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Legal Limitations on Public Pension Plan Reform

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Legal Limitations on Public Pension Plan Reform

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ABSTRACT

There is significant interest in reforming retirement plans for public school employees, particularly in light of current market conditions. This paper presents an overview of the various types of state regulation of public pension plans that affect possibilities for reform. Several states have legal protections that effectively prevent a state from making any changes to its retirement plans that would reduce the monetary value of an employees pension from what he or she would have earned under the terms of the plan in effect on the employee's date of hire. Many other states allow changes to their pension plans only if any disadvantages of the plan amendment are offset by comparable new advantages to participants. Other states allow retirement plan changes as long as participants have been afforded due process. Nearly all of the various approaches to public pension plan protection taken by the states have significant flaws. These flaws include a lack of clarity regarding what plan changes the relevant legal standard will allow, combined with either too much or too little protection for plan participants. This paper argues that states would be well served to adopt the approach used by the federal government with respect to pension plans. The federal approach protects plan participants' currently accrued benefits, but gives employers freedom to change plan terms going forward. This approach is clear, protects legitimate participant interests, and preserves an employer's ability to respond to changing economic conditions.

I. Introduction

Public pensions plans[1] hold a vast amount of assets,[2] are responsible for contributing to the retirement security of many Americans, and are a significant source of strain for state governments in times of market decline and decreasing revenue. They also can have significant labor market effects, influencing who enters public service and how long they remain employed.[3] Interest in reforming public pension plans is significant, driven both by cost issues and labor market issues. This paper provides an overview of the legal limitations on the ability of states to amend their existing pension plans. While this paper attempts to provide an overview of the primary legal approaches taken by states in protecting public pension benefits, it is not a comprehensive 50-state survey.

The legal protection of public pensions has undergone significant change in the last century. Historically, public pensions in this country were viewed as mere gratuities that could be withdrawn or amended by the state at any time. Following well-publicized cases where the gratuity approach led to perceived injustice to pension plan participants, the vast majority of states have rejected the gratuity theory and instead protect public pensions under contract or property rights theories. How these theories are interpreted and applied by various states differs significantly, but the end result is that in many states it can be very difficult to amend a public pension plan in any way that diminishes the

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[1] The term "public pension plan" is used to indicate a retirement plan of a state or one of its subdivisions. The term will be used interchangeably with "public retirement plan", "state retirement plan", and "state pension plan."

[2] As of the end of 2007, public pension plans held $3.2 trillion in assets, although that amount declined by $1 trillion by October 2008. Alicia H. Munnell et al., The Financial Crisis and State/Local Defined Benefit Plans, Center for Retirement Research at Boston College, Nov. 2008, No. 8-19 at 2, *available at* http://crr.bc.edu/images/stories/Briefs/ib_8-19.pdf.

[3] *See, e.g.*, Robert M. Costrell & Michael Podgursky, *Peaks, Cliffs, & Valleys: The Peculiar Incentives of Teacher Pensions*, EDUCATION NEXT, Winter 2008, 22.

monetary value of a participant's pension. This article will first briefly examine federal regulation of retirement plans, before examining different state approaches to public retirement plan protection. Finally, the article critiques the various theories of state pension protection and suggests a different approach that states could take in balancing the interests of participants and the state.

II. Federal Limits on Retirement Plan Amendments

There are two federal laws that govern employer-provided retirement plans, the Internal Revenue Code of 1986 (the "Code") and the Employee Retirement Income Security Act of 1974 ("ERISA"). ERISA, while very broad in reach, exempts governmental plans from its authority.[4] A governmental plan includes a plan established or maintained "by the government of any State or political subdivision thereof, or by any agency or instrumentality of any of the foregoing."[5] As a result, public pension plans are exempt from ERISA's provisions, and need only comply with federal tax code requirements for such plans.

The tax code grants favorable tax treatment to employer-provided retirement plans, provided the requirements of section 401(a) of the Code are satisfied. Plans that meet these requirements are referred to as "qualified retirement plans." Participants in qualified retirement plans are not taxed on the benefits that accrue under such plans until such amounts are distributed. In addition, employers are allowed an immediate deduction for contributions to such plans, even though such amounts are not included in employee

[4] 29 U.S.C. § 1003(b)(1) (2000).
[5] 29 U.S.C. § 1002(32) (2000).

income until many years later.[6] In order to qualify for such favorable tax treatment, plans must satisfy, among other things, nondiscrimination requirements, vesting and benefit accrual requirements, and various rules regarding plan distributions.[7] The Code specifically provides in section 411(d)(6) that a plan will not be qualified under section 401(a) if the "accrued benefit of a participant is decreased by an amendment of the plan." This provision is commonly referred to as the "anti-cutback rule." The Code therefore protects benefits accrued to date under the terms of a qualified plan, but does not prevent reductions in or elimination of yet-to-be-accrued future benefits.[8] State plans, however, are specifically exempted from the anti-cutback rules.[9] The functional result is that state law is responsible for setting the applicable limits on state retirement plan changes. An overview of the principle approaches taken by the states to such regulation are discussed in more detail below.

