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LEGAL MEMORANDUM

TO: Members, State Administration and Veterans' Affairs Committee and Legislative Finance Committee

FROM: David Niss, Staff Attorney

RE: Recent Developments in Pension Case Law and Proposals

DATE: May 21, 2012

I
Introduction

Since I advised the State Administration and Veterans' Affairs Committee (SAVA) and the Legislative Finance Committee (LFC) on the subject of the importance of the case law dealing with alternatives to any legislation that impairs the employment/retirement pension contracts of government employees[1] and made presentations to both Committees,[2] more decisions by trial and appellate courts have come to light holding various pension-impairing legislation to be unconstitutional because that legislation impaired employment/retirement contracts. Also, since those presentations, the Governor has proposed his own program for shoring up the PERS and the TRS. Finally, the LSD and LFC staff have prepared several written scenarios for shoring up those retirement systems. The purpose of this memorandum is to review those judicial decisions and the Governor's proposal and give both Committees additional detail on the constitutionality of those budget scenarios that contain provisions that may impair employment/pension benefit contract.

II
Discussion

A. The Importance of the U.S. Trust Opinion

As pointed out in an earlier memorandum on this subject,[3] the language of U.S.

[1]Legal Memorandum dated January 5, 2012, "Constitutionality of Amendment of GABA Statutes to Tie Amount of GABA to State Investment Earnings for Current Retirement System Members", from this author to the State Administration and Veterans' Affairs Committee and the Legislative Finance Committee.

[2]The author appeared before the SAVA Committee on January 27, 2012, and before the LFC on March 8, 2012, and discussed the cited memorandum and the recommendations in the memorandum.

[3]Id, p. 2.

Trust Company of New York v. New Jersey, 431 U.S. 1 (1977) ("U.S. Trust") is highly important and even controlling. In that opinion, in short, the Court held that an impairment will be held unconstitutional if: (1) the impairment is a "substantial" impairment, in other words, not a "technical impairment",[4] and (2) the government enacting impairing legislation does not first at least seriously consider nonimpairing or lesser impairing legislation. Mr. Justice Blackmun wrote:

> But a State is not completely free to consider impairing the obligations of its own contracts on a par with other policy alternatives. Similarly, a State is not free to impose a drastic impairment when an evident and more moderate course would serve its purposes equally well.

Because of this language in the U.S. Trust opinion, courts considering impairing legislation have focused on whether the impairment was "substantial" and whether other nonimpairing alternatives, or less drastic impairments, were at least genuinely considered by the government, if not actually enacted, first.[5]

B. The Importance of the Record in the Case Law

There is no unanimity in judicial opinions subsequent to the Supreme Court's opinion in U.S. Trust whether the alternatives to impairment discussed in that opinion must actually be tried, i.e., enacted, or just studied and rejected by the government. What is clear from the language of the U.S. Trust opinion and opinions in subsequent

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[4]There is little question that a reduction in the GABA would be held to be a substantial impairment. The Ninth Circuit has held that a contract impairment is substantial if it minimally alters a financial term of the agreement. In S. Cal. Gas Co. v. City of Santa Anna, 336 F.3d 885 (9th Cir. 2003), the Ninth Circuit held that the application of a 3-day delay in payment over six different time periods was a substantial impairment. Interestingly, in this case, the Ninth Circuit noted: "In the last thirty-five years, no Ninth Circuit or Supreme Court case has found a statute or ordinance necessary when the law in question altered a financial term of an agreement to which a state entity was a party."

