, “The Takings Clause is addressed to ‘every sort of interest the citizen may possess.’ . . . Here, Plaintiffs had a legitimate expectation that they would receive annual pension increases at the levels specified under the law when they retired.”¹⁹³

¹⁹² See, e.g., *E-470 Public Highway Authority v. Revenig*, 91 P.3d 1038, 1045 n.10 (Colo. 2004) (quotation omitted) (“Although the language of article II, section 15 of our constitution differs from its federal counterpart, we have considered decisions of the United States Supreme Court construing the federal takings clause as a guide in determining what constitutes a taking.”); *Wensmann Realty v. City of Eagan, Inc.*, 734 N.W.2d 623, 631-32 (Minn. 2007).

¹⁹³ Minnesota Plaintiffs’ Opposition to Motion for Summary Judgment, at 50 (available

Thus, in a North Carolina cases, the state supreme court relied on the Takings Clause to strike down pension legislation that newly subjected pension benefits to taxation: “Plaintiffs contracted, as consideration for their employment, that their retirement benefits once vested would be exempt from state taxation. The Act now undertakes to place a cap on the amount available for the exemption, thereby subjecting substantial portions of the retirement benefits to taxation. This is in derogation of plaintiffs’ rights established through the retirement benefits contracts and thus constitutes a taking of their private property.”¹⁹⁴

The question of whether a plaintiff has a property right to a pension is basically the same under the Contract Clause and the Takings Clause.¹⁹⁵ As the First Circuit said, “It is clear that this case does not involve tangible personal property or real property. It does not involve an effort to reclaim benefits already paid. The only property interest alleged is an expectancy interest claimed to derive from a contract between the state and the plaintiffs to afford a certain level of pension benefits. The facts here require us to consider whether plaintiffs had the requisite property right to support a Takings Clause claim by analyzing their claim under the Contract Clause.”¹⁹⁶ By the same token, pension benefits that are not contractually protected “are not property as to which the government, before repealing, must provide just compensation.”¹⁹⁷

from author).

¹⁹⁴ Bailey v. State of North Carolina, 500 S.E.2d 54, 69 (N.C. 1998).

¹⁹⁵ Ruckelshaus v. Monsanto Co., 467 U.S. 986, 1003 (1984) (noting that valid contracts are property within the meaning of the Takings Clause); Rhode Island Brotherhood of Correctional Officers v. State of Rhode Island, 264 F. Supp. 2d 87, 103 (D. R.I. 2003) (“In sum, without a contract, there is no property right, and without a property right, there is no Takings Clause violation.”).

¹⁹⁶ Parella v. Retirement Bd. of Rhode Island Employees’ Retirement System, 173 F.3d 46, 58-59 (1st Cir. 1999).

¹⁹⁷ Hoffman v. City of Warwick, 909 F.2d 608, 616 (1st Cir. 1990).

Thus, because a Takings Clause claim is parasitic on a Contracts Clause claim,¹⁹⁸ it would not result in any additional relief under current doctrine.

Nor should the Takings Clause require a different result than the Contracts Clause theory I have laid out. When a state modifies the way that pension benefits are accrued in future years, or the contribution rate that employees pay in future years, it is difficult to see how any genuine property interest of the employees has been affected. To think that the Takings Clause is independently implicated in such a circumstance, one would have to show that employees have a property interest not just in money that they have already been paid or promised for past work, but also in a particular benefit rate that they had hoped to accrue in the future for work not yet performed.

One additional issue arises in the Takings Clause context: some state governments have attempted to defend pension legislation by arguing that the Takings Clause simply does not apply to takings of *money*. They cite, for example, a Federal Circuit holding that “while a taking may occur when a specific fund of money is involved, the mere imposition of an obligation to pay

¹⁹⁸ See, e.g., Nat’l Educ. Ass’n-Rhode Island ex rel. v. Ret. Bd. of the Rhode Island Employees’ Ret. Sys., 172 F.3d 22, 30 (1st Cir. 1999) (“It would make nonsense of such rulings--and the clear intent requirement--to conclude that an expectancy insufficient to constitute an enforceable contract against the state could simply be renamed ‘property’ and enforced as a promise through the back door under the Takings Clause.”); Rhode Island Council 94, A.F.S.C.M.E. v. State of Rhode Island, 705 F. Supp. 2d 165, 182 (D. R.I. 2010) (“Since the Court has concluded that there is no valid contract binding the State of Rhode Island for the prospective retiree health benefits affected by Article 4, Plaintiffs have failed to allege sufficient facts that would support a Takings Clause claim.”); Order, *Justus v. State of Colorado*, 2010 CV 1589 (Denver, Colo. Dist. Ct., June 29, 2011), at 11 (“Any arguable property right here is premised on the notion that the Plaintiffs have a contractual right to a particular COLA and thus fails where there is no such right.”); Order and Memorandum, *Swanson v. State of Minnesota*, Court File No. 62-CV-10-05285 (Second Judicial District, Ramsey County, Minn., June 29, 2011), at 26 (“Plaintiffs’ Takings claims fail because they rest ultimately on the expectation that future adjustments would be made pursuant to a particular formula. As shown above, that expectation has neither a contractual basis, nor a reasonable basis enforceable by estoppels principles.”).

money, as here, does not give rise to a claim under the Takings Clause of the Fifth Amendment.”¹⁹⁹

What such cases are really about, however, is whether taxes and fees can violate the Takings Clause.²⁰⁰ The reason for holding the Takings Clause inapplicable is that to hold otherwise would eviscerate the government’s ability to tax. But such cases do not answer the question whether the government has improperly taken someone’s property not when it imposes a tax or fee, but when it directly reduces a benefit that has been promised to someone. Return to the idea that pension benefits are really a form of backloaded wages. No one doubts that the Takings Clause does not prevent the government from imposing an income tax. But it would be a different matter altogether if the government passed legislation that specifically targeted a group of workers to have their salaries retroactively reduced. The Takings Clause might then apply, even if it does not yet protect those workers’ salaries or pension benefits that might be earned in future years.

¹⁹⁹ *Commonwealth Edison, Co. v. U.S.*, 271 F.3d 1327, 1340 (Fed. Cir. 2001).

²⁰⁰ See, e.g., *Kitt v. United States*, 277 F.3d 1330 (Fed.Cir. 2002).

IV. STATE AND LOCAL PENSION REFORM AND ENSUING LAWSUITS

In this chapter, the dissertation analyzes the most prominent recent lawsuits alleging that pension reform measures in certain states and municipalities are unconstitutional. The time period between 2009 and 2012 is the first time in U.S. history when generous defined benefit plans have run up against a national (indeed, worldwide) financial crisis that effectively zeroed out a decade of stock market growth. Hence, it is the first time in U.S. history when numerous states and municipalities have begun a sustained effort to cut back on pension benefits, even as to retirees in some cases, and to establish new forms of pension systems entirely (e.g., hybrid systems).

As a result, courts are in need of guidance in determining how to apply traditional Contracts Clause analysis to these new pension reforms. Courts should not veer between the historical extremes of holding either that pension benefits are entirely within legislative discretion or that pension benefits are frozen in place as of the first day of employment (as seen below, more than one recent court decision can be found at either extreme). Rather, this dissertation shows how a more subtle analysis can more effectively resolve many of the real-world cases that have arisen thus far.

A. *Colorado*

The Colorado Public Employees' Retirement Association, or PERA, "manages retirement benefits for approximately 92,000 PERA retirees and 373,600 PERA members who work for more than 400 employers (as of June, 2010)."²⁰¹ It is "the 21st largest public pension plan in the

²⁰¹ Geoffrey Johnson, Colorado Legislative Council Staff, *Colorado PERA 2010 Reform Legislation and Historical Funded Status* (Sept. 28, 2010), available at <http://www.colorado.gov/cs/Satellite?blobcol=urldata&blobheader=application/pdf&blobkey=id&blobtable=MungoBlobs&blobwhere=1251666724124&ssbinary=true> (hereinafter "Colorado Memo").

United States.”²⁰²

Before March 1, 1994, Colorado law applicable to PERA provided that “cost of living increases in retirement benefits and survivor benefits shall be made only upon approval by the general assembly.”²⁰³ The Colorado legislature adopted a statutory cost-of-living allowance (COLA) formula for PERA as of March 1, 1994, that led to the following COLAs²⁰⁴:

Year	Increase
1994	2.82%
1995	2.53%
1996	2.84%
1997	2.91%
1998	2.22%
1999	1.34%
2000	2.23%

Effective March 1, 2001, a new law went into effect guaranteeing a 3.5% COLA.²⁰⁵

In early 2010, spurred to action by projections showing that the state pension system would run completely out of money in 26 to 29 years,²⁰⁶ the Colorado legislature passed and the governor signed Senate Bill 10-001.²⁰⁷ Senate Bill 10, as it is called, made many revisions to the state pension system, including the following:

²⁰² PERA website, <http://www.copera.org/pera/about/overview.htm>.

²⁰³ Colo. Rev. Stat. § 24-51-1101 (1992).

²⁰⁴ First Amended Class Action Complaint, *Justus v. State of Colorado*, 2010cv1589 (Denver, Colo. Dist. Ct. 2010), ¶¶ 34-35 (hereinafter “Colorado Complaint”), available at <http://saveperacola.files.wordpress.com/2010/06/complaint-1st-amended1.doc>.

²⁰⁵ Laws 2000, Ch. 186, § 7; Colo. Rev. Stat. § 24-51-1002 (2009). The Denver Public Schools’ Retirement System had a slightly different history of granting COLAs: it adopted a 2% COLA in 1974, which was raised to 3% in 1981 and 3.25% in 1985. When the Denver school system became part of PERA in 2010, PERA retained the 3.25% COLA for school employees. Colorado Complaint ¶¶ 38-40.

²⁰⁶ See <http://www.copera.org/pdf/Misc/LACGraphs2008.pdf>.

²⁰⁷ The bill’s full text is available here: http://www.leg.state.co.us/CLICS/CLICS2010A/csl.nsf/fsbillcont3/DD3F57C1B220E34A872576A80029E75E?Open&file=001_enr.pdf.

First, it lengthened the amount of time worked and the age at which non-vested members and new hires would be eligible to retire with full benefits.²⁰⁸ Second, it increased the amount of money to be contributed by state and school employers.²⁰⁹ Finally and most significantly, it reduced the COLA given to people who are already retired and drawing a pension. As the chief executive of PERA told the *Wall Street Journal*, “‘No matter how draconian you got on the new hires, you ran out of money’ if you didn’t cut benefits to current retirees.”²¹⁰

As noted above, before Senate Bill 10, Colorado pension law gave retirees an automatic increase of 3.5% per year in their pensions.²¹¹ But Senate Bill 10 “cut future annual benefit increases for current retirees to 2 percent, unless PERA experiences a negative investment year, at which point the COLA for the next three years will be the lesser of the average of monthly annual inflation rates from the prior calendar year or 2 percent.”²¹² In addition, Senate Bill 10 establishes a 0.25% increase to the 2.0% cap if the pension system is 103% funded or better, with a 0.25% decrease if pension system is less than 99% funded.²¹³

The lawsuit *Justus v. Colorado*²¹⁴ was filed on March 17, 2010, in Denver County. According to the complaint, the main plaintiff “Gary R. Justus is a Colorado resident who worked for more than 29 years for the Denver Public Schools (“DPS”) before retiring in 2003. Until December 31, 2009, he received his pension through the Denver Public Schools Retirement

²⁰⁸ See Colorado Memo, pp. 5-8.

