State and Local Pension Plans and Fiscal Distress: A Legal Overview

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Summary

Controversy has arisen over the funded status of some state and local government pension plans. It has been reported that several of these plans have not fully funded their future obligations and they could face substantial future shortfalls. While there is considerable debate over whether this is a problem that needs to be addressed, and if so, the extent and the possible causes of these shortfalls, some estimates have placed the combined unfunded liabilities anywhere from hundreds of billions of dollars to over $3 trillion. Governments facing investment losses combined with lower revenues are looking at ways to address these shortfalls and protect their fiscal stability. State governors and legislators in several states have proposed and enacted various modifications to their pension plans. There have been calls for modification of federal, state, and local laws affecting these pension plans and the benefits provided to participants and beneficiaries. This report provides an overview of how public pension plans are regulated at the federal and state levels, discusses selected legal issues that may arise if attempts are made to remedy or prevent public pension plan underfunding by modifying public pension plan benefits, and addresses possible federal regulation of state and local public pension plans.

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Introduction

Public pension plans, also referred to as governmental plans, are generally plans that provide retirement or deferred income to employees of the U.S. government, a state government or its political subdivision, or any agency or instrumentality of those governments.[1] According to a 2010 GAO report,[2] approximately 20 million employees and over 7 million retirees and survivors are covered by state and local government pension plans, typically through a traditional defined-benefit plan.[3] Recently, questions have been raised about the funded status of many public pension plans, as it has been reported that many of these plans are facing substantial future funding shortfalls. Concerns have been raised that these liabilities could jeopardize the fiscal stability of some state and local governments.

There is considerable debate over whether this is a problem that needs to be addressed and if so, the cause and the extent of public pension plan underfunding. While it has been reported that public pension funds experienced recent gains,[4] some of the estimates have placed the combined unfunded liabilities anywhere from hundreds of billions of dollars to over $3 trillion.[5] In an effort to address these issues, some legislators and others have argued to reform public pension plans and the benefits they offer. In 2011 alone, over 20 states introduced or passed legislation aimed to reduce or otherwise modify pension plan benefits for current or future retirees,[6] and more proposals have been introduced this year. This report provides an overview of how public pension plans are regulated at the federal and state levels. It discusses selected legal issues that may arise if attempts are made to remedy or prevent public pension plan underfunding, in particular, by

[1] 29 U.S.C. §1002(32); 26 U.S.C. §414(d). For purposes of this report, the term public pension plan, or governmental plan, will only refer to a retirement plan of a state or its subdivision, and not a federal retirement plan. For information on pension benefits provided by the federal government, *see* CRS Report 98-810, *Federal Employees' Retirement System: Benefits and Financing*, by (name redacted)

[2] U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-10-754, STATE AND LOCAL GOVERNMENT PENSION PLANS: GOVERNANCE PRACTICES AND LONG-TERM INVESTMENT STRATEGIES HAVE EVOLVED GRADUALLY AS PLANS TAKE ON INCREASED INVESTMENT RISK 1 (2010).

[3] A defined benefit plan is a pension plan under which an employee is promised a specified future benefit, traditionally an annuity beginning at retirement. In a defined benefit plan, the employer bears the investment risk and is responsible for any shortfalls. *See* 29 U.S.C. §1002(35).

[4] *See, e.g.*, U.S. CENSUS BUREAU, G11-QRET2, QUARTERLY SUMMARY OF THE FINANCES OF SELECTED STATE AND LOCAL GOVERNMENT EMPLOYEE RETIREMENT SYSTEMS (2011) (noting that for the 100 largest public-employee retirement systems in the country, total holdings and investments were up in the second quarter of 2011, reaching the highest level since the second quarter of 2008).

[5] *See, e.g.,* Congressional Budget Office, The Underfunding of State and Local Pension Plans, May 2011, available at http://www.cbo.gov/ftpdocs/120xx/doc12084/05-04-Pensions.pdf. *See also The Role of Public Employee Pensions in Contributing to State Insolvency and the Possibility of a State Bankruptcy Chapter*, *Hearing Before the Subcomm. on Courts, Commercial, and Administrative Law*, 112th Cong. (2011)(statement of Joshua Rauh) ("Under their own accounting rules, state and local governments have around $1.3 trillion of unfunded pension liabilities. Using valuation methods and accounting practices that are consistent with financial economics, Robert Novy-Marx and I have calculated that the already-promised part of these unfunded liabilities actually amounts to over $3 trillion, more than the approximately $2.6 trillion of recognized debt on state and local government balance sheets."); *But see* Leigh Snell, Setting the Record Straight About Public Pensions, Government Finance Review 9 (Feb. 2011) ("Public pension plans are not in crisis …organizations representing public pension plans, plan sponsors, and plan participants have been advising Congress that state and local governments are moving aggressively to address sustainability challenges confronting their pension plans….").