[5]The contract clauses of both the U.S. and Montana Constitutions protect only contract rights that have become vested. This concept, especially as to amendment of the statutory contracts created by section 19-2-502(2) or 19-20-501(6), MCA, or Montana Supreme Court opinions, has not been dealt with definitively by that court. For example, Montana Supreme Court opinions have held that the contract "arises" when the employee begins work, but section 19-2-502(2), MCA, provides that the statutes forming the contract may be amended to provide further benefits under the contract to the employee. Other courts outside Montana have held that amendments of the employment/retirement pension contract vest when the employee keeps working following the amendment of the contract and, thereby, accepts the new contract provision and provides the *quid pro quo* as consideration for the increased benefit. However, the Supreme Court also said, in Gulbrandson v. Carey, 272 Mont. 494, 502 P.2d 573 (1995), that "[t]he terms of Gulbrandson's retirement benefit contract are determined pursuant to the statutes in effect at the time of his retirement...". Taken literally, this statement would allow amendment of the retirement pension contract up to the day on which an employee retires. However, there is no indication in section 19-2-502(2) or 19-20-501(6), MCA, that the statutory terms of the contract become effective on any date other than the effective date of the statutes.

cases relying upon U.S. Trust, however, is that *impairing alternatives cannot be the first or only solution that the government resorts to and that a government that imposes impairment first without either enactment or serious analysis and consideration of, first, nonimpairing alternatives and, secondly, less drastic impairments, will not see the impairing legislation upheld in legal action applying the U.S. Trust test for constitutionality of impairment of contracts.* Several judicial opinions, two issued since the last memorandum on this subject, make this point.

In AFL-CIO-CLC v. Government of the U.S. Virgin Islands, 2012 U.S. Dist. LEXIS 43461 (March 29, 2012), the U.S. District Court held that by enacting several cost-cutting measures, including raising taxes and fees, in order to cure projected deficits ranging from $17 million to $90 million per year over a 3-year period, seeing those measures prove insufficient, considering other plans to reduce spending (including layoffs, elimination of paid holiday leave, work furloughs, and a gross receipts tax increase), and finally, as a last resort, reducing government employee salaries by 8% for a limited period of time, the Virgin Islands Legislature, Governor, and other defendants had not acted unconstitutionally under the standards of the U.S. Trust opinion. The Virgin Islands case is one of a very small number of cases approving a financial impairment for government employees.

In Williams v. Scott, case no. 2011 CA 1584, Circuit Court of the Second Judicial Circuit for Leon County, Florida (March 6, 2012), the Court held that it was insufficient for the state to show that there were significant budget shortfalls in order to justify the elimination of a 3% cost of living adjustment because (a) employers were given a substantial decrease in the amount of their contributions, and (b) the Legislature left a positive $1.3 billion balance in the state general fund. There was nothing in the record reviewed by the Circuit Court to indicate why the Legislature had impaired the contracts while actually reducing employer contributions and leaving such a strong cash balance in the general fund.

In the case of United Firefighters of Los Angles City v. Los Angeles,[6] in which the city adopted a 3% cap on cost of living adjustments and the plaintiffs claimed an impairment of their contract, the California Court of Appeals said, in reviewing the alternatives to the cap, that "...in adopting cost-cutting measures to further an important public purpose, there must be some indication the public entity has given considered thought to the severity of the effect an enactment might have on the particular contractual scheme at issue and to the possibility of alternative, less drastic, means of accomplishing the public goal."

[6] 210 Cal. App. 3d 1095, 259 Cal. Rptr. 65 (1989).

Finally, in University of Hawaii Professional Assembly v. Cayetano,[7] the Ninth Circuit Court of Appeals pointed out, in striking down a pay lag as an unconstitutional impairment of contract, that "Defendants have not explained why it is reasonable and necessary that the brunt of Hawaii's budgetary problems be borne by its employees."

These opinions indicate that if the Legislature is going to choose a remedy to repair the effect of the market losses in the assets of the retirement funds that impairs employees' employment/retirement pension contracts by eliminating or altering the GABA or other retirement benefits for existing members of those funds (active or retired), the impairing legislation would stand the best chance of being upheld under the U.S. Trust standard if the Montana Public Employees Retirement Board or other defendant in a contract impairment lawsuit could rely upon a demonstrable rationale of the Legislature for enacting the impairing legislation. The very best source of this rationale, which would explain why various nonimpairing alternatives were perhaps not chosen, is the official records of the Legislative Committee(s) recommending or reviewing the impairing legislation. The same judicial opinions, and therefore the same reasoning, apply to the choice of a larger impairment over a smaller impairment and also apply no matter what the source[8] of the impairing legislation is.