²⁰⁹ *Id.* at 9-10.

²¹⁰ Jeannette Neumann, *Pension Cuts Face Test in Colorado, Minnesota*, WALL STREET JOURNAL (June 12, 2010), available at <http://online.wsj.com/article/SB10001424052748704463504575301032631246898.html>.

²¹¹ Colorado Memo, p. 10.

²¹² *Id.* at 10-11.

²¹³ Colo. Rev. Stat. § 24-51-1009.5 (2010).

²¹⁴ 2010 CV 1589 (Denver, Colo. Dist. Ct. 2010).

System (“DPSRS”). On January 1, 2010, DPSRS became part of the Public Employees’ Retirement Association of Colorado (“PERA”), and since then Mr. Justus now receives his pension benefits from PERA.”²¹⁵

Justus and a few other named plaintiffs sought to represent a class of all the people who were eligible to retire between March 1, 1994 and February 28, 2010 (in the case of PERA employees) or between 1974 and February 28, 2010 (in the case of Denver Public School employees), as well as their survivors.²¹⁶ In other words, the lawsuit represents people who were eligible to retire during the time period *after* PERA and the Denver public school system adopted COLAs in the first instance, but *before* Senate Bill 10 went into effect.

As the plaintiffs’ lawyer told the *Wall Street Journal*, the retirees “lived up to their end of the bargain, and the state is not living up to theirs.”²¹⁷ The complaint included a chart showing that “hypothetical ‘average’ retiree will lose more than \$165,000 in benefits over the next twenty years” due to a 2% COLA rather than a 3.5% COLA.²¹⁸

The plaintiffs primarily claimed that the pension reform bill violated the U.S. Contracts Clause and the parallel Colorado constitutional clause.²¹⁹ They also alleged a violation of the Takings Clause, on the rationale that the plaintiffs “had a legitimate expectation that they would receive annual pension increases at the levels specified under the law and by the PERA and DPSRS plans in effect when they became eligible to retire or when they retired,” and the COLA

²¹⁵ Colorado Complaint ¶ 1.

²¹⁶ *Id.* ¶ 12.

²¹⁷ Jeannette Neumann, *Pension Cuts Face Test in Colorado, Minnesota*, WALL STREET JOURNAL (June 12, 2010), available at <http://online.wsj.com/article/SB10001424052748704463504575301032631246898.html>.

²¹⁸ Colorado Complaint ¶¶ 51-52.

²¹⁹ Colorado Complaint ¶¶ 63, 71

decrease took away their property right to that specific stream of payments without any compensation.²²⁰

On June 29, 2011, the state judge issued an order granting summary judgment to the state of Colorado.²²¹ The judge held that “[w]hile Plaintiffs unarguably have a contractual right to their PERA pension itself, they do not have a contractual right to the specific COLA formula in place at their respective retirement, for life without change.”²²² The judge based this determination on the fact that the statutory COLAs “have never included durational language stating or suggesting that a particular COLA provision formula (and there have been many) was for life without change. For four decades the COLA formulas as applied to retirees have repeatedly changed and have never been frozen at the date of retirement.”²²³ The judge also was swayed by the fact that some retirees had barely worked towards a 3.5% COLA at all: as to one particular plaintiff, the judge noted that “[a]t the time she retired on August 1, 2001, the 3.5% compounding COLA formula to which she would claim a lifetime right had been changed so often that it had only been in place for a total of five months.”²²⁴ The plaintiffs have since appealed the dismissal of their claim.²²⁵

Under the legal theory I have outlined, however, this Colorado ruling went too far. Some of the retirees could have been working under a system promising a 3.5% COLA for as long as nine years, between 2001 and 2010. Yet those retirees were not given a pro-rated COLA based

²²⁰ Colorado Complaint ¶¶ 75-76.

²²¹ Order, *Justus v. State of Colorado*, 2010 CV 1589 (Denver, Colo. Dist. Ct., June 29, 2011).

²²² *Id.* at 4.

²²³ *Id.*

²²⁴ *Id.* at 8.

²²⁵ See <http://www.saveperacola.com>.

on their period of service. Instead, the COLA was reduced outright, with no allowance made for the period of time during which workers or retirees had been promised a higher COLA. A better way would be to treat such promises as contractual in nature. As noted above, the legislature could have said that each retiree's COLA will be determined by prorating according to whatever COLA formula and/or statutory level was in place for various years of the retiree's working life.

B. South Dakota

South Dakota, like Colorado, recently passed legislation that amended COLAs for its state pension system.²²⁶ First a bit of history: as of 1982, the COLA for South Dakota retirees was the percentage change in the consumer price index (CPI), but not exceeding 3% compounded annually.²²⁷ As of 1988, the COLA was guaranteed to be 3% compounded annually.²²⁸ As of 1993, the COLA was raised to a guaranteed 3.1%.²²⁹

The new legislation went into effect on July 1, 2010, and resulted in the following changes to all COLAs, including for people who are already retired:

- 1) COLAs are eliminated for first-year retirees;
- 2) the 2010 COLA was reduced from 3.1% to 2.1%;
- 3) for all future years, the COLA will be determined based on the pension system's funded status and the CPI (at 100% funding, the COLA is 3.1%; at 90+% funded status, the COLA is linked to the CPI with a 2.1% minimum and 2.8% maximum; at 80+% funded status, the COLA is linked to the CPI with a 2.1% minimum and 2.4% maximum; and if the funded

²²⁶ See South Dakota Senate Bill 20 (2010), available at <http://legis.state.sd.us/sessions/2010/Bill.aspx?Bill=20>.

²²⁷ South Dakota Laws § 3-12-47(29) (1987).

²²⁸ South Dakota Laws § 3-12-47(29) (1988).

²²⁹ *Id.* (2009 version).

status drops below 80%, the COLA is 2.1%).²³⁰

The lawsuit *Tice v. South Dakota*²³¹ was filed in Hughes County, South Dakota, and purported to represent all of the people who retired between July 1, 1982 and June 30, 2010, and their survivors.²³² The complaint contended that due to the COLA adjustment, a typical retiree would “lose between \$40,264.62 and \$77,414.68 in pension benefits over the next 20 years.”²³³

The first count alleged that the COLA adjustment violated South Dakota’s Contracts Clause, which states, “No ex post facto law, or law impairing the obligation of contracts or making any irrevocable grant of privilege, franchise or immunity, shall be passed.”²³⁴ The complaint likewise alleged a violation of the U.S. Constitution’s Contracts Clause.²³⁵ Count III alleged a violation of the U.S. Constitution’s Takings Clause,²³⁶ while Count IV alleged a violation of substantive due process.²³⁷

The South Dakota courts have barely ever considered the issue of contractual protection for public pension rights. The most recent case I could find came from 1953, and the South Dakota Supreme Court there held that a public worker was not vested in a pension until the actual retirement date.²³⁸ Specifically, the court said, “There is nothing in the Act which supports plaintiffs’ contention that 30 years of service creates a vested right. It is retirement that brings

²³⁰ *Id.* § 3; see also South Dakota Code § 3-12-47(41).

²³¹ Civil No. 10-225 (Hughes, S.D. Cir. Ct. 2010).

²³² South Dakota Complaint, ¶ 12.

²³³ *Id.* ¶ 36.

²³⁴ South Dakota Const., art. VI, § 12.

²³⁵ South Dakota Complaint, ¶¶ 47-50.

²³⁶ *Id.* ¶¶ 51-55.

²³⁷ *Id.* ¶¶ 59-63.

²³⁸ *Tait v. Freeman*, 74 S.D. 620, 57 N.W.2d 520, 522 (S.D. 1953).

into existence the fund upon which the pensioner has the right to depend.”²³⁹

Thus, unsurprisingly, the trial court’s April 11, 2012 decision upheld the state’s pension reform. In that decision, the court relied heavily on legal precedent noting that statutes should be construed as within the discretion of the legislature to change going forward, absent some clear indication that an unbreakable contract was established.²⁴⁰ Because the South Dakota statute did not contain any clear indication that would create a “forever 3.1% COLA,” plaintiffs did not have such a contractual right.²⁴¹ Indeed, the court suggested that it would be “hesitant” ever to find such a right, because a legislature in one year should not be able to “limit the powers and duties of future legislatures to provide sound governance of a fund so critical to so many present and future retirees, not to mention to taxpayers.”²⁴² The court further observed that under the plaintiffs’ preferred approach, “future legislatures would, no doubt, dramatically scale back future COLAs for *all participants in all market conditions*, in the knowledge that any COLA is forever.”²⁴³ The court thus acknowledged the perhaps counterintuitive fact that to hold in favor of one set of workers might be to disadvantage many other workers.

Again, though, by my reasoning, this court went too far. Under the pro rata approach, a worker who retired in 2012 after having started work in 1982 would receive COLAs calculated as follows: For approximately one-fifth of the COLA (accounting for the 1982-88 time period), the plan would look at the current CPI but with a 3% cap; for approximately one-sixth of the COLA, the plan would apply the 3% compounded figure in place from 1988-93; for the 1993-

²³⁹ *Id.*

²⁴⁰ Memorandum Decision at 10, *Tice v. South Dakota*, Civil No. 10-225 (Hughes, S.D. Cir. Ct. April 11, 2012).

²⁴¹ *Id.* at 12.

²⁴² *Id.* at 15.

²⁴³ *Id.* at 16.

2010 period, the plan would apply 3.1%; for 2010 itself, the plan would apply the 2.1% rate; and for 2011-12, the plan would apply the formula that is now in place. Having averaged all of that together on a weighted basis, the plan would then come up with the actual COLA given to this particular retiree. This calculation may seem complicated, but it would be quite simple to set up with any computer spreadsheet.

C. *Minnesota*

From 1981 to 1992, the Minnesota State Retirement System applied COLAs on an ad hoc basis determined by investment earnings.²⁴⁴ In 1992, the Minnesota Legislature changed to a complicated formula that included a component for inflation (up to a maximum of 2.5%) and a component for investment returns if investments earned more than the actuarial assumption of 8.5%; no investment component was paid between 2003 and 2009, and the COLA during that period averaged 2.1% per year.²⁴⁵ In 2009, the Legislature replaced that formula with a guaranteed 2.5% COLA.²⁴⁶

Minnesota passed an Omnibus Pension Bill²⁴⁷ on May 15, 2010. The bill made a wide number of modifications to several different plans, most significantly including adjusting all of the COLAs downwards to somewhere between zero and 2% until the plan(s) are fully funded.²⁴⁸ “The state passed legislation based on the severe drop in the market,” Minnesota State

²⁴⁴ *Swanson v. State of Minnesota*, No. 62-CV-10-5285, at ¶ 36 (Second Judicial District, Ramsey County, Minn., amended complaint filed July 2, 2010) (“Minnesota Complaint”). The complaint and further details about the case are available at <http://minnesotapensions.com/>.

²⁴⁵ Minnesota Complaint ¶ 37-41.

²⁴⁶ Minn. Stat. § 356.415 (2010).

²⁴⁷ SF2918/HF3281 (Minnesota Session Laws 2010). The bill was incorporated into Minnesota Laws 2010, Chapter 359, and the text of Chapter 359 with additions and deletions can be found here: <https://www.revisor.mn.gov/laws/?id=359&doctype=chapter&year=2010&type=0>.

²⁴⁸ *Id.* §§ 77-80.