[6] *See* Ronald K. Snell, *Pensions and Retirement Plan Enactments in 2011 State Legislatures*, National Conference of State Legislatures (Sept. 30, 2011), http://www.ncsl.org/documents/.../PensionEnactmentsSept30-2011.pdf.

changing plan benefits. This report will also briefly address possible federal regulation of state and local public pension plans.

Regulation of Public Pension Plans

Employment-based retirement benefits[7] are governed at the federal level by two main laws, the Employee Retirement Income Security Act (ERISA) and the Internal Revenue Code.[8] In general, these two laws address two types of pension plans: defined benefit and defined contribution plans. Under a defined benefit plan, an employee is promised a specified future benefit, traditionally an annuity beginning at retirement. Benefits often are based on average pay and years of service. To fund the plan, an employer makes contributions to the common pension fund that are actuarially expected to grow through investment to cover the promised benefits. Under the terms of the plan, employees may make contributions as well. Most public pension plans are traditional defined benefit plans.

A defined contribution plan (e.g., a 401(k) plan) is one in which the contributions are specified, but not the benefits. A defined contribution plan (also called "an individual account" plan) is one that provides an individual account for each participant that accrues benefits based solely on the amount contributed to the account and any income, expenses, and investment gains or losses to the account. The employee bears the investment risk in a defined contribution plan. Some state and local governments maintain defined contribution plans, and there have been proposals in various states to switch from a defined benefit to a defined contribution plan.

Enacted in 1974, ERISA provides a comprehensive federal scheme for the regulation of pension and other employee benefit plans offered by private-sector employers. While ERISA does not require an employer to offer employee benefits, it does mandate compliance with its provisions if such benefits are offered. Title I of ERISA imposes various federal standards aimed at protecting the interests of plan participants and beneficiaries, including reporting and disclosure, vesting, participation, funding, fiduciary duty, and civil enforcement requirements. Title IV of ERISA created a plan termination insurance program, under which pension benefits are paid to plan participants and beneficiaries up to a statutory maximum if the benefits cannot be paid by the employer. Public pension plans are generally exempt from these provisions of ERISA,[9] but may be subject to federal regulation under the Internal Revenue Code.[10]

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[7] This report does not address Social Security, which is funded in part by is funded by payroll taxes paid by covered workers and their employers. *See* CRS Report RL33544, *Social Security Reform: Current Issues and Legislation*, by (name redacted).

[8] It should be noted that other federal laws govern various aspects of public pension plans. For example plans may be subject to the Civil Rights Act of 1964, the Age Discrimination in Employment Act (ADEA), and the Family and Medical Leave Act.

[9] While it is often expressed that governmental plans are exempt from ERISA, this statement is technically incorrect. Governmental plans may be subject to Title II of ERISA, which amended the Internal Revenue Code to impose requirements for plan qualification that a plan must meet in order to receive favorable tax treatment. These qualification requirements in the Code parallel many of the provisions in Title I of ERISA. However, as discussed *infra*, governmental plans are exempt from a number of these qualification requirements.

[10] It should be noted that there are different types of governmental plans subject to different requirements under the Internal Revenue Code. *See, e.g.*, 26 U.S.C. §403(b); 26 U.S.C. §457. This report will not focus on these differences.

The Internal Revenue Code grants certain tax benefits to "qualified" retirement plans.[11] Among these tax advantages, employer contributions to a qualified plan on behalf of its employees are tax deductible for the employer. In addition, qualified retirement plan participants do not pay tax on employer contributions or the benefits they accrue in the pension plan until the participant (or beneficiary) takes a distribution. Given that state and local governments do not pay federal taxes, the tax benefit for employer contributions is irrelevant to them. However, public pension plans must be qualified so that the plan participants can avoid paying taxes on their pension benefits until the benefits are actually received. In order to be a qualified plan under the Internal Revenue Code, pension plans must meet several requirements. Governmental plans, however, are only subject to a subset of the qualification requirements that private-sector pension plans must meet.[12] In many cases, public pension plans are subject to different requirements under the Internal Revenue Code than private-sector plans, including certain less stringent pre-ERISA requirements for vesting and funding.