III. State Limits on Retirement Plan Amendments

In the absence of federal limits on the ability of states to amend their retirement plans, state law is responsible for providing protection to state employees' retirement benefits. Historically, most states viewed public pensions as mere gratuities that could be withdrawn or amended at any time.[10] Today, nearly every state has abandoned the gratuity theory in favor of some other approach that provides significantly more protection to participants in public pension plans. States generally protect public pensions under either a contract-based theory or a property-rights theory, while one state

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[6] This violates what is known as the "matching principle" of tax law, that an employer's compensation deduction should occur at the same time or "match" the inclusion of such compensation in an employee's income.
[7] *See* I.R.C. §401(a).
[8] Employers who reduce the rate of future benefit accruals under a pension plan must notify participants in advance of the change, pursuant to section 204(h) of ERISA. *See* 29 U.S.C. §1054 (2000).
[9] I.R.C. § 411(e)(1).
[10] Note, *Public Employee Pensions in Times of Fiscal Distress*, 90 HARV. L. REV. 992, 993 (1977).

does so under principles of promissory estoppel. After briefly summarizing the continuing adherence to the gratuity approach in two states, the subparts below will address the contract-based, promissory estoppel, and property rights approaches in turn.

(a) The Gratuity Approach

The so-called gratuity approach to public pensions holds that the pensions of public employees are mere gratuities that do not vest and can be amended or modified at any time by the state.[11] This approach has been rejected by a majority of states, and is today followed only by Indiana[12] and Texas.[13] In Indiana, the gratuity approach is followed only with respect to involuntary or compulsory plans, where the employee has no choice regarding whether to contribute to the plan or keep the compensation.[14]

(b) Public Pensions as Contracts

In rejecting the gratuity approach to public pensions, many states have either found at common law or provided through statute or state constitution that public pension plans create a contract between the state and plan participant. Where there is state constitutional protection specific to state pension plans, the courts must interpret what protection is granted by the state constitution and apply it. In states where a contract is created or implied by statute or common law, courts must analyze any proposed changes to public pension plans under the Federal Constitution's Contract Clause.[15] Holding that

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[11] *Id.* at 993-97.
[12] *See* Ballard v. Bd. of Trustees of Police Pension Fund of City of Evansville, 324 N.E.2d 813, 815 (Ind. 1975) (involuntary plans are "gratuities from the sovereign").
[13] Cook v. Employees Ret. Sys. of Texas, 514 S.W.2d 329, 331 (Tex. Civ. App. 1974); Kunin v. Feofanov, 69 F.3d 59, 63 (5th Cir. 1995)
[14] *See* Ballard, 324 N.E.2d at 815.
[15] In some states, there is also a state constitution contract clause that mirror the federal constitutional language. *See, e.g.*, Article I, section 9 of the California constitution which provides, in part, "A…law impairing the obligation of contracts may not be passed."

a public pension plan creates a contract creates significant limitations on the changes that can be made to a public pension system because the Contract Clause of the United States Constitution provides that "No State shall…pass any…Law impairing the Obligation of Contracts."[16] This constitutional protection applies to both private and public contracts.[17] Where a state is seeking to modify its own contractual obligations, the Supreme Court has held that no deference to legislative judgment shall be given and the court must assess whether the state's action was "necessary and reasonable."[18] Courts undertake a three-part analysis to determine whether state actions are unconstitutional under the Contract Clause. The first step is to determine whether a contractual relationship exists. Where the statute at issue is ambiguous, the court looks to whether "the language and circumstances evince a legislative intent to create private rights of a contractual nature enforceable against the State."[19] The second step in a Contract Clause analysis is to determine whether the state action constitutes a substantial impairment of a contractual relationship.[20] If the answer to step two is affirmative, the action may still be constitutional if it is justified by a important public purpose and if the action undertaken to advance the pubic interest is reasonable and necessary.[21] In determining reasonableness, it is relevant whether the circumstances that necessitated the change "were unforeseen and unintended by the legislature" when the statute creating the contractual obligation was adopted.[22] In order for an action to be considered necessary,

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[16] U.S. Const. art. I, § 10, cl. 1.
[17] *See* U.S. Trust Co. of New York v. New Jersey, 431 U.S. 1, 17 (1977).
[18] *See* U.S. Trust Co. of New York, 431 U.S. at 25.
[19] *Id.* at 17, n.14
[20] *Id.* at 23.
[21] *Id.* at 25.
[22] *Id.* at 27.