Retirement System Executive Director Dave Bergstrom said. “We wanted to make sure our plans are sustainable.”²⁴⁹

Plaintiffs filed a lawsuit on behalf of the class of all people who retired between July 1, 1992 and May 15, 2010. The lawsuit claimed that the 2010 bill “violates the vested right of all Class Members to receive annual postretirement adjustments to their pension benefits according to the formula in effect when they began receiving a pension.”²⁵⁰ According to the complaint, the average pension recipient would lose “just over \$28,000 in benefits over the next ten years due to the elimination of the guaranteed 2.5% annual increase and if the Public Employee Retirement Fund does not reach a 90% funding level.”²⁵¹

The lawsuit included counts alleging a violation of Minnesota’s Contracts Clause (which provides, “No bill of attainder, ex post facto law, or any law impairing the obligation of contracts shall be passed”²⁵²), Minnesota’s Takings Clause (which provides, “Private property shall not be taken, destroyed or damaged for public use without just compensation therefor, first paid or secured”²⁵³), and the U.S. Constitution’s Contracts and Takings Clauses.²⁵⁴

On June 29, 2011, the state court judge issued an order granting summary judgment to the state.²⁵⁵ The court noted that “statutes are not contracts absent plain and unambiguous terms that show an intent to contract,” and that to conclude otherwise would intrude on the

²⁴⁹ Jonathan Miltimore, *States Eye Minnesota Pension Lawsuit*, WATCHDOG.ORG (Aug. 24, 2010), available at <http://watchdog.org/6322/states-eye-mn-pension-lawsuit/>.

²⁵⁰ Minnesota Complaint ¶ 49.

²⁵¹ Minnesota Complaint ¶ 52.

²⁵² Minnesota Const., art. I, § 11.

²⁵³ Minnesota Const., art. I, § 13.

²⁵⁴ Minnesota Complaint ¶¶ 54-75.

²⁵⁵ Order and Memorandum, *Swanson v. State of Minnesota*, Court File No. 62-CV-10-05285 (Second Judicial District, Ramsey County, Minn., June 29, 2011).

“Legislature’s policymaking authority.”²⁵⁶ In response to the plaintiffs’ argument that the legislature had not expressly reserved the right to change the COLA calculations, the court held that this was placing the burden on the wrong side: it was the plaintiffs who must show via “compelling language” that the statute was meant to create unamendable rights, while the “Legislature need not reserve the right to exercise its inherent authority” to amend statutes.²⁵⁷

Moreover, even if the statute provided contractual protections, the amendments were “a minimal alteration in the calculation of future adjustments to retirees’ annuities and a reasonable response to a fiscal threat that jeopardized the long-term interests of Plan members, the State, and the State’s taxpayers.”²⁵⁸ The court added that “legislative flexibility to respond to unintended operational consequences of plan terms, or funding deficiencies stemming from economic and marketplace forces beyond the control of the Legislature and the Plans, is critical to fulfilling the broader public interest in providing a benefit adequate for all members.”²⁵⁹

By the theory I have outlined, this judge erred in the same way as did the Colorado judge. For example, workers who retired with a full career’s worth of service in 2010 should presumptively be entitled to a pro-rated COLA based on the following weighted average: one year of employment with a guaranteed 2.5%, 17 years of employment with the formula in place between 1992 and 2009, and another 12 years of employment with the ad hoc investment-based calculation in place before 1992. The average COLA for each employee might be different, but would be based on that employee’s actual service and the terms in place at that time. Moreover, although these calculations seem complex, all that would be required is setting up a fairly simple

²⁵⁶ *Id.* at 3.

²⁵⁷ *Id.* at 17-18.

²⁵⁸ *Id.* at 4.

²⁵⁹ *Id.* at 18-19.

spreadsheet in which each employee's years or months of service can be entered under the appropriate factor.

D. New Hampshire

There have been numerous recent pension reform bills and lawsuits in New Hampshire.

1. The AFT case

HB 653 (2007)²⁶⁰ restricted funding to the “special account” for COLAs to years in which the overall funding ratio was at least 85%, and then only to the extent that the remaining assets of the retirement system earned in excess of 10.5%.²⁶¹ Then, HB 1945 (2008)²⁶² redefined “earnable compensation”— on which pensions are based – to exclude most forms of compensation other than wages,²⁶³ transferred \$250 million out of the “special account” that funded COLAs,²⁶⁴ and limited COLAs to 1.5% of the first \$30,000 (instead of the former limit of 5%), and then only in the fiscal year 2008-09.²⁶⁵ After that year, no more COLAs would be paid.

The first New Hampshire lawsuit, *American Federation of Teachers et al. v. State of New Hampshire*, was filed by a coalition of nine state employees' unions, along with several individually named plaintiffs.²⁶⁶ The lawsuit purported to represent all NH pension members as of August 29, 2008, who might receive benefits in the future, as well as retirees receiving

²⁶⁰ Available at <http://www.gencourt.state.nh.us/legislation/2007/HB0653.html>.

²⁶¹ *Id.* § 8.

²⁶² Available at <http://www.gencourt.state.nh.us/legislation/2008/hb1645.html>.

²⁶³ *Id.* § 1.

²⁶⁴ *Id.* § 8.

²⁶⁵ *Id.* § 19.

²⁶⁶ Amended Complaint, No. 09-E-0290 (Merrimack County Superior Court, NH, filed May 14, 2010) (“New Hampshire Complaint”), available at http://molanmilner.com/yahoo_site_admin/assets/docs/First_Amended_Petition.143122542.pdf. All of the filings in this lawsuit are available through the local counsel's website: http://molanmilner.com/cases_to_follow.

COLAs as of July 1, 2007 or July 1, 2008.²⁶⁷ The complaint challenged pension reform on the grounds that 1) prior to August 29, 2008, “earnable compensation” included not just wages, but “other compensation paid to the member by the employer,”²⁶⁸ but now the law excludes all “other compensation”²⁶⁹; 2) from 1993 to 2007, COLAs had ranged from 1% to a maximum of 5%, subject to available funding from a “special account” established for the precise purpose of funding COLAs, but HB 653 and HB 1745 prevented the special account from being funded to nearly the extent that it once was²⁷⁰; and 3) HB 1645 limited COLAs to a 1.5% payment in the 2008 fiscal year.²⁷¹

The complaint alleged violations of the contracts clauses of the New Hampshire Constitution²⁷² and the U.S. Constitution,²⁷³ the U.S. Constitution’s Takings Clause,²⁷⁴ and the U.S. Constitution’s protection of substantive due process.²⁷⁵ In addition, the complaint alleged that HB 1645’s section transferring \$250 million out of the “special account” for COLAs violated a provision of the New Hampshire Bill of Rights stating that “all of the assets and proceeds, and income there from, of the New Hampshire retirement system . . . and all contributions and payments made to any such system to provide for retirement and related benefits shall be held, invested or disbursed as in trust for the exclusive purpose of providing for

²⁶⁷ *Id.* ¶ 20.

²⁶⁸ *Id.* ¶ 33.

²⁶⁹ *Id.* ¶¶ 38-39.

²⁷⁰ *Id.* ¶¶ 45-46, 49.

²⁷¹ *Id.* ¶ 50.

²⁷² *Id.* ¶¶ 51-54.

²⁷³ *Id.* ¶¶ 55-57.

²⁷⁴ *Id.* ¶¶ 58-61.

²⁷⁵ *Id.* ¶¶ 62-64.

such benefits and *shall not be encumbered for, or diverted to, any other purposes.*²⁷⁶ The most recent event in this case is an order on class certification, but the court has not yet addressed the merits at all.

As outlined above, the best way to resolve this case would be for a court to hold that: 1) pre-2008 service should be eligible for extra compensation to be counted towards final average salary on a prorated basis; and 2) 1993-2007 service should be eligible for prorated COLAs by applying whatever formula was then in effect.

2. *The Judges case*

In another 2010 case, a New Hampshire court struck down pension reform on the grounds that public employees have a right to the same terms as when they began employment. The case of *Cloutier v. State of New Hampshire*²⁷⁷ involved a 2003 statutory change to the judicial retirement system. Prior to 2003, the judicial retirement system was governed by a provision granting retired judges 75% of the “currently effective annual salary of the office from which the [judge] retired.”²⁷⁸ In 2003, the legislature decided that retired judges would receive no more than 75% of their own final year’s salary.²⁷⁹ In effect, this meant that retired judges would no longer receive “the advantages of any raises or COLAs instituted for the benefit of the judges presently sitting after their retirement.”²⁸⁰

Retired judges sued, claiming that the modification violated contractual protections in the

²⁷⁶ New Hampshire Const., art. I, § 36-a (emphasis added); New Hampshire Complaint ¶¶ 92-93.

²⁷⁷ No. 219-2009-cv-00525 (Order, Strafford Superior Court, NH, Sept. 21, 2010) (“NH Judges Ruling”), available at http://molanmilner.com/yahoo_site_admin/assets/docs/SCAN3812_000.28645027.pdf.

²⁷⁸ *Id.* at 2.

²⁷⁹ *Id.*

²⁸⁰ *Id.*

state and federal constitutions. (New Hampshire’s Constitution does not contain an actual Contracts Clause, but does have a bar on “ex post facto” laws that the state supreme court has held to provide an equivalent protection,²⁸¹ which is not that surprising given that other states and the federal Constitution all treat the impairment of contracts as something parallel to an ex post facto law.)

On September 21, 2010, a state judge issued an order granting summary judgment to the retired judges. The judge found first that the “plaintiffs’ retirement benefits vested when they became permanent employees.”²⁸² These benefits included the previous statutory right to receive a higher pension due to future raises and COLAs.

The judge next found that the 2003 statute was a “substantial” impairment of this contractual benefit, because “retirement benefits are precisely the kind intended to promote an employee’s reliance” – that is, “judges are entitled to plan their retirement knowing that the legislature will not significantly alter earned benefits after the completion of his or her tenure.”²⁸³ The judge found that the state’s desire to avoid unfunded liabilities was “not sufficient to establish that the statute is reasonable and necessary.”²⁸⁴ The judge cited a United States Supreme Court holding to the effect that if a “State could reduce its financial obligations whenever it wanted to spend the money for what it regarded as an important public purpose, the Contract Clause would provide no protection at all.”²⁸⁵ Thus, the 2003 statutory change was “unconstitutional as applied to the judges who accepted their positions before the statutory

²⁸¹ *State v. Fournier*, 158 N.H. 214, 221 (2009) (federal contracts clause and state ex post facto clause provide “equivalent protections where a law impairs a contract, or where a law abrogates an earlier statute that is itself a contract”).

²⁸² NH Judges Ruling at 7.

²⁸³ *Id.* at 8.

²⁸⁴ *Id.* at 9.

²⁸⁵ *Id.* at 10 (quoting *U.S. Trust Co. of N.Y. v. New Jersey*, 431 U.S. 1, 26 (1977)).

change.”²⁸⁶

On March 30, 2012, the New Hampshire Supreme Court issued a decision in this case.²⁸⁷ The court said that “whether a public retirement plan creates a contract between a public employee and the State is a question of first impression in New Hampshire.”²⁸⁸ Nonetheless, the court cited a number of previous New Hampshire cases noting that pensions are a means of attracting employees, that they are a substantial part of compensation, and that they would be of little use if they could be “whisked away at the whim” of the employer.²⁸⁹ Based on these holdings, along with cases from California and elsewhere, the New Hampshire Supreme Court concluded that the N.H. pension statutes “created an implied-in-fact contract between the State and the judges who entered into employment when the statutes were in effect, which vested when they were appointed to be judges subject to attaining the age and service requirements.”²⁹⁰

The N.H. Supreme Court rejected, however, the trial court’s conclusion that any abridgment of a right that “induced the parties to contract in the first place” was inherently substantial.²⁹¹ Instead, just as in other states, a reduction could be balanced by a countervailing benefit. Hence, the N.H. Supreme Court reversed and remanded “for the court to determine in the first instance whether the contractual impairment is offset by any compensating benefits.”²⁹²

The New Hampshire courts’ belief that employees are entitled to keep in place a system of pension accruals merely because it existed on their first day of employment finds no basis in

²⁸⁶ *Id.*

²⁸⁷ *Cloutier v. State of New Hampshire*, No. 2010-714 (N.H. 2012).