Aside from the requirements set out in the Internal Revenue Code, public pension plans are primarily regulated under state statutes, local ordinances, and state constitutions. These laws typically address the basic features of public pension plans, including eligibility, contributions, and types of benefits provided, and the laws vary widely from jurisdiction to jurisdiction.[13] While public pension plans have no guarantor of plan benefits, states generally have constitutional or statutory provisions that dictate how pension plans are to be funded, protected, managed, or governed.[14]

Benefit Accrual and Vesting Requirements

In evaluating whether pension plan benefits may be modified, requirements for benefit accrual and vesting are implicated. Under federal law, both ERISA and the Internal Revenue Code provide requirements for benefit accrual, which generally refers to the rate at which benefits are earned by a plan participant. Both federal laws prohibit private-sector pension plan amendments that eliminate or reduce benefits already accrued by plan participants.[15] This prohibition is commonly referred to as the "anti-cutback rule."[16] However, private-sector pension plans may be free to freeze accrued benefits, reduce the rate at which benefits will accrue in the future, or eliminate future benefit accruals altogether. In other words, under the anti-cutback rule, past benefit accruals are protected, but future benefits accruals can be modified. Governmental plans are exempt from the anti-cutback rule. Therefore, analysis of the changes that may be made to accrued benefits under a public plan is a state-by-state inquiry.

[11] In general, for purposes of this report, a qualified plan generally means an employer-sponsored pension plan that meets the requirements set forth under 26 U.S.C. §401(a); eligible plans are described in 26 U.S.C. §457.

[12] For a list of the Internal Revenue Code requirements that public pension plans must meet, *see* Barry Kozak, "Clarifying Qualification Requirements for Eligible Governmental Plans" IRS Increases Education, Compliance Efforts," CCH Planning Guide, Benefit Practice Portfolios (July 2008).

[13] U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-07-1156, STATE AND LOCAL GOVERNMENT RETIREE BENEFITS: CURRENT STATUS OF BENEFIT STRUCTURES, PROTECTIONS, AND FISCAL OUTLOOK FOR FUNDING FUTURE COSTS 20 (2007).

[14] Legal protections may also be recognized under common law. *See id.*

[15] 29 U.S.C. §1054(g); 26 U.S.C. §411(d)(6).

[16] Certain exceptions to the anti-cutback rule may apply. For example, ERISA allows for a plan to reduce accrued benefits by a retroactive amendment in certain cases where a plan is confronted with a "substantial business hardship." *See, e.g.,* ERISA §204(g)(1), 29 U.S.C. §1054(g)(1) (citing ERISA §302(d)(2), 29 U.S.C. §1082(d)(2)).

While accrued benefit refers to the amount of benefits earned, vesting occurs under federal law when a plan participant's accrued benefit is considered to be non-forfeitable.[17] ERISA and the Internal Revenue Code impose two general vesting requirements on private-sector defined benefit pension plans: one depending on age and one depending on length of service.[18] Governmental plans are exempt from these federal vesting requirements. However, in order to be qualified, governmental plans must meet pre-ERISA vesting standards under the Internal Revenue Code, which include the requirement that upon plan termination or complete discontinuance of contributions, employees' rights to benefits accrued as of the date of the termination or discontinuance are non-forfeitable, but only to the extent that the benefits are funded.[19] States may also impose additional vesting requirements for pension benefits, and these can vary by state.

Can State and Local Governments Modify Pension Benefits?

Recently, in an effort to alleviate pension plan underfunding and protect state and local government budgets, governors and legislators in several states have proposed and enacted various modifications to their pension plans.[20] Over the past few years, almost two-thirds of states have made some form of benefit and/or contribution change to their plans (e.g., reducing benefit levels, requiring higher employee contributions, or amending age and service requirements to lengthen the accumulation and shorten the distribution period of pension benefits).[21] While the majority of changes are directed at future participants and/or benefit accruals, some of the changes affect current employees and retirees. Although states may not face obstacles in changing the pension benefits available for new employees, the issue is not as clear with respect to existing ones. As discussed below, certain legal parameters may affect the ability of state and local governments to amend their pension plans.[22] These parameters vary by state and depend on each state's laws and constitutional provisions governing its retirement system, what these laws provide with respect to the protection of an individual's pension benefits, and when any right to a pension benefit attaches.

Courts have conceptualized the legislative modification of public employee pension plan benefits in different ways. Historically, most courts viewed public pensions as gratuities that could be amended at any time. Although it may not be controlling in the interpretation of a state law, the Supreme Court has historically found that statutes providing retirement benefits to pensioners create a mere "expectancy" that may be modified, revoked, or suspended by the authority

[17] There can be confusion in understanding the difference between when benefits accrue and when benefits vest. As articulated by the Supreme Court, accrual is "the rate at which an employee earns benefits to put in his pension account." Central Laborers' Pension Fund v. Heinz, 541 U.S. 739, 749 (2004). Vesting, on the other hand, is "the process by which an employee's already-accrued pension account becomes irrevocably his property." *Id.*

[18] For additional description of ERISA's vesting requirements, see CRS Report RL34443, *Summary of the Employee Retirement Income Security Act (ERISA)*, by (name redacted) and Jennifer Staman.