(1) no other less drastic modification could have been implemented and (2) the state could not have achieved its goals without the modification.[23]

The finding of the existence of a contract significantly limits the ability of a state to modify its pension plans. However, state courts adopting a contractual based approach differ greatly in (1) when a contract is deemed to be created and (2) what the contract is deemed to protect. The end result is that, even among states adopting a contract-based approach, the changes to public pension plans that can legally be made differs significantly from state to state. The subsections below review the primary approaches taken by states that have adopted contract-based pension protections.

(i) Constitutional Protection of Benefit Formula From Date of Entry into Retirement System

A handful of states provide through specific constitutional provisions that state retirement plans cannot be amended in any way that results in a participant receiving a lower retirement benefit than that which would be payable under the plan terms in effect as of the date the employee first became eligible to participate in the plan.[24] New York and Illinois' constitutions specifically provide that rights are fixed as of the date the employee enters the retirement system and cannot thereafter be diminished or impaired.[25] Unlike federal retirement plan protections, which protect the benefit accrued to date, this type of state protection is significantly more generous. Once hired into a retirement benefit-eligible position, an employee's retirement benefit cannot be less than it would be if calculated under the terms of the plan as they existed on the date the employee became

[23] *Id.* at 29-30.
[24] *See* N.Y. Const. art. V, § 7; Ill. Const. art. XIII, § 5; Alaska Const. art. XII, § 7.
[25] *See* N.Y. Const. art. V, § 7; Ill. Const. art. XIII, § 5.

eligible to first participate in the retirement plan.[26] The reservation of the right to amend the plan is not effective in these circumstances to allow the state to change the terms of the plan in any way that diminishes benefits.[27] For example, adopting new actuarial factors for use in calculating benefits is impermissible if the result for a single participant is to reduce the dollar amount of benefits that the individual would have received under the actuarial factors in place at the time of her initial eligibility for the plan.[28] However, in interpreting this constitutional protection, New York courts have held that it does not protect changes in employment conditions nor statutes or regulations that may incidentally have an adverse effect on benefits payable upon retirement.[29] For example, an employee's salary level could be diminished, which would in turn decrease that employee's pension, without violating the constitutional protection of the employee's pension benefit.

Alaska offers protections to public retirement plans similar to those of New York and Illinois, although the language of its constitutional protection is significantly different: "Membership in employee retirement systems of the State or its political subdivisions shall be a contractual relationship. *Accrued benefits* of these systems shall

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[26] *See, e.g.*, Birnbaum v. New York State Teachers' Ret. Sys., 152 N.E.2d 241 (N.Y. 1958) (actuarial table other than that in place at the time employees enrolled in the retirement system could not be used where the new actuarial table would produce lower pension); McCaffrey v. Bd. of Ed. of E. Meadow Union Free Sch. Dist., 48 A.D.2d 853, 368 N.Y.S.2d 863 (N.Y. App. Div. 1975) (even where plan amendment benefits the majority of participants, individuals who would receive a lower retirement benefit as a result of the amendment must be provided a benefit calculated under the terms of the plan at the time of their enrollment). *See also* Kraus v. Bd. of Trustees of Police Pension Fund of Vill. of Niles, 390 N.E.2d 1281 (Ill. App. Ct. 1979).

[27] *See, e.g.*, Civil Serv. Employees Ass'n Inc., Local 1000, AFSCME, AFL-CIO v. Regan, 525 N.E.2d 1 (N.Y. 1988).

[28] *See, e.g.*, Birnbaum, 152 N.E.2d 241 (actuarial table other than that in place at the time employees enrolled in the retirement system could not be used where the new actuarial table would produce lower pension);

[29] *See* Lippman v. Bd. of Educ. of the Sewanhaka Cent. High Sch. Dist., 487 N.E.2d 897 (N.Y. 1985).

not be diminished or impaired."[30] While the language is specific to accrued benefits, Alaska has interpreted the provision to protect the benefits of employees from the time they are employed and enrolled in the system.[31] As a result, Alaska's constitutional protection has been interpreted in a manner similar to New York's. For example, the Supreme Court of Alaska has prohibited the use of actuarial factors different than those in place at the commencement of employment, where such new actuarial factors resulted in a lower pension for the plaintiff, even where a state statute specifically contemplates periodic changes to such actuarial factors.[32] While Alaskan courts have protected pension benefit formulas in place as of the date of hire, they have also stated that this protection "does not preclude modifications of the system;… however… any changes in the system that operate to a given employee's disadvantage must be offset by comparable new advantages to that employee."[33] The functional result appears similar to New York, in that no changes to a public pension plan can be made that in any way diminish the retirement benefit the participant would be entitled to under the benefit formula in effect as of the employee's date of hire.