²⁸⁸ *Id.* at 6.

²⁸⁹ *Id.* at 7.

²⁹⁰ *Id.* at 8-9.

²⁹¹ *Id.* at 9.

²⁹² *Id.* at 11.

actual contract law or other employment contracts. To be sure, the legislature should not be allowed free rein to alter the pension system *to the extent* that it takes away accrued benefits for previous years of employment. Thus in that sense, an employee ought to have a measure of contractual protection from the first day of employment (as the days go on, an employee's entitlement to a pension ought to parallel the number of days he or she has been employed under that system). But it goes to the opposite extreme to say that pension systems cannot be changed even on a going-forward basis for current employees; such a holding would be akin to locking the current level of salaries in place forever, even for future years in which the employees have not yet performed any labor or even been guaranteed a job at all.

The best way to resolve this case is therefore for a court to hold that 1) retired judges are presumptively entitled to the salary calculation as in place during their years of service (if tying their pensions to the current judicial salary is too onerous, this would merely encourage the state not to raise current judicial salaries too high); 2) current judges are entitled only to a prorate version of the final salary average calculation, as described above.

3. *The House Bill 2 cases*

Finally, a further New Hampshire bill in 2011 (House Bill 2) increased member contribution rates by two percentage points, among many other things.²⁹³ It was immediately followed by a union lawsuit filed in June of that year, challenging the increased contribution rates, and a second lawsuit filed on February 29, 2012 (this will be further discussed below). As to the first lawsuit, the unions' lawyer told a local newspaper that the bill was "a 2 percent tax on 50,000 public employees" "without a commensurate benefit."²⁹⁴

²⁹³ See New Hampshire House Bill 2 (July 1, 2011), available at <http://www.gencourt.state.nh.us/legislation/2011/HB0002.html>.

²⁹⁴ Elizabeth Dinan, "Union, retirement system sue over new pension reform law," *Sea*

The claims in the lawsuit were numerous. As usual, the plaintiffs alleged that the contribution rate increase violated the U.S. and New Hampshire contracts and takings clauses. The plaintiffs also alleged that the rate increase was an unreasonable tax, in violation of a New Hampshire constitutional provision authorizing the government to levy only “proportional and reasonable assessments, rates, and taxes.”²⁹⁵ Finally, the plaintiffs alleged that the rate increase violated the New Hampshire constitutional provision stating, “The employer contributions certified as payable to the New Hampshire retirement system or any successor system to fund the system’s liabilities, as shall be determined by sound actuarial valuation and practice, independent of the executive office, shall be appropriated each fiscal year to the same extent as is certified.”²⁹⁶

A New Hampshire Superior Court issued an order on January 6, 2012.²⁹⁷ The court dismissed the plaintiffs’ claim arising under the N.H. constitutional provision requiring “sound actuarial practice,” on the theory that the plaintiffs had no economic stake in actuarial practice as their benefits would be guaranteed by the state “regardless [of] the level of funding in the system.”²⁹⁸ The court also dismissed plaintiffs’ claim regarding disproportionate taxation, because paying into a pension trust fund is merely a fee for services, rather than a tax laid upon

Coast Online, 29 June 2011, available at <http://www.seacoastonline.com/articles/20110629-NEWS-110629716>.

²⁹⁵ N.H. Const. Part 2, Art. 5.

²⁹⁶ N.H. Const. Part 2, Art.36-a.

²⁹⁷ *Professional Firefighters of New Hampshire v. State of New Hampshire*, No. 217-2011-CV-385 (N.H. Superior Court, Merrimack, SS, Jan. 6, 2012). This decision is available at http://www.molanmilner.com/yahoo_site_admin/assets/docs/01062012_Order_from_MSCS_copy.31134912.pdf.

²⁹⁸ *Id.* at 7.

the population to support general revenue.²⁹⁹ As to the Contracts Clause arguments, the court was not persuaded by either side’s arguments – the state had argued that benefits could be “legislatively abolished up until the very day” of retirement, while plaintiffs had argued that “benefits vest as soon as an employee begins full time permanent employment.”³⁰⁰ Under the relevant N.H. statute, however, benefits were deemed “vested” after 10 years of service,³⁰¹ and there is no reason to think that such vested benefits could be stripped away at any time before actual retirement.³⁰² Without discussing how an increased contribution rate (which necessarily applies only to *future* accruals) would affect the previously vested benefits, the court then held that the impairment of an increased contribution rate was substantial because “it requires employees, who have already met the requisite service and age requirements, to pay additional amounts – which may be an amount reserved for other expenses, like mortgages, housing, and food – without receiving additional benefit.”³⁰³ All of that said, the court held that because the plaintiffs had not specifically alleged that they satisfied the 10-year-vesting requirement, they had failed to allege an element of their case, and their complaint would therefore be dismissed with leave to amend.³⁰⁴ The plaintiffs did amend their complaint, and a trial is scheduled for October 2012. As noted above, however, increasing contribution rates on a going-forward basis should be presumptively constitutional in all cases.

The same law firm (Molan Milner) then filed a separate lawsuit on Feb. 29, 2012, in a different New Hampshire court, challenging several aspects of House Bill 2 other than the

²⁹⁹ *Id.* at 8-9.

³⁰⁰ *Id.* at 14.

³⁰¹ *Id.* at 16.

³⁰² *Id.* at 17-18.

³⁰³ *Id.* at 22.

³⁰⁴ *Id.* at 23-24.

contribution rate increase. Specifically, the complaint alleges that House Bill 2 violates the U.S. and N.H. Contracts and Takings Clauses by limiting earnable compensation by excluding vacation and sick pay, increasing final average salary calculation period to 5 years, lowering the maximum benefit, increasing a minimum age requirement, reducing the multiplier from 2.5% to 2.1%, and repealing an accidental disability exception.³⁰⁵ In this case, all of the revisions can be calculated on a prorated basis as described in greater detail above.

E. New Mexico

The pension struggle in New Mexico is somewhat different from the other states considered here. In 2009, the New Mexico legislature passed H.B. 854, “An Act Relating to the Retirement of Public Employees; Providing a Temporary Increase in Certain Employee Contribution Rates and a Corresponding Temporary Decrease in the Employer Contribution Rates.”³⁰⁶ The bill was effective as of July 1, 2009.

What the Act did was this: For employees making over \$20,000 in all the various New Mexico pension plans (*e.g.*, general employees, police, etc.), the employee contribution was increased by 1.5 percentage points for a 2-year period, while the employer contribution was decreased by the same 1.5 percentage points for that same period.³⁰⁷

A lawsuit was filed on June 15, 2009, in the case of *AFSCME v. State of New Mexico*.³⁰⁸ The lawsuit alleged that the real purpose of the contribution swap here was to increase state

³⁰⁵ See *Professional Firefighters of New Hampshire v. State of New Hampshire*, No. 216-2012-CV-00193 (Superior Court of Hillsborough, N.H., complaint filed Feb. 29, 2012), available at http://www.molanmilner.com/yahoo_site_admin/assets/docs/Petition_for_Declaratory_Injunctive_Relief.59111305.pdf.

³⁰⁶ The full text of the bill is available at <http://www.nmlegis.gov/Sessions/09%20Regular/final/HB0854.pdf>.

³⁰⁷ *Id.* §§ 1-11.

³⁰⁸ No. CV-2009-7148 (County of Bernalillo, Second Judicial District Court, NM, filed June 15, 2009) (available from author) (“New Mexico Complaint”).

revenue, and that public employees were effectively going to “contribute to the State approximately \$80 million for general revenues purposes.”³⁰⁹ The lawsuit brought counts based on various New Mexico constitutional provisions regarding taxation and finances, as well as the federal and state contracts and takings clauses.³¹⁰

The legal background in New Mexico is also different from that in other states. A 1996 New Mexico Supreme Court case actually rejected contractual protection: in *Pierce v. New Mexico*,³¹¹ the New Mexico Supreme Court held that “[o]ur four retirement plans do not clearly and unambiguously create private contractual rights. We decline to join those states that find a contractual relationship where one does not clearly and unambiguously exist and that proceed to justify how the legislature may nonetheless unilaterally modify this contract without the consent of the participants.”³¹²

That said, a 1998 addition to the New Mexico Constitution created property rights – not contract rights – in state pension payments. That addition states, “Upon meeting the minimum service requirements of an applicable retirement plan created by law for employees of the state or any of its political subdivisions or institutions, a member of a plan shall acquire a vested property right with due process protections under the applicable provisions of the New Mexico and United States constitutions.”³¹³ The provision goes on to state, however, that “[n]othing in this section shall be construed to prohibit modifications to retirement plans that enhance or

³⁰⁹ *Id.* ¶ 29.

³¹⁰ *Id.* ¶¶ 32-86.

³¹¹ 121 N.M. 212, 910 P.2d 288 (1995).

³¹² *Id.* at 304.

³¹³ N.M. Const. art. XX, § 22D.

preserve the actuarial soundness of an affected trust fund or individual retirement plan.”³¹⁴

Thus, whatever this “vested property right with due process protections” might mean, New Mexico legislators appear to retain the authority to modify pension benefits so as to aid the actuarial soundness of the plan. As argued extensively above, courts should preserve the ability of a state legislature to adjust contribution levels on a going-forward basis.

F. Massachusetts

In 2009, Massachusetts passed a pension reform bill that modified how state pensions are calculated. The state had been roiled by a newspaper report finding that “over the prior six years, 102 Boston firefighters had substantially enhanced their tax-free disability pensions by claiming career-ending injuries while they were filling in for superiors at higher pay grades. Some firefighters have sought the enhanced benefit after filling in for a superior for just one day, leading critics to call it the ‘king-for-a-day’ provision.”³¹⁵ In addition, the law at the time based pensions on the worker’s “salary, wages or other compensation in whatever form.”³¹⁶

The pension reform legislation did two significant things. First, it redefined “regular compensation” and “wages” in Section 1 of Chapter 32 of the Massachusetts General Laws so that pensions would now be calculated solely based on the worker’s actual “wages.”³¹⁷ Second, the legislation expressly addressed the firefighter issue by providing that “if an individual was in a temporary or acting position on the date such injury was sustained or

³¹⁴ *Id.* art XX, § 22E.

³¹⁵ Michael Levenson and Donovan Slack, *Firefighters on disability race to retire*, Boston Globe (June 30, 2009), available at http://www.boston.com/news/local/massachusetts/articles/2009/06/30/with_new_law_closing_a_loophole_boston_firefighters_race_to_retire_by_tomorrow/.

³¹⁶ Mass. General Laws, chapter 32, § 1 (2008).