[19] *See* 26 U.S.C. §411(e)(1) (stating that governmental plans are subject to vesting requirements of 1974).

[20] *See generally* Randy Diamond, DB *Plans in Cross Hairs in State Budget Battles*, Pensions & Investments (Mar. 7, 2011).

[21] *See* Leigh Snell, *Setting the Record Straight About Public Pensions*, 28 Government Finance Review 8 (Feb. 2011).

[22] *See generally* Mary A. Brauer, *State and Local Government Pensions: In What Circumstances Can Governments Reduce Pension Benefits?* 20 Benefits Law Journal 65 (Winter 2007).

granting it through subsequent legislation.[23] However, this view has now been abandoned in most states, and public employee pension benefits are generally afforded greater protection under current state and constitutional law.[24] This is, at least in part, because many courts now characterize public plan pensions as deferred compensation—that an employee is entitled to these benefits for work that has already been performed.[25]

Public Pension as a Contractual Right[26]

In rejecting the gratuity approach to public pensions, many state courts have found that based on common law, state statute, or state constitution, public pension benefit plans create a contract between the state and plan participant.[27] If a contract is found to exist between the state or local government and pension plan participants, then this can limit the ability of a state to amend its pension plans.[28] In some states, there is a specific constitutional provision addressing protection for public pensions as contractual obligations.[29] At least six states[30] have a constitutional provision that, in general, explicitly provides that membership in, or accrued benefits from, a state's retirement system creates a contract between the state and its employees that cannot be impaired. One lawsuit demonstrating the effect of this type of pension protection is *McDermott v. Regan*.[31] In this case the New York legislature, in response to a state fiscal crisis, changed the funding method for the state's retirement systems. The change had the effect of reducing the government's contribution to the system. In finding that the state law violated the New York constitution,[32] the court explained that the amendment depleted money in the fund and arguably

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[23] Pennie v. Reis, 132 U.S. 464 (1889). *See also* Zucker v. United States, 758 F.2d 637 (Fed. Cir. 1985), cert. denied, 474 U.S. 842 (1985); Walton v. Cotton, 19 How (60 U.S.) 355, 358 (1857); United States ex rel. Burnett v. Teller, 107 U.S. 64, 68 (1883);; McLeod v. Fernandez, 101 F.2d 20 (1st Cir. 1938), *cert. denied*, Toste v. McLeod, 308 U.S. 561 (1939); Steinberg v. United States, 163 F. Supp. 590, 591 (Ct. Claims 1958); Flemming v. Nestor, 363 U.S. 603, 609-610 (1960); Stouper v. Jones, 284 F.2d 240 (D.C. Cir. 1960); United States Railroad Retirement Board v. Fritz, 449 U.S. 166 (1980).

[24] It should be noted that a small minority of state courts still view some public pensions as gratuities. *See e.g.,* Haverstock v. State Public Employees Retirement Fund, 490 N.E.2d 357, 360-61 (Ind. Ct.App.1986)("Where employee participation in the retirement plan is compulsory or mandatory, however, it is termed a pension. Pensions are mere gratuities springing from the appreciation and graciousness of the state. Under such a plan, the employee has no vested contract rights until he fulfills all conditions existing at the time of his application for benefits.")

[25] R. D. Hursh, Annotation, *Vested Right of Pensioner to Pension*, 52 A.L.R.2D FED, 437 (2011).

[26] While not nearly as common as a contractual right, it should be noted that rights to a pension benefit may be based on something other than a contract. For example, the New Mexico State Constitution provides that a pension benefit is a property right. It states that "[u]pon 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." N.M. Const. art. XX, §22.

[27] *See* Amy Monahan, *Public Pension Reform: Legal Framework,* 5 Education, Finance & Policy, 617-646 (2010).

[28] *Id.*

[29] It should be noted that several states have provisions in their state constitutions that address protection of the state retirement system as a whole. Among other things, state constitutions address how public pension plans should be funded and provide that retirement system assets are exclusively for the purpose of the retirement system. *See* 2007 GOV'T ACCOUNTABILITY OFFICE, note 12 *supra*, at 19. The protections discussed here concern the protection of the pension rights of an individual participant.

[30] These states include Alaska, Arizona, Hawaii, Illinois, Michigan, and New York.

[31] 82 N.Y.2d 354 (1993), as cited in National Education Association Issue Brief on Pension Protections Available in State Constitutions, available at http://www.nea.org/assets/docs/PensionProtectionsinStateConstitutions04.pdf.