C. The Governor's Proposal and the "California Rule"

On April 10, the Governor proposed, at a press conference in the Governor's reception room, that both the TRS and PERS could achieve actuarial balance by tapping several sources of funding, among them a 1% increase in employee contributions for both retirement systems, but no increase in benefits for the members of either system.

In 1973, then Attorney General Woodahl issued an opinion to Mr. Larry Nachtsheim, a former administrator of the Montana Public Employees' Retirement System, holding that because the relationship between the state and its game wardens regarding wardens' retirement benefits was contractual and game wardens were obligated by statute to pay only 7% of their compensation to the Game Wardens' Retirement Fund, any additional 1% contributions to the Fund had to be made by the state and not by the wardens, unless the wardens received an advantage comparable to the 1% increase in additional contribution. The only support for this proposition, that a retirement pension contract may be impaired if a comparable advantage is also given,

[7] 183 F.3d 1096 (1999).

[8] In other words, if the Legislature enacts contract-impairing legislation, in order to provide the best chance that the legislation would be sustained, the legislative history should show the basis for any choice of impairing legislation over nonimpairing legislation no matter what the source of the legislation is, whether that source is an interim committee bill, a standing committee bill, or an individual member's bill.

is language in Clarke v. Ireland,[9] in which the Montana Supreme Court held:

> It is true that the public interest in retirement funds and retirement programs for employees and public officers alike demands that those in charge of the funds be constantly watchful of the integrity of the fund. Changes in interest rates, increase in the life span of the employees, experience in the operation of the retirement program, may require changes to insure that all the members of the system have the benefits which they have contracted for. Great latitude should be permitted the legislature in making alterations to strengthen the system. But such changes are subject to the above constitutional limitations. If the legislature is convinced of the need to safeguard and protect the fiscal base of the retirement system and plans changes to maintain the solvency of the system it must legislate within the framework of the Constitution.

From the foregoing quote it can be seen that there is nothing in Ireland that clearly and expressly adopts what has been referred to in previous legal memorandums on this subject[10] as the "California rule".[11] The Ninth Circuit Court of Appeals has, however, used this approach.[12]

The Ninth Circuit Court of Appeals has sanctioned the use of the California Rule approach to increasing contributions from employees. So if the California rule were applied by the courts to judge the constitutionality of the Governor's April 10 proposal, the principal question that must be asked is, "What is the comparable benefit to the employees?" Because no increase in benefits was proposed by the Governor, the apparent answer is that the comparable benefit is the actuarial soundness of the retirement systems themselves. Several courts have considered the issue of whether the actuarial soundness of a retirement system is sufficient justification for impairment of a contract but have held that justification to be insufficient. In both Ass'n of Penn. St. College and Univ. Faculties v. St. Syst. of Higher Ed.[13] and Singer v. City of Topeka,[14] the Supreme Courts of Pennsylvania and Kansas, respectively, considered and rejected this claim, holding that the strengthened retirement systems gave no specific

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[9]122 Mont.191, 199 P.2d 965 (1948).

[10]Memorandum of August 14, 2009, page 6.

[11]One of the first reported cases from California to adopt the "California rule" was Allen v. City of Long Beach, 45 Cal.2d 128, 287 P.2d 765 (1995).

[12]See, e.g., State of Nevada Employees Ass'n, Inc. v. Keating, 903 F.2d 1223 (9th Cir. 1990).

[13]479 A.2d 962 (1984).