³¹⁷ Massachusetts Senate Bill 2079, § 3 (2009), available at <http://nepba.org/sites/nepba.prometheuslabor.com/files/SB2079.pdf>.

hazard undergone[,] the amount to be provided under this subdivision shall be based on the average annual rate of the individual's regular compensation during the previous 12-month period for which he last received regular compensation immediately preceding the date such injury was sustained or such hazard was undergone."³¹⁸

Oddly enough, there was a huge and suspicious spike in disability retirements just prior to the legislation's effective date. As the *Globe* reported on June 30, 2009, 29 Boston area firefighters had filed for disability retirement on the preceding day, "just two days before a new state law ends a controversial benefit that allows them to significantly enhance their pensions if they claim career-ending injuries occurred while filling in for a superior at a higher pay grade."³¹⁹ The *Globe* further noted that "of the 29 who filed yesterday, 25 said they were filling in for a superior at the time of their injuries, according to city officials, which makes them eligible for a pension benefit at the higher salary scale. That perk, which can add hundreds of thousands of dollars over a retiree's lifetime and cost taxpayers millions, will not be available to anyone filing after today."³²⁰

In any event, firefighters were not happy with the elimination of this loophole. A class of firefighters and police officers filed a lawsuit in United States District Court in Boston in mid-2009.³²¹ The complaint stated that the plaintiffs had worked "under a law which expressly promised that the definition of 'regular compensation' and the specified method of calculating

³¹⁸ *Id.* § 8.

³¹⁹ Michael Levenson and Donovan Slack, *Firefighters on disability race to retire*, Boston Globe (June 30, 2009), available at http://www.boston.com/news/local/massachusetts/articles/2009/06/30/with_new_law_closing_a_loophole_boston_firefighters_race_to_retire_by_tomorrow/.

³²⁰ *Id.*

³²¹ *Boston Police Superior Officers Federation v. Patrick*, No. 1:09-cv-11137 (D. Mass. filed July 2, 2009) ("Massachusetts Complaint").

their pensions would not be changed. Now, when they retire, they face reduction of their pension benefits under the new legislative regime.”³²² That is, they had assumed that their pensions would be based on “longevity pay, hazardous duty pay, clothing allowances and payments for unused vacation,” but now their pensions would be based only on “wages.”³²³

The lawsuit claimed that in redefining “wages” for all “Massachusetts public pension members . . . who have not yet retired,”³²⁴ the legislation had breached the U.S. Constitution’s Contracts Clause, as well as Articles 1, 10, and 12 of the Massachusetts Constitution.³²⁵ In addition, the complaint pointed out that Massachusetts law expressly stated that most provisions of the pension statute (including the definition of “wages”) “shall be deemed to establish . . . a contractual relationship under which members who are or may be retired . . . are entitled to contractual rights and benefits, and no amendments or alterations shall be made that will be deprive any such member or any group of such members of their pension rights or benefits provided for thereunder.”³²⁶

In any event, this lawsuit fizzled out eventually. In 2010, a Massachusetts state appeals court issued a ruling holding that under state statute, certain extra allowances were not part of base compensation in the first place.³²⁷ The parties ultimately agreed to dismiss the lawsuit on May 26, 2011.

Under the contractual theory presented in this dissertation, a legislature can refine wages on a going-forward basis, but the presumption (absent a showing of an actual fiscal emergency)

³²² Massachusetts Complaint ¶ 4.

³²³ *Id.* ¶ 33.

³²⁴ *Id.* ¶ 48.

³²⁵ *Id.* ¶¶ 61, 63.

³²⁶ Mass. General Laws, chapter 32, § 25.

³²⁷ O’Brien v. Contributory Ret. App. Bd., No. 2000-P-533 (Mass. App. Ct. 2010).

should be that retiring public employees would get a pension calculated by prorating the compensation based on years worked. For example, if an employee had worked for 20 years with the expectation of retiring with overtime being counted towards final compensation, and then 10 years with overtime having been eliminated in that calculation, then the ultimate pension awarded should include 2/3 of any overtime in the final compensation on which the pension is based.

As for the “king for a day” provision, this seems like nothing more an egregious loophole that encourages either fraudulent claims of disability or fraudulent claims to have been filling in for a superior. In such a case, courts should not credit legislatures with having intended to create a contractual right that would never be tolerated under the light of public scrutiny.

G. Rhode Island

In 2009, Rhode Island passed pension reform legislation³²⁸ amending Chapter 36 of the Rhode Island Laws. Among other things, the bill required pensions to be based on the average of the highest five (rather than three) years of consecutive compensation for anyone retiring on or after October 1, 2009³²⁹; required members to contribute the “full actuarial cost” of various service credits purchased³³⁰; raised the standard retirement age from 60 to 62 for people retiring on or after October 1, 2009³³¹; and, for employees not eligible to retire as of Sept. 30, 2009, lowered the COLA from a guaranteed 3% per year to the lower of 3% or the percentage increase in the Consumer Price Index.³³²

³²⁸ Rhode Island Public Laws (2009), chapter 68, art. 7. The bill is available here: <http://www.rilin.state.ri.us/billtext09/housetext09/article-007-sub-a-as-amended.pdf>.

³²⁹ Rhode Island Laws § 36-8-1(4).

³³⁰ Rhode Island Laws § 36-8-1(9).

³³¹ Rhode Island Laws § 36-10-9.

³³² Rhode Island Laws, § 36-10-35(c)(3), available at

On May 12, 2010, unions in Rhode Island filed a lawsuit against the state pensions and various state officials.³³³ The complaint raised only two counts, under the Contracts and Takings Clauses of the Rhode Island Constitution. On September 16, 2011, the court issued an initial decision just on the issue of whether the Rhode Island pension system was subject to contractual protections or whether the state could change the entire pension system at will.³³⁴ At the outset, the court said, “It is important to emphasize that this Court is asked to limit its decision to the stipulated issue: whether a contract exists between Plaintiffs and the State. Accordingly, the Court’s inquiry addresses only one element in contract clause analysis.”³³⁵ That is, the court did not consider whether the contract was breached, whether the breach was substantial, or whether the breach was justified by a legitimate public purpose.

The court then noted that “[u]nlike a number of other states, Rhode Island has not expressly stated in its constitution or the ERSRI that pension benefits are contractual in nature.”³³⁶ Nonetheless, even without statutory language on point, the fact remains that

<http://www.rilin.state.ri.us/Statutes/TITLE36/36-10/36-10-35.HTM>. Rhode Island lowered the COLA again in 2010. According to Ronald Snell (*supra* note 4), “Public Law 23 of 2010 (HB 7397(the budget bill), Article 6, reduces post-retirement benefit increases for state employees, teachers, justices and judges who are ineligible for retirement as of the date of enactment. The legislation limits post-retirement cost of living adjustments for such future retirees to the first \$35,000 of retirement benefits, with that base to be increased annually by the CPI-U or 3%, whichever is less.”

³³³ Rhode Island Council 94, AFSCME, AFL-CIO v. Carcieri, P.C.C.A. No. 10-2859 (R.I. Superior Court, amended complaint filed July 21, 2010), available at <http://www.ricouncil94.org/Portals/0/Uploads/Documents/Public/amend1complaint-final.pdf>.

³³⁴ Rhode Island Council 94, AFSCME, AFL-CIO v. Carcieri, C.A. No. PC 10-2859 (Rhode Island Superior Ct., Sept. 16, 2011).

³³⁵ *Id.* at 9.

³³⁶ *Id.* at 31; *cf.* Nat’l Educ. Ass’n-Rhode Island ex rel. v. Ret. Bd. of the Rhode Island Employees’ Ret. Sys., 172 F.3d 22, 28 (1st Cir. 1999) (“[W]e do not think that the Rhode Island general pension statute ‘clearly and unequivocally’ contracts for future benefits . . . [n]owhere does the statute call the pension plan a ‘contract’ or contain an ‘anti-retroactivity clause’ as to future changes.”).

“provisions at issue constituted offers intended to “induce people to enter public employment” and to continue in that employment over a substantial period of time.”³³⁷ And that, in the court’s view, is the essence of a contractual offer or a “bargained-for exchange.”³³⁸

In the court’s view, the Rhode Island defendants were making the argument that “the State may, with or without justification, significantly alter or completely terminate a public employee’s pension benefits at any time—even just one day—before retirement.”³³⁹ Simply because the court rejected that view does not imply that any of the actual reforms in Rhode Island were a substantial breach or were unjustified by a legitimate public purpose. It remains to be seen what the Rhode Island court will do with those questions

Then, in late 2011, Rhode Island enacted major pension reform, thanks to the efforts of state treasurer Gina Raimondo, who ran for office solely on the pension issue, and who spent all of 2011 warning that the looming \$9 billion deficit in the Rhode Island pension systems would prevent the state from paying for schools, roads, libraries, and more.³⁴⁰ Raimondo noted that Rhode Island taxpayers are paying 225% more for pension contributions than they were in 1998, and that the number is “projected to more than double during the next five years.”³⁴¹ These new costs will burden already-endangered state spending items: “In recent years, state aid to cities and towns, which is used mostly for K-12 education, has decreased annually by eight percent,” while “Rhode Island has recently been ranked as having the worst maintained bridges and roads

³³⁷ Rhode Island decision at 34.

³³⁸ *Id.*

³³⁹ *Id.* at 38.

³⁴⁰ See generally Gina Raimondo, *Truth in Numbers: The Security and Sustainability of Rhode Island’s Retirement System* (May 2011).

³⁴¹ *Id.* at 9.

of any state in the country.”³⁴²

Why was Rhode Island in this situation? For a number of reasons, including too-optimistic investment assumptions and longer lifespans.³⁴³ But a main driver of the pension costs in Rhode Island was that from the 1960s to 1980s, “pension benefits were substantially increased for state employees and teachers *without corresponding contributions being made*.”³⁴⁴

Exacerbating the problem, “[a]ll of these benefit increases were applied retroactively to current employees,” meaning that someone who was one day away from retirement could retire with a higher pension than had ever been contemplated in his or her career.³⁴⁵ Indeed, Raimondo noted that “retired public employees can routinely earn retirement benefits that exceed 100 percent of their final average earnings by the time they are several years into their retirement,” while “[m]any retirees can earn more in retirement annually than a current employee in the same job position earns today.”³⁴⁶

These problems could not be addressed simply by making going-forward reforms as to current workers, who were already “contributing a significant amount of their salary to the pension system, the majority of which goes to pay for past service, not for their own future retirement.”³⁴⁷ Some reductions had to apply to current workers and retirees.

That is exactly what Rhode Island ultimately did in a bill passed on November 17, 2011. As described in greater detail above, the bill moved current workers to a new hybrid system, lowered the multiplier, increased the retirement age, and reduced or eliminated COLAs, among

³⁴² *Id.*

³⁴³ *Id.* at 5-6.

³⁴⁴ *Id.* at 4 (emphasis added).

³⁴⁵ *Id.* at 4.

³⁴⁶ *Id.* at 5.

³⁴⁷ *Id.* at 13.

other things.

Chapter 2 of this dissertation explained in more detail why the Rhode Island legislation is a model for implementing the principle of protecting past accruals even while making radical changes going forward. But what will happen given Rhode Island jurisprudence is debatable. Some cases suggest that at least retirees have a contractual right under Rhode Island law not to have their cost-of-living benefits decreased. In the 2007 case of *Arena v. City of Providence*,³⁴⁸ a state statute was in effect approving a city collective bargaining agreement that had granted a 5% compounded COLA.³⁴⁹ After the plaintiffs (city firefighters) had retired, the city passed new ordinances that reduced the COLA to a non-compounded three percent.³⁵⁰ On a contracts analysis, the court “agree[d] with plaintiffs and hold that they have a vested interest in the COLA provided in Ordinance 1991-5,” that is, the ordinance with the 5% COLA.³⁵¹ This is because “in Rhode Island, pension benefits vest once an employee honorably and faithfully meets the applicable pension statute’s requirements,”³⁵² whereas the statute in effect at that time expressly provided that “eligibility for a retirement allowance and the amount of such allowance shall be determined in accordance with the provisions of the ordinance to provide for the retirement of employees of the City of Providence as in effect on the last day of a member’s employment.”³⁵³

³⁴⁸ 919 A.2d 379 (R.I. 2007).