Reform options in New York, Illinois, and Alaska would be quite limited. The only option for reform would be to amend the retirement plan with respect to newly-hired employees. Employees who are already in the system could not be subject to any plan amendment that results in a lower benefit than that calculated under the terms of the plan

[30] Alaska Const. art. XII, § 7 (emphasis added).
[31] Hammond v. Hoffbeck, 627 P.2d 1052, 1057 (Alaska 1981); Municipality of Anchorage v. Gallion, 944 P.2d 436 (Alaska 1997).
[32] Sheffield v. Alaska Pub. Employees' Ass'n, Inc., 732 P.2d 1083 (Alaska 1987).
[33] Hammond, 627 P.2d at1057.

at their date of enrollment. The only possibility for changing existing employees' retirement benefits would be to have such employees voluntarily agree to plan changes.[34]

(ii) Constitutional Protection of Benefits Accrued to Date

Michigan and Hawaii have state constitutional provisions that have been interpreted as protecting pension benefits accrued to date, mirroring the approach taken by the federal government. For example, Article IX, §24 of the Michigan Constitution states, "The accrued financial benefits of each pension plan and retirement system of the state and its political subdivisions shall be a contractual obligation thereof which shall not be diminished or impaired thereby."[35] Both Michigan and Hawaii courts have interpreted their respective constitutions as granting contractual rights to pension benefits that have already been earned, but not to retirement benefits that have yet to be earned through services rendered.[36] As a result, in Michigan and Hawaii retirement benefits related to service already performed cannot be diminished, but plan amendments can be made prospectively.

(iii) Strict Contractual Approach

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[34] *See, e.g.*, Vill. of Fairport v. Newman, 90 A.D.2d 293, 295-6, 457 N.Y.S.2d 145 (N.Y. App. Div. 1982) (clarifying that while unilateral amendments were prohibited under the constitution, the parties were free to negotiate and agree on changes). The case Rosen v. New York City Teachers' Ret. Bd., 282 A.D. 216, 122 N.Y.S.2d 485 (N.Y. App. Div. 1953) *aff'd*, 116 N.E.2d 239 (N.Y. 1953), offers another potential avenue. In that case, the Board of Education offered employees temporary increases in salary, but the payments were conditional on non-inclusion in the employees' pension salary. The court held that such conditional payments were permissible under New York's constitutional provisions.

[35] Mich. Const. art. IX, § 24. Hawaii has a substantially similar constitutional provision, which provides that Membership in any employees' retirement system of the State or any political subdivision thereof shall be a contractual relationship, the accrued benefits of which shall not be diminished or impaired." Haw. Const. art. XVI, § 2.

[36] Ass'n of Prof'l & Technical Employees v. City of Detroit, 398 N.W.2d 436 (Mich. Ct. App. 1986). Hawaii's constitutional provision has been similarly interpreted. *See* Kaho'ohanohano v. State, 162 P.3d 696 (Haw. 2007) *reconsideration denied*, 169 P.3d 684 (Haw. 2007).

Even in states without constitutional provisions establishing contractual protections for public pensions, several states have found that statutes establishing state pension plans themselves create contracts. Arizona case law embraces what is known as a strict contractual approach even in the absence of a constitutional provision. The Arizona Supreme Court has explained that "where…services are rendered under…a pension statute, the pension provisions become a part of the contemplated compensation for those services, and so in a sense a part of the contract of employment itself."[37] The court further explains, "[t]hat an applicant for retirement may not earn the right to benefits because he does not perform the condition does not mean that from the moment of entrance into [employment] there is not a firm, binding contract [for pension benefits]."[38] From there, the court reasons that an individual's pension right becomes vested upon acceptance of employment.[39] Finally, the court notes that a contract cannot be unilaterally modified and rejects the California standard (discussed below) that holds that an employee does not have the right to any fixed or definite retirement benefits but only to a substantial or reasonable pension.[40] The Arizona standard therefore appears to be the functional equivalent of