[32] Article V, Section 7 of the New York Constitution provides that "membership in any pension or retirement system of the state or of a civil division thereof shall be a contractual relationship, the benefits of which shall not be diminished or (continued...)

destabilized the retirement system. Thus, it was an unconstitutional impairment of the pension funds.

In the absence of a state constitutional provision expressly prohibiting the modification of pension benefits, a state's statutes or case law may be found to provide contractual rights for state and local government employees to their pension benefits. As noted above, if a contract is found to exist between the state or local government and pension plan participants, then this can limit the ability of a state to amend its pension plans. A public employee's contractual right to an unaltered pension benefit may be protected under the Contract Clause of the U.S. Constitution or an analogous state constitutional provision.[33] The Federal Contract Clause provides, "No state shall ... pass any ... Law impairing the Obligation of Contracts."[34] Although the language of the Contract Clause appears straightforward, its prohibition against state impairment of contracts is not absolute but rather "must be accommodated to the inherent police power of the state 'to safeguard the vital interests of its people.'"[35] The Contract Clause applies to contracts between private parties, as well as those where the state is a party to the contract.[36] However, in general, instances where the state is impairing a contract for its own benefit invite more judicial scrutiny.[37]

Based on Supreme Court jurisprudence, courts typically evaluate whether a state law violates the Contract Clause under a multi-pronged test. With respect to a public contracts, as a preliminary matter, courts may look at whether there is a contractual obligation that has been impaired.[38] In order to determine whether a contractual relationship exists, a court may look to legislative intent to create a contract between the state and a private party.[39] As the Supreme Court has explained,

> In determining whether a law tenders a contract to a citizen it is of first importance to examine the language of the statute. If it provides for the execution of a written contract on behalf of the state the case for an obligation binding upon the state is clear…. The presumption is that such 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. He who asserts the creation of a contract with the state in such a case has the burden of overcoming the presumption.[40]

(...continued)

impaired."

[33] An analysis of provisions analogous to the Contract Clause in state constitutions is beyond the scope of this report.

[34] U.S. Const. Art. I, §10, cl. 1.

[35] Energy Reserves Group, Inc. v. Kansas Power & Light Co., 459 U.S. 400, 410 (1983) (quoting Home Bldg. & Loan Assn. v. Blaisdell, 290 U.S. 398 (1934)). *See also* United States Trust Co. v. New Jersey, 431 U.S. 1, 21 (1977)("Although the Contract Clause appears literally to proscribe 'any' impairment, this Court observed … that 'the prohibition is not an absolute one and is not to be read with literal exactness like a mathematical formula.' Thus, a finding that there has been a technical impairment is merely a preliminary step in resolving the more difficult question whether that impairment is permitted under the Constitution.") (citation omitted).

[36] A contract that includes a state as a party will hereinafter be referred to as a "public contract."

[37] *See, e.g.*, McGrath v. Rhode Island Retirement Bd., 88 F.3d 12, 16 (1st Cir. 1996) ("[w]hen a state is itself a party to a contract, courts must scrutinize the state's asserted purpose with an extra measure of vigilance.")(citing U.S. Trust, 431 U.S. at 25.

[38] *U.S. Trust*, 431 U.S. at 21-22.

[39] *See U.S. Trust*, 431 U.S. 18 f. 14 ("In general, a statute is itself treated as a contract when the language and circumstances evince a legislative intent to create private rights of a contractual nature enforceable against the State.")

[40] Dodge v. Board of Education, 302 U.S. 74, 78-9 (1937).

State statutes that establish retirement plans generally do not address whether a contract is created; thus, ascertaining whether a contract exists for a public plan pensioner can, in some cases, be difficult.[41]

However, if it is established that a contract exists, one must then ascertain whether a plaintiff's contractual rights are "substantially impaired."[42] Factors that courts have taken into account in determining whether a substantial impairment exists include whether a statute applies prospectively, or retroactively;[43] disrupts a party's "reasonable expectations" regarding an agreement;[44] or "alters its terms, imposes new conditions, or lessens [a contract's] value."[45] In the context of public pensions, benefit formula changes, changes in plan funding sources or methodology, and the elimination of cost of living supplement payments have all been found by courts in certain instances to be substantial impairments of the pension contract.[46] But, in general, state law amendments that were not anticipated to have an effect on pension benefits or on employer rights and responsibilities may not be considered impairments.[47]

If a substantial impairment exists, however, the state law may still be constitutional if "it is reasonable and necessary to serve an important public purpose."[48] This rule ensures that in impairing a contract, the state is protecting the broad public interest, rather than its own self-interest.[49] As the Supreme Court has explained with respect to the impairment of public contracts, reasonableness must be considered "in light of the surrounding circumstances."[50] Necessity depends upon two considerations: first, whether the impairment was essential or whether a less "drastic modification" was available, and also whether a state could have adopted an alternative means to bring about the desired end without impairing contract obligations.[51] As the Supreme Court noted in *U.S. v. New Jersey*, "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

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[41] *See* Monahan, *supra* note 27.