³⁴⁹ *Id.* at 382-83.

³⁵⁰ *Id.* at 383-84.

³⁵¹ *Id.* at 392.

³⁵² *Id.* at 393.

³⁵³ *Id.* Later versions of the same city ordinance provided that “[a]ll cost-of-living retirement adjustments granted to retirees under this section shall be considered voluntary gratuities. The payment of such voluntary gratuities may be reduced or suspended by Ordinance at any time upon a finding by the City Council that due to the existence of a depressed economy affecting the fiscal condition of the City it becomes expedient to reduce expenses in order to avoid or minimize a tax increase.” *Id.*

It was important to the court that the plaintiffs had already retired: “the city has broad discretion to prospectively change the pension benefit plan for firefighters and police officers *who have not yet retired* by enacting a new ordinance. Nevertheless, the issue confronting us is whether the council has authority to *retroactively* redefine a pension term.”³⁵⁴ The court thus held that “plaintiffs’ interest in a 5 percent compounded COLA vested upon their retirement and cannot be altered by future ordinances.”³⁵⁵

Based on this case, Rhode Island courts may view the legislature as having the authority to alter prospective accruals for existing workers, but not the terms applicable to people who have already retired.

H. New Jersey

In late 2011, New Jersey passed legislation increasing employee contribution rates by one to three percentage points.³⁵⁶ For general public employees and teachers, the rate increased from 5.5% to 6.5% immediately, with a phased-in increase to 7.5% over the next seven years.³⁵⁷

Unions responded by filing a federal lawsuit alleging violations of the federal and state contracts clauses.³⁵⁸ On March 5, 2012, the federal district court judge issued an order dismissing the lawsuit, albeit not on the merits.³⁵⁹ Instead, the court held that because the plaintiffs were asking for a return of contributions, their complaint violated the U.S. Constitution’s 11th

³⁵⁴ *Id.* (emphasis in original).

³⁵⁵ *Id.* at 395.

³⁵⁶ See New Jersey Chapter 78, P.L. 2011 (June 29, 2011), available at <http://www.nj.gov/treasury/pensions/reform-2011.shtml>.

³⁵⁷ See <http://www.nj.gov/treasury/pensions/coltr11.shtml#contribratelocal>.

³⁵⁸ See Edith Honan, “New Jersey unions sue state over benefits changes,” Reuters, 1 Sept. 2011, available at <http://www.reuters.com/article/2011/09/01/us-newjersey-pension-idUSTRE78055120110901?feedType=RSS&feedName=domesticNews>.

³⁵⁹ *New Jersey Education Association v. State*, No. 11-5024 (D. N.J., March 5, 2012).

Amendment, which has been interpreted by the Supreme Court to disallow most lawsuits against state governments for retrospective money damages.³⁶⁰ Further, to the extent that the plaintiffs were asking for contractual relief, that was also forbidden by the 11th Amendment.³⁶¹ Immediately upon dismissal, the plaintiffs filed a duplicate lawsuit in New Jersey state court, where nothing has happened as yet.³⁶² As noted above, though, the courts should allow any contribution rate to go forward.

At the same time, a different set of retiree plaintiffs challenged the COLA reduction in the same New Jersey law.³⁶³ According to news reports, the state judge issued an oral ruling (with no written decision) that the retired plaintiffs are not contractually entitled to COLAs on retirement.³⁶⁴ Assuming that this ruling was accurately described, the judge may have gone too far in holding that even retired plaintiffs are not presumptively entitled to a prorated version of whatever COLA was promised to them during actual years of employment.

I. Washington

In October 2011, the state of Washington enacted House Bill 2021 eliminating future COLAs for retirees in two state pension plans.³⁶⁵ While a previous 1995 law had provided an automatic COLA, the new legislation essentially froze pension payments as of the bill's effective

³⁶⁰ *Id.* at 7-8.

³⁶¹ *Id.* at 8 (citing *In re Ayers*, 123 U.S. 443 (1887)).

³⁶² *New Jersey Education Association v. State*, Docket No. MER-L-771-12 (Superior Court, Mercer County, NJ, filed Mar. 29, 2012).

³⁶³ *Berg v. Christie*, No. MER-L-2996-11 (Superior Court, Mercer County, NJ, filed Dec. 2, 2011).

³⁶⁴ "Should retired public workers continue to receive cost-of-living increases?", NJ.com (May 30, 2012), retrieved from http://www.nj.com/hudson/voices/index.ssf/2012/05/daily_poll_should_retired_publ.html.

³⁶⁵ See <http://apps.leg.wa.gov/documents/billdocs/2011-12/Pdf/Bills/House%20Passed%20Legislature/2021-S.PL.pdf>.

date, including for existing retirees. Defenders of the legislation contended that the 1995 law establishing the COLA gave the state legislature the prerogative to make changes.

State employee unions filed multiple lawsuits alleging violations of the state and federal contracts clauses.³⁶⁶ Those lawsuits were consolidated on January 17, 2012, and class certification was granted on May 21, 2012.³⁶⁷ No further developments have taken place on the substantive issues.

What might happen in this case? Previous state court rulings suggest that Washington pension benefits receive contractual protection after vesting, and can be amended only to protect the financial stability of the system. In *Bakenhus v. Seattle*,³⁶⁸ the Washington Supreme Court held that an “employee who accepts a job to which a pension plan is applicable . . . is entitled to receive the same when he has fulfilled the prescribed conditions. His pension rights may be modified prior to retirement, but only for the purpose of keeping the pension system flexible and maintaining its integrity.”³⁶⁹ Then a 1993 Washington Supreme Court seemed to adopt the “contract at time of employment” theory, holding that a public worker’s right to a pension is a “vested, contractual right based on a promise made by the State at the time an employee commences service,” and any reduction “must be counterbalanced with increases in pension levels.”³⁷⁰

³⁶⁶ Brad Shannon, “End of automatic COLAs for some retirees spurs suit,” *Olympian*, 11 Oct. 2011, available at <http://www.theolympian.com/2011/10/11/1834885/end-of-automatic-colas-for-some.html#ixzz1aa4Nwkoe>.

³⁶⁷ See *Retired Public Employees Counsel of Washington v. Washington Department of Retirement Systems, Consolidated COLA Litigation*, Master Cause No. 11-2-02213-4 (Superior Court of Washington, Thurston County, May 21, 2012 order).

³⁶⁸ 48 Wn.2d 695, 296 P.2d 536 (Wa. 1956).

³⁶⁹ *Id.* at 701-02.

³⁷⁰ *Bowles v. Washington Dept. of Retirement Systems*, 121 Wn.2d 52, 65, 847 P.2d 440 (Wa. 1993).

A 2010 lower court case from Washington may suggest the outer limits of pension protection in that state. In 1998 and 2000, the legislature had enacted a “gain sharing” provision that would essentially return to members at least part of any investment gains that exceeded 10% for a 4-year period. Then the gain-sharing law was repealed in 2007. A lawsuit ensued, and a state trial judge struck down the repeal.³⁷¹ Notably, the gain-sharing legislation had included a prominent disclaimer: “The legislature reserves the right to amend or repeal this [law] in the future and no member or beneficiary has a contractual right to receive this post retirement adjustment not granted prior to that amendment or repeal.”³⁷² The court struck down the repeal in somewhat ambiguous terms. That is, it is not clear whether the court was merely striking down an attempt to eliminate gain-sharing awards that had already been made, or whether it was further striking down any attempt to restrict gain-sharing awards that might take place in the future (for employees who were already in place before 2007, of course).

In any event, the court cited a Washington Supreme Court case holding that under basic contractual analysis, “even though the employer has reserved the right to amend or terminate the plan, once an employee, who has accepted employment under such plan, has complied with all the conditions entitling him to participate in such plan, his rights become vested and the employer cannot divest the employee of his rights thereunder.”³⁷³ (Again, though, this reasoning was not entirely clear on whether the court intended merely to protect past gain-sharing awards made prior to 2007, or whether it intended to guarantee all pre-2007 employees a right to get future gain-sharing awards for the rest of their lives.) Because the removal of gain-sharing had

³⁷¹ Order, *Washington Education Ass’n v. Washington Dept. of Retirement Systems*, No. 07-2-17203-3 (County of King, WA, Superior Court, Sept. 10, 2010).

³⁷² *Id.* at 3.

³⁷³ *Id.* at 6 (quoting *Navlet v. Port of Seattle*, 164 Wn.2d 818, 848, 194 P.3d 221 (Wa. 2008)).

not been balanced by the addition of new benefits, the court struck down the law.³⁷⁴

J. Arizona

In 2011, Arizona passed a law akin to the New Mexico law; whereas employers and employees had formerly split contributions 50/50, the new law changed the employer/employee ratio to 47/53, thereby requiring employees to pay “more” towards their pensions.³⁷⁵ Said a local news story, “Just because there was a 50-50 split when these workers were hired does not entitle them to the same treatment as long as they are employed, argued Assistant Attorney General Charles Grube in court papers filed Aug. 11.”³⁷⁶ In addition, the average amount contributed by an employee earning \$50,000 a year would rise by merely \$12.41 per paycheck, whereas the cumulative savings for the state would be considerable.³⁷⁷ The state contended that the law merely “provides for a change to the terms of future employment,” akin to the “power of the state to change salaries.”³⁷⁸

An Arizona state court issued a ruling on February 1, 2012 (made final on April 12) holding in favor of the plaintiffs.³⁷⁹ As is the case in other states, Arizona’s constitution provides

³⁷⁴ *Id.* at 6-8. In a further ruling on Jan. 31, 2012, the court affirmed a second part of the pension legislation that withdrew certain additional benefits in the event that the gainsharing repeal was held unconstitutional (as indeed it had been).

³⁷⁵ Howard Fischer, “State wants suit over benefit contributions thrown out,” *Arizona Business Gazette* 1 Sept. 2011, available at <http://www.azcentral.com/business/abg/articles/2011/09/01/20110901abg-legal-asrs0901.html#ixzz1Wr3xNN4l>.

³⁷⁶ *Id.*

³⁷⁷ *Id.*

³⁷⁸ *Id.*

³⁷⁹ *Barnes v. Arizona State Retirement System*, No.CV 2011-011638 (Superior Court of Arizona, Maricopa County, Feb. 1, 2012) (“Arizona Order”). The docket for that case is here: <http://www.superiorcourt.maricopa.gov/docket/CivilCourtCases/caseInfo.asp>.

that “public retirement system benefits shall not be diminished or impaired.”³⁸⁰ The court said that the plaintiffs had received retirement benefits (actually, the promise thereof) for which they had agreed to pay 50% of the cost, but an increase in that contribution rate “retroactively and unilaterally seeks to substantially change terms of a contract previously agreed to by the parties.”³⁸¹ Without further elaboration, the court added that the impairment was substantial and lacked any public purpose.³⁸² The court tied the contractual protection to the first date of employment: “by paying a higher proportionate share for their pension benefits than they had been required to pay when hired, Plaintiffs are forced to pay additional consideration for a benefit which has remained the same.”³⁸³ In a further wrinkle, as of May 7, 2012, state lawmakers in Arizona enacted a bill (House Bill 2264) to reverse the contribution rate change complete with a refund of the excess contributions.