[14]227 Kan. 356, 607 P.2d 467 (1980).

advantage to the plaintiffs in those cases.[15] And in Barnes v. Ariz. St. Ret. Syst., CV 2011-011638 (Superior Court of Ariz., Maricopa County, 2012), the Court stated: "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." Based upon these opinions, there is little reason to suspect that a unilateral increase in a current retirement system member's contribution rate, at least when there has been no corresponding increase in any tangible benefit to the same member, will be treated by the courts any differently than a unilateral reduction in retirement benefits for current members.

D. The Five LSD/LFD Pension Plan Funding Scenarios

The staffs of the Legislative Services Division and the Legislative Finance Division have devised five scenarios for making the actuarially required funding payments to pay off the unfunded liability that now exists beyond the 30-year goal. Scenario Number 1, making the payments only with increased employer contributions, involves no constitutional impairment of contract issues. Scenario Number 2, making those payments with increased employer and employee contributions, raises constitutional impairment of contract issues if those increased contributions come from current members (working or retired) of the retirement systems whose right to a retirement benefit has already vested. To the extent that those increased contributions are required from current members of the systems whose right to a retirement pension benefit has become a vested contract right, the opinions noted in the foregoing paragraphs concerning the Governor's proposal indicate that requiring increased contributions impairs the state's contract with its employees and would be held unconstitutional, at least without a comparable increase in another benefit under the "California rule", pursuant to Article I, sec. 10, of the U.S. Constitution and Article II, section 3, of the Montana Constitution as well.[16]

Funding Scenario Number 3 involves no impairment of contract issues. Scenario Number 4 is the most clearly problematic scenario of the four alternatives if it is applied to current members of the retirement systems because it involves the elimination of a pension contract benefit, the GABA, that both federal and state courts have indicated would be a violation of the respective contract clauses of the federal and state

[15]However, the Supreme Courts in both cases did not address the issue whether strengthening the retirement systems could provide an off-setting advantage for different plaintiffs.

[16]There is, additionally, some question as to whether a vested benefit may, as a matter of both contract and statute, be reduced at all, or at least without amending section 19-20-501(6), MCA, which seems to indicate that only "enhancements" may be applied to a vested contract. This provision, as well as the "enhancement" itself, may now be a part of the contract of many public employees. No reported Montana cases have dealt with these issues.

constitutions, as indicated in the January 5, 2012, memorandum.[17]

Funding Scenario Number 5 is a generic scenario intended to address other possible funding methods not described by the previous four scenarios. To the extent that those other scenarios whose exact terms or provisions are not addressed in the previous four involve an impairment of vested contract rights, the legal analyses accompanying the previously discussed Scenarios Number 2 and 4 are likely to apply.

III
Conclusion

If legislation is enacted impairing vested rights under contracts established by section 19-2-502 or 19-20-501, MCA, or as found in the jurisprudence of the Montana Supreme Court, and that legislation is tested by the courts under the impairment of contracts standard adopted in U.S. Trust Co. v. New Jersey, the constitutionality of the impairment will depend upon whether the impairment is substantial and what alternatives were first enacted or seriously considered and rejected by the Legislature. If nonimpairing alternatives are not adopted by the Legislature before substantial impairing alternatives, whether a substantial impairment is held constitutional is likely to depend upon the extent to which nonimpairing alternatives, or lesser-impairing alternatives, were analyzed and seriously considered by the Legislature. In other words, that question will turn upon the breadth, detail, and strength of the analysis of nonimpairing or lesser-impairing alternatives by the Committees, as reflected in the records and reports of the Committees and their staff. It is also possible that the courts might uphold a substantial impairment that has been chosen over nonimpairing alternatives, or a lesser impairment, if the impairment is offset by other benefits enacted by the Legislature.

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[17] See footnote no.1. While it was not mentioned in that memorandum, this writer did mention in the oral presentation to both Committees the Ninth Circuit Court of Appeals case of University of Hawaii Professional Assembly v. Cayetano, supra, note 6.