[42] Energy Reserves Group, Inc. v. Kansas Power & Light Co., 459 U.S. 400, 413 (1983).

[43] *See, e.g.,* Howell v. Anne Arundel County, 14 F. Supp. 2d 752, 755 (D. Md. 1998); Pennsylvania Mortg. Bankers Ass'n v. Zimmerman, 664 F. Supp. 186, 194 (M.D. Pa. 1987) ("contract clause does not apply to prospective state action").

[44] *See, e.g.,* Transport Workers, Local 290 v. SEPTA, 145 F.3d 619, 624 (3d Cir. 1998) (no impairment to public pension plan when employees had no reasonable expectation that plan would not change); Buffalo Teachers Federation, 464 F.3d 362, 368 (2d Cir. 2006) (school district wage freeze disrupts reasonable expectations of workers so much that it substantially impairs workers' contracts with the city).

[45] Retired Pub. Employees Council of Wash. v. Charles, 148 Wash.2d 602, 625 (Wash. 2003).

[46] Monahan, *supra* note 27, (citing Betts v. Bd. of Admin., 582 P.2d 614 (1978); Valdes v. Cory, 139 Cal. App. 3d 773 (Cal. Ct. App. 1983); Bd. of Admin. v. Wilson, 52 Cal. App. 4th 1109,(Cal. Ct. App. 1997); Calabro v. City of Omaha, 531 N.W.2d 541 (Neb. 1995)).

[47] *Id*. (citing, e.g., Retired Pub. Employees Council of Wash. v. Charles, 148 Wash.2d at 626 (reduction in employer contributions acceptable under Washington State constitution's contract clause provision because, among other things, there was no indication that the lower contribution amounts would impair the pension system).

[48] *U.S. Trust*, 431 U.S. at 25.

[49] As noted in *U.S. Trust*, "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 Contract Clause would provide no protection at all." Id. at 26. (citing El Paso v. Simmons, 379 U.S. 497 (1965); Faitoute Iron & Steel Co. v. City of Asbury Park, 316 U.S. 502 (1942); Louisiana v. New Orleans, 102 U.S. 203 (1880)).

[50] *U.S. Trust*, 431 U.S. at 31.

[51] *Id*. at 25.

purposes equally well."[52] While some courts have found that a state's desire to reduce spending and avoid financial crisis is an important public purpose under which a modification of a contractual right is acceptable under the Contract Clause,[53] others have found to the contrary.[54]

In addition, a number of state courts, such as in California, permit reasonable modifications to an individual's pension benefits. However, "the modification must bear some material relationship to the purpose of the pension system and its successful operation; and any disadvantage to employees must be accompanied by comparable new advantages"[55] (e.g., an increased pension amount). Thus, as explained by one commentator, the idea is that public employees are not entitled to any particular terms of a pension, but of the substance of the benefit which they could reasonably expect to receive.[56] It should be noted that courts may reach varying conclusions as to whether a more financially sound pension plan is a comparable advantage that may accompany a modification of pension benefits.[57]

Attachment of Pension Rights

While states that protect public pensions under contract principles typically evaluate a case under the legal standard discussed above, they reach varying conclusions based on when the contract is deemed to be formed, and what terms and conditions the contract includes.[58] While courts generally find that the pension benefits of individuals who have already retired may not be diminished or impaired, this outcome is not as clear for current employees.[59]

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[52] *Id.* at 30-31.

[53] *See, e.g.,* Maryland State Teachers Ass'n v. Hughes, 594 F. Supp. 1353, 1371 (D. Md. 1984) (finding that courts lack the resources to second guess legislature on what is necessary to ensure the financial stability of pension funds); Subway-Surface Supervisors Ass'n v. New York City Transit Authority, 44 N.Y.2d 101 (1978) (court upheld 1975 Financial Emergency Act for the City of New York, an act that suspended all employee wage increases for a one-year period, in light of financial crisis). *See also generally* Brazelton v. Kansas Public Emp. Retirement System, 607 P.2d 510 (court states, in dicta, that "[t]here may be times when changes [to a state's retirement system] are necessary to protect the financial integrity of the system or for some other compelling reason…").