In 2011, Arizona also passed Senate Bill 1609, which limited future COLAs given to retired elected officials, who promptly sued. In a May 29, 2012 ruling, a state trial court issued a ruling striking down the law. The court relied on the Arizona constitutional provision quoted above, as well as an Arizona law providing that each retiree “is entitled to receive a permanent increase in the base benefit equal to the amount determined pursuant to this section.”³⁸⁴ Because all of the plaintiffs had already retired, there was nothing further they had to do to be guaranteed

³⁸⁰ Arizona Const. Art. 29, § 1.

³⁸¹ Arizona Order at 3.

³⁸² *Id.*

³⁸³ *Id.*

³⁸⁴ *Fields v. Elected Official Retirement Plan of the State of Arizona*, Case no. CV-2011-017443 (Maricopa County Superior Court, Arizona, May 29, 2012), Ruling at 5 (quoting Ariz. Rev. Stat. § 38-818(A)).

the promised level of benefit increases.³⁸⁵

The court did note that it was not deciding the issue whether benefits had vested at any point prior to retirement, which is obviously a key question that would strongly affect the viability of any future pension reform efforts in Arizona.³⁸⁶ That said, Arizona has seemingly given the strongest protection to pension benefits. In the landmark case of *Yeazell v. Copins*,³⁸⁷ the plaintiff had worked from 1942 to 1962, was already retired, and wished to have the benefit of the pension benefit originally promised as of 1942 (with final average salary calculated over a one year period) rather than as of a 1952 amendment to the plan (final average salary equal to the average over five years). The Arizona Supreme Court held that “the right to a pension becomes vested upon acceptance of employment,” noting that pension benefits “are not dependent upon the benevolence of the employing agency but are prescribed by the legislature and the conditions of the employment” as a “valuable part of the consideration for the entrance into and continuation in public employment.”³⁸⁸ Thus, in the words of the court:

It is evidence from what we have said that appellant had the right to rely on the terms of the legislative enactment of the Police Pension Act of 1937 as it existed at the time he entered the service of the City of Tucson and that the subsequent legislation may not be arbitrarily applied retroactively to impair the contract. Appellant’s right to be retired under the Police Pension Act of 1937 existed until he evidenced an intention to be bound by or assented to the modifications provided in the amendment of 1952. The presumption would, of course, be that until appellant exercised his right of election the 1952 amendment was acceptable to him, but once having made an election both he and his widow are forever bound thereby. We do not consider that appellant can be compelled to a choice between the 1937 act or the 1952 amendment by legislative coercion. His acquiescence in the application of the 1952 amendment during his employment is not alone sufficient to establish a waiver or an estoppel of rights under the 1937 act³⁸⁹

³⁸⁵ *Id.*

³⁸⁶ *Id.* at 6 n.1.

³⁸⁷ 98 Ariz. 109, 402 P.2d 541 (1965).

³⁸⁸ *Id.* at 114-15.

³⁸⁹ *Id.* at 117.

At the limits, this is a surprising holding. It implies that if a worker starts on Day One with a pension benefit promised at a particular level, and if the pension benefit is reduced on Day Two through the rest of his 30 years of state employment, the fact that he worked 30-year-minus-one-day at the lower promised level of pension benefits would not count as any sort of acquiescence in that level of pension benefits.³⁹⁰ Instead, at retirement, he would have a legal right to the higher level in effect for only a single day thirty years before.

To be sure, as discussed earlier, the *Yeazell* case involved a worker who had been employed for a full 10 years under the previous level of pension accrual, and to apply the 1952 law would have essentially invalidated the benefit of those 10 years of employment. The 1952 law, in other words, did not prorate the benefit calculation (as I have suggested) based on the number of years of service under the prior rule; instead, it purported to apply a new calculation wholesale to anyone who retired after 1952. In that circumstance, the court (which never considered the issue of proration) was inclined to protect the employee's previous 10 years of accrual.

Still, even if *Yeazell* can be limited in this fashion, Arizona courts would do better to explicitly harmonize their pension jurisprudence with the jurisprudence as to other employee benefits that admittedly can be changed on a forward-looking basis even if past accruals are

³⁹⁰ By contrast, the Arizona Supreme Court has expressly created an asymmetry whereby employees can be presumed to agree to benefit increases by continuing to work. *Thurston v. Judges' Retirement Plan*, 179 Ariz. 49, 52, 876 P.2d 545 (1994) (“Where the modification is detrimental to the employee, it may not be applied absent the employee’s express acceptance of the modification because it interferes with the employee’s contractual rights. . . . Because the amendment in this case was beneficial to the employee and survivor, it became part of the contract.”).

protected. For instance, in *Bennett ex rel. Arizona State Personnel Commission v. Beard*,³⁹¹ a state architect had been hired when annual leave accrued at 18 days per year, but then the law was changed to reduce annual leave to 15 days per year. The architect sued, claiming that the rate of annual leave accrual could not be reduced. The Arizona court rejected this claim, holding that under *Yeazell*, the architect had a right to 18 days of leave for the year he had worked under the old system, but that the legislature had the right to alter the future terms of employment. Indeed, the court characterized *Yeazell* as having involved “the attempted retroactive change of previously vested contractual rights,” whereas this case involved “future benefits as yet unvested.”³⁹² Similarly, in a 1981 case, the Arizona appeals court reiterated that in previous cases (including *Yeazell*), “the courts recognized that a vested contractual right to benefits existed only when an employee had already performed services and earned benefits, the payment of which was to be made at a future date. This same rationale does not apply where a city has merely adopted an ordinance which provides for the payment of certain benefits, and an employee has yet to perform services entitling him to the benefits.”³⁹³

The same rule should apply to pensions: if a pension benefit is being retroactively altered, then that should be presumptively a contract violation. But if (unlike the case in *Yeazell*) the state only modifies the rate of accrual going forward, there is no reason to give employees a right to block such legislation any more than they can block the rate at which leave days are accrued. In either case, the law is leaving past accruals in place while altering the terms for future work that has yet to be performed.

³⁹¹ 27 Ariz. App. 534, 556 P.2d 1137 (1976).

³⁹² *Id.* at 1140.

³⁹³ *Abbott v. City of Tempe*, 129 Ariz. 273, 279, 630 P.2d 569 (Ariz. Ct. App. 1981).

K. *Cincinnati*

In mid-2011, the Cincinnati city council made several changes to its pension plan, including increasing retirement age to age 60 with 30 years of service (previously, it had been 30 years of service at any age), and reducing the COLA from a guaranteed 3% compounded rate to 2% on the base pension. In June 2011, employees filed a state court lawsuit based on state and federal contracts clauses. There has been no activity in the lawsuit since July 2011, however, and there is no indication that a court ruling is forthcoming.³⁹⁴

To review the Ohio jurisprudence on this question: although early Ohio cases treated pensions as mere gratuities,³⁹⁵ a seminal 1948 case rejected that line of reasoning and followed the trend in other states of holding that people who had retired with a particular level of pension benefits “have acquired a vested right to the pensions granted them which cannot be taken away or adversely affected by subsequent legislation or rule.”³⁹⁶ Unlike many states, however, Ohio actually has a statute providing that pension benefits are vested when actually *granted* by the pension board – that is, after retirement.³⁹⁷ Thus, in the one Ohio Supreme Court case applying a Contracts Clause analysis to pension benefits during the past 50 years, a public school teacher’s husband whose wife had died prior to retirement filed a lawsuit demanding the return not just of her contributions to the retirement system but the interest on those contributions as well. The court held that “a right does not become vested until it is granted,” and “public school teachers

³⁹⁴ The lawsuit is *Bock v. City of Cincinnati*, No. A-1105049 (Hamilton County Court of Common Pleas). See the docket at http://www.courtclerk.org/case_summary.asp?sec=history&casenumber=A%201105049.

³⁹⁵ See *Mell v. State of Ohio*, 130 Ohio St. 306, 199 N.E. 72 (1935).

³⁹⁶ *State ex rel. Cunit v. Trustees of Cleveland Police Relief & Pension Fund*, 149 Ohio St. 477, 483, 79 N.E. 2d 316 (1948).

³⁹⁷ Ohio Ann. Code § 145.561 (“[T]he granting of a retirement allowance, annuity, pension, or other benefit to any person pursuant to action of the public employees retirement board vests a right in such person . . .”).

do not possess contract rights in any [pension] benefit unless and until the benefit vests.”³⁹⁸

Because the teacher had not yet retired at the time of death, her right to receive a refund of interest had not yet vested, and therefore no Contracts Clause issue arose when the state refused to pay her widower anything above the actual contributions made.³⁹⁹

If Ohio courts stick with this sort of holding, then there are effectively few limits on how the state could modify pension accruals at any time prior to retirement. Indeed, the state might be free to reduce past pension accruals prior to retirement, on the theory that even past accruals had not yet vested. As a matter of how employment benefits should be structured, this would seem too far in the direction of *not* protecting accruals. At the same time, the risk of state modification logically ought to take into account when state employees and employers come to terms on wages and benefits. If state employees are effectively accepting higher wages and/or current benefits in exchange for more insecurity about the level of pension benefits, then that is simply all part of the give-and-take of the labor market. In any event, while the Contracts Clause protects the actual terms of contracts that have been made, it does not require that a particular type of contract term be forcibly written into all contracts in the first place.

L. Baltimore

In Baltimore, the pension system had a so-called “variable benefit” feature enacted in 1982.⁴⁰⁰ Under that variable benefit, if investment returns exceeded 7.5% in any given year, retirees got a boost to their monthly payment for the rest of their life. The system established two

³⁹⁸ State ex rel. Horbath v. State Teachers Retirement Board, 83 Ohio St. 3d 67, 77-78, 697 N.E.2d 644 (1998).

³⁹⁹ *Id.* See also Mascio v. Public Employees Retirement System of Ohio, 160 F.3d 310, 313-14 (6th Cir. 1998) (treating a judge’s double-dipping as constitutionally protected because the statute revoking double-dipping had been enacted after he retired, which is when his first pension was “vested”).

⁴⁰⁰ Baltimore City Code, Art. 22, § 36A.

funds to hold “variable benefit” assets and to buy fixed-income instruments for each retiree as benefits were awarded. Variable benefits were further used in compounding fashion whenever future variable benefits were awarded (i.e., previous variable benefits were used as part of the base pay for future calculations). Variable benefits were a one-way ratchet, however: retirees did not have their prior variable benefits lowered when investment returns faltered.

Notably, the variable benefit statute included a provision stating that the “continuation of any benefit increase previously accrued . . . is specifically made contingent on the ability of the [funds] to provide these benefits in the future.”⁴⁰¹ The statute allowed the board to reduce or eliminate previous variable benefits for retirees who lived longer than expected so as to cause a “decline in the value of the [funds].”⁴⁰² Finally, the statute even contained a provision stating that “§§ 37 and 42 to the contrary notwithstanding, any benefit increase provided under this section is not and does not become an obligation of the City of Baltimore. In the event of any conflict between this section and either or both § 37 or § 42, this section prevails.”⁴⁰³ Sections 37 and 42, in turn, respectively provided that pensions were obligations of the City and that such benefits would not be diminished or impaired. Thus, the variable benefit statute went as far out of the way as possible to make clear that the variable benefit was not a contractual obligation regardless of any other statute protecting pension benefits in general.