[54] *See, e.g.,* Bailey v. State, 500 S.E. 2d 54 (N.C. 1998)(making retirement benefits taxable in light of federal court decision was neither necessary nor reasonable for achieving an important state interest; court explains there were numerous other ways to comply with the decision); Calabro v. City of Omaha, 247 Neb. 955, 970 (Neb. 1995)(city's elimination of a cost of living supplemental benefit plan unconstitutional; court states in dicta that "[t]he city has not convinced us that terminating the supplemental benefit plan was the only viable alternative for correcting its alleged fiscal woes.")

[55] Public Employees' Retirement Bd. v. Washoe County, 615 P.2d 972, 975 (Nev. 1980). *See also* Betts v. Board of Administration of Public Employees' Retirement System, 21 Cal. 3d 859 (Cal. 1978).

[56] Brauer, *supra* note 22. *See also*, e.g., Maryland State Teachers Ass'n v. Hughes, 594 F. Supp. 1353, 1363 (D. Md. 1984) (reduction in benefits may be permissible if benefits lost are offset by new benefits received); Public Employees' Retirement Bd. v. Washoe County, 96 Nev. 718, 722, 615 P.2d 972, 975 (1980) (for modification to be sustained any disadvantage to employee must be offset by new advantage).

[57] *See e.g.,* Houghton v. City of Long Beach, 330 P.2d 918 (Cal. 1958)(increase in employee contributions without a compensating increase in pension benefits upheld because city demonstrated that the additional revenues would result in improved financial stability for the system); *cf.* Singer v. Topeka, 607 P.2d 467 (1980) (court does not accept City's claim that the actuarial soundness of the local plan was an advantage for the plaintiff after increasing employee plan contributions). *See generally* ("there can be extraordinary circumstances where the employee may be required to increase his contributions without a corresponding increase in benefits in order to preserve the financial integrity of the system.").

[58] Monahan, *supra* note 27.

[59] *Id*.

The ability of states to modify their pension plans for current employees varies depending upon when a contract is deemed to exist, and this varies from state to state.[60] For example, in some states, courts have held that an employee's right to a pension cannot be changed in any way that reduced the benefit that would be payable upon the day of hire or the first day the employee could participate in the plan.[61] This view entitles plan participants to the most generous amount of protection for their pension benefits, as employees have a right to accrue benefits in the future.[62] States may, however, alter the benefits available to new hires.[63]

In other states, reductions in pension plan benefits could be prohibited when, under the terms of a state statute, a participant is eligible to receive a pension (e.g., the employee has fulfilled the plan's service requirement).[64] This approach is in line with federal requirements for private sector pension benefits. Under this view, retirement benefits must be provided for service already performed, but prospective plan modifications may still be acceptable. It is also possible that based on interpretation of a state statute, contractual rights to a pension take effect at other times. For example, interpreting an Ohio statute, one court found that the right to a pension benefit attached at retirement.[65]

Despite the variation in when a contractual right to a public plan pension benefit begins, as noted above, state courts generally find that the benefits of individuals who have already retired may not be diminished or impaired.[66] However, modifications affecting post-retirement benefits have recently been challenged by retired state workers. For example, litigation in Minnesota, North Dakota, and Colorado was initiated based on adjustments that the state legislatures made to post-retirement cost of living adjustments (COLA) in an attempt to address pension plan underfunding.[67] Plaintiffs have claimed, among other things, that they have a contractual right to a certain level of future post-retirement increases. On the other hand, the state defendants have argued that nothing supports the idea that the public employees are entitled to a specific cost of

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[60] *See id.*

[61] Brauer, *supra* note 22. *See also, e.g.,* Olson v. Cory, 26 Cal. 3d 672 (Cal. 1980)("A long line of this court's decisions has reiterated the principle that a public employee's pension rights are an integral element of compensation and a vested contractual right accruing upon acceptance of employment.") *See also* Yeazell v. Copins, 98 Ariz. 109, 402 P.2d 541 (1965).

[62] Brauer, *supra* note 22.

[63] *Id*.

[64] For example, in *Petras v. State Board of Pension Trustees*, a retired schoolteacher sought to claimed he had an enforceable right to a pension calculated under the version of state law in effect when he began teaching in the state. In denying his claim, the Delaware Supreme Court opined that "it is clear that no contract exists between an employee and the State, concerning the state pension plan, unless and until the pension vests. This result is consistent with that reached in other jurisdictions… Because in 1964 the period for vesting of pensions was 30 years, Petras, who had only completed two years service before the [pension formula] 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.")(citations omitted). *See also* Baker v. Oklahoma Firefighters Pension & Retirement Sys., 718 P.2d 348, 350-51 (Okla.1986) (contractual right begins when eligible to receive pension).