In 2010, the city council finally decided that the Variable Benefit feature was unaffordable. It enacted a new ordinance that did away with new Variable Benefit increases entirely, substituting a COLA of 1% for retirees between 55 and 64 and 2% for older retirees. The ordinance did not eliminate any previously-awarded variable benefit increases, but left them

⁴⁰¹ *Id.* § 35A(e)(ii) (Dec. 31, 2009).

⁴⁰² *Id.* § 36A(e)(3)(iii).

⁴⁰³ *Id.* § 36A(e)(ii).

in place for retirees' lifetimes.

Retirees still sued, alleging that they had a contractual right not just to receive past variable benefit awards, but to keep receiving them in the future too. A federal court issued a preliminary order on Sept. 6, 2011, addressing only the issue of impairment.⁴⁰⁴ The court noted that “legislative action that modifies or reduces future pension benefits which have not yet vested does not constitute an ‘impairment,’” but that impairment “only occurs where the legislative action applies retroactively to vested pension benefits.”⁴⁰⁵ Using that framework, the court issued a three-part holding as to impairment, holding that people who were already retired and eligible for Variable Benefit increases had a “retroactive impairment”; that people who were eligible to retire but who were still working (and hence not yet receiving benefits) had a “retroactive impairment” as to any years of previous service, but not as to any future years of service; and that people who were not yet eligible to retire had no retroactive impairment.⁴⁰⁶ In the latter holding, the court thought that it would “unduly stretch the concept of a ‘vested’ right” to accept plaintiffs’ argument that “rights vest the first day of employment under the Plan.”⁴⁰⁷

The court next addressed the issue of whether the impairment was retroactive. The city had argued that no retroactivity was possible, because all previous variable benefit awards were still being paid, and the only consequence of the new law was that future variable benefit awards would be eliminated. The court rejected this argument, noting that on such reasoning, “anything that affects what will take place in the future could be said to have no retroactive effect,” even,

⁴⁰⁴ *Cherry, Jr. v. Mayor and City Council of Baltimore City*, No. 1:10-cv-1447 (D. Md. Sept. 6, 2011) (“Second Trial Decision Re: Substantial Impairment”).

⁴⁰⁵ *Id.* at 14.

⁴⁰⁶ *Id.* at 19-23.

⁴⁰⁷ *Id.* at 22.

say, reducing a pension benefit from \$500 to \$400 a month.⁴⁰⁸ To the contrary, reducing future vested payments in such a way would have a retroactive impact, in that it would reduce the value of rights that had already accrued and vested. Similarly, the court reasoned, “While the value of the right to Variable Benefit increases cannot be determined with certainty, it is a certainty that a right to a pension benefit with a possibility of future Variable Benefit increases is more valuable than a right to a pension benefit with no such possibility.”⁴⁰⁹

The next question was whether the impairment was substantial. The court held that it was, because the previous history of Variable Benefit increases had averaged 3% a year for all 26 years, whereas the new COLAs maxed out at 2% (and then only for older retirees).⁴¹⁰

What about the statutory language reserving the right to eliminate benefits as well as that making the variable benefit not an “obligation” of the City? The federal court said that even though the city could change or eliminate benefits, this was only in certain circumstances involving depletion of the funds: “This provision does not provide the City with discretion to cancel or eliminate the annual Variable Benefit calculation. Nor can the City fail to pay past awarded Variable Benefit increases if there are funds available.”⁴¹¹ And the language about the City having no “obligation” merely meant that if the funds ran out of money, the City would have “no obligation to make the payments from other sources.”⁴¹²

On the whole, this decision – which addresses only the issue of impairment, not whether the impairment was justified by a public purpose – seems fairly consistent with the theory I have

⁴⁰⁸ *Id.* at 24.

⁴⁰⁹ *Id.* at 25.

⁴¹⁰ *Id.* at 34-35.

⁴¹¹ *Id.* at 9.

⁴¹² *Id.*

outlined. The court found impairment only as to retirees and as to the previously accrued benefits of workers who were eligible to retire. But there was no impairment for any workers who had yet to be eligible to retire, and even workers past the retirement age were not impaired as to future variable benefit awards. In other words, the court drew a clear line between previous accruals that had vested at retirement age vs. any and all future accruals.

M. Gadsden, Alabama

In mid-2011, the Alabama Legislature enacted Act 2011-676; among other things, that act raised the contribution rate for public employees in the state retirement system from 6 percent to 8.25 percent as of October 1, 2011, and to 8.5 percent as of October 1, 2012. One provision of the bill allowed local municipalities whose firefighters participate in the state retirement system to opt into the same contribution increases. In August 2011, the Gadsden, Alabama city council voted to opt for the contribution increases.⁴¹³ Gadsden firefighters then filed a federal class-action lawsuit, alleging that the change violated state and federal contracts clauses.⁴¹⁴

On February 23, 2012, the federal district court issued an order denying the city's motion to dismiss.⁴¹⁵ As to the first element of a Contracts Clause claim, the city had argued that no contractual protection existed at all unless it had been "unmistakable." The court held that the unmistakability doctrine did not apply, as there was "no clear Supreme Court or Eleventh Circuit precedent" on the point; moreover, unmistakability was a point reached, if at all, only upon close examination of the actual provisions, and on a motion to dismiss, inferences should be drawn in

⁴¹³ Andy Powell, "Gadsden firefighters sue city over retirement cost increase," Gadsden Times 16 Sept. 2011, available at <http://www.gadsdentimes.com/article/20110916/NEWS/110919808/1016/NEWS?p=1&tc=pg>.

⁴¹⁴ *Id.*

⁴¹⁵ Memorandum Opinion and Order, Taylor v. City of Gadsden, No. 4:11-cv-3336 (N.D. Ala. Feb. 23, 2012).

favor of the plaintiff.⁴¹⁶ The court similarly concluded that plaintiffs had sufficiently alleged an impairment of the contract, and that the impairment (a “30 percent increase in their pension contributions” with no countervailing benefit) was substantial.⁴¹⁷

As for the state claim, the court could not find any Alabama court opinion construing the state Contracts Clause other than to identify its purpose as “to preserve sacred the principle of the inviolability of contracts.”⁴¹⁸ The court therefore construed the Alabama constitutional provision as mirroring that of the federal Constitution.⁴¹⁹

All that this holding meant, of course, was that the trial could go forward. The court was not holding that the plaintiffs would necessarily win in the end. Nonetheless, in my judgment, the court reached the wrong conclusion. As high as the bar might be for granting a motion to dismiss, raising employee contributions ought to be presumptively constitutional. After all, as noted above, no one has even considered raising employee contributions retroactively, such that employees would now owe more money just to get the same pension rights that they had already accrued in previous years. But raising the employee contribution rate going-forward is no different than freezing salary terms going forward, and absent a very specific employment contract guaranteeing raises regardless of circumstance, courts generally hold that legislatures *are* allowed to change salary terms going forward. As I have pointed out, there ought to be no inherent constitutional problem with offering new terms to employees for work that has not yet been performed in years yet to come.

⁴¹⁶ *Id.* at 13-14.

⁴¹⁷ *Id.* at 15.

⁴¹⁸ *Id.* at 10 (quoting *Opinion of the Justices No. 333*, 598 So. 2d 1362, 1365 (Ala. 1992)).

⁴¹⁹ *Id.* at 20.

N. *Chart of Recent Lawsuits*

The following table depicts more succinctly what has happened in the above states:

Rulings that disallow even forward-looking changes	Rulings that fail to protect past accruals sufficiently	Rulings that protect past accruals while allowing future accrual changes	Preliminary rulings	Jurisdictions in which rulings are forthcoming
Florida New Hampshire Arizona Gadsden, Alabama (federal court)	Colorado South Dakota Minnesota New Jersey	Baltimore (federal court)	Rhode Island	Washington New Jersey (contribution rate) Rhode Island (2011 reforms) Cincinnati New Mexico New Hampshire (AFT and House Bill 2 cases)

As can be readily seen, courts are taking widely differing approaches. In four jurisdictions, courts have disallowed even forward-looking changes, such as changing employee contribution rates. In another four jurisdictions, courts have taken the opposite approach, allowing pension payments to be reduced even for retirees. In only one recent case (the Baltimore case before the U.S. District Court for the District of Maryland) has a court made a more careful delineation of accrual rights that are protected (i.e., for retirees and people eligible to retire) vs. accrual rights that can be changed on a forward-looking basis (i.e., for workers not yet eligible to retire).

V. CONCLUSION

States that engage in pension reform will have to do so with an eye towards lawsuits that allege a Contracts Clause violation. Courts should beware of two alternative extremes that have so far won the day in multiple states. At one extreme, courts in some states (such as Florida, New

Hampshire, and Arizona) have all recently held that state employees are essentially entitled to keep accruing pension wealth at the same rate in all future years of employment, with no increase in contribution rates and with no alteration even for employees who just started work yesterday. This extreme version of pension protection needlessly hamstring the capabilities of state legislatures and municipal employers, given that they need to be able to adjust the entire package of salaries and benefits so as best to compete in the labor market. Moreover, as Amy Monahan has pointed out, this form of pension rights likely harms many of the workers that it is intended to protect, because the state's remaining avenue for saving money would be to freeze salaries or lay off workers. Given that many workers may prefer to retain a job, or to have a difference balance of current salary vs. pension, it makes little sense to tie the legislature's hands only as to one component of the employment package.

At the other extreme, however, courts in other states (most recently Colorado, Minnesota, South Dakota, and New Jersey) have held that legislatures are entitled to reduce benefits even for people who already completed their entire career and are now retired. Such holdings typically glide over the fact that retirees spent at least part of their careers working with the promise of a particular benefit calculation when they retired, and at a minimum, a court should start the contractual analysis by assuming that the retirees have a right to the pro rata portion of benefits calculated in that manner. With that baseline protection in place, courts can of course proceed to determine whether the contractual alteration was justified by an important public purpose, such as a financial emergency.

In any event, states should have the prerogative both to change the terms of pension accrual on a going-forward basis for current employees, and even to cut retiree benefits on a pro-rated basis to the extent that those retirees spent some portion of their career having been

promised a different benefit. While cutting retiree benefits in such a way would still be painful, it may be the only option for states under dire financial pressure that would otherwise limit spending on other valuable services.

This dissertation then explained how such pro rata reductions could be most logically implemented. In the case of changes to the multiplier, changes to the COLA, and changes to the contribution rate, it is fairly easy and intuitive to calculate a weighted average. Even for changes to the retirement age, Rhode Island has now showed how it is possible to raise the retirement age in inverse proportion to the years already served towards the current retirement age (and it would be further possible, as explained above, to annuitize the value of benefits as would have been received at the previous retirement age and then carry forward that value with interest to the new retirement age, thus preserving any previously accrued-value to the penny). Changes to the way that final average salary is calculated can also be prorated, as described above. Finally, even wholesale revisions to the retirement system, such as replacing a defined benefit plan with a cash balance plan or 401(k)-style plan, can preserve prior accruals by annuitizing the present value of pension wealth at the point of conversion to the new plan, and then carrying forward that value with interest until retirement.

In short, while any actual pro rata calculations may seem daunting to a non-actuary, the underlying principles are fairly straightforward and should be reasonably understood by any state or federal judge who hears a pension reform lawsuit. Judges should therefore start with these principles as a baseline contractual protection, subject to reduction in cases of demonstrated financial need.

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