[65] *See* State *ex rel*. Horvath v. State Teachers Retirement Bd., 83 Ohio St. 3d 67, 77 (Ohio 1998)("Accordingly, under [the state statute], a right does not become vested until it is granted, and only grants of retirement allowances, annuities, and pensions give rise to vested rights.").

[66] Monahan, *supra* note 27.

[67] Justus et al. v. State of Colorado, No. 2010CV1589 (D. Colo. filed Feb. 26, 2010); Swanson et al. v. State of Minnesota, No.CV-lO-5285 (Dist. Minn. filed May 17, 2010); Tice v. South Dakota, No. 10-225, (S.D. Cir. Ct. filed June 14, 2010).

living adjustment formula.[68] So far, these plaintiffs' claims in the Colorado and Minnesota cases have been dismissed by lower courts, finding no contractual right to a specific COLA level.[69]

Federal Legislation Affecting State and Local Governmental Pension Plans

In order to address the issue of public pension plan underfunding, some have called for federal action. In the past, there have been efforts to regulate public pension plans similar to ERISA. In particular, following enactment of ERISA, various proposals were introduced that would have required public plans to meet various federal standards, such as reporting, disclosure, and fiduciary duty requirements.[70] Legislative history indicates that Congress intentionally exempted these plans from ERISA for various reasons, most of which center around the differences inherent in regulating a private pension plan versus one sponsored by a state or local government.[71] Because of these differences, it was concluded that additional data and study were necessary before attempting to regulate public plans.[72] Federalism concerns were also raised, based on the idea that regulating state and local pension plans would constitute impermissible federal interference in the affairs of state and local government.[73] However, the legal landscape has changed due to Supreme Court decisions issued after ERISA's enactment in 1974.[74]

While it appears that to date no proposals have been introduced in the 112th Congress to comprehensively regulate public pension plans, there had been discussion of possible federal legislation to allow states to declare bankruptcy, something that states cannot currently do, in order to avoid or reduce certain financial obligations, such as pension obligations.[75] Another proposal addressing public pension plans, the Public Employee Pension Transparency Act, would require public pension plan sponsors to file various plan financial data with the Treasury

[68] *See, e.g*., Swanson et al. v. State of Minnesota, No.CV-lO-5285, (Dist. Minn. filed Aug. 18, 2010) at 36.

[69] Justus v. Colorado, No. 2010CV1589, (Colo. Dist. Ct., June 29, 2011); Swanson v. Minnesota, No. 62-CV-10-05285 (June 29, 2011).

[70] *See, e.g.,* H.R. 5144, Public Employee Pension Plan Reporting and Accountability Act (PEPPRA), 98th Cong. 2nd Sess., (1984); and H.R. 4929, Public Employee Retirement Income Security Act (PERISA), 97th Cong., 1st Sess. (1981).

[71] As explained in *Rose v. Long Island R. Pension Plan*, 828 F.2d 910, 914 (2nd Cir. 1987):

> The governmental plan exemption [to ERISA] was included for several reasons. First, it was generally believed that public plans were more generous than private plans with respect to their vesting provisions. Second, it was believed that "the ability of the governmental entities to fulfill their obligations to employees through their taxing powers" was an adequate substitute for both minimum funding standards and plan termination insurance. Finally, there was concern that imposition of the minimum funding and other standards 'would entail unacceptable cost implications to governmental entities.' (citations omitted).

[72] 29 U.S.C. §1231(a)(3).

[73] *See, e.g.,* Feinstein v. Lewis, 477 F. Supp. 1256, 1261 (S.D.N.Y. 1979) (purpose of ERISA governmental exemption was to "refrain from interfering with the manner in which state and local governments operate employee benefit systems"), aff'd, 622 F.2d 573 (2d Cir. 1980).

[74] For a discussion of Supreme Court cases addressing the lines of authority between states and the federal government, see CRS Report RL30315, *Federalism, State Sovereignty, and the Constitution: Basis and Limits of Congressional Power*, by (name redacted).

[75] However, recent reports suggest that a proposal to allow states to declare bankruptcy is no longer being given serious consideration. *See, e.g., Wall Street Journal: Rep. McHenry: Idea of State Bankruptcy is Off the Table* (Apr. 13, 2011).

Secretary, including plan assets at fair market value and plan liabilities at an interest rate based on the U.S. Treasury obligation yield curve.[76] The bonds issued by governmental entities that did not comply with the disclosure requirements would lose their federal tax exemption. Among other things, the legislation also states that the federal government would not be liable for any obligation related to a shortfall in any public pension plan.

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[76] H.R. 567, 112th Cong. (2011); S. 347, 112th Cong. (2011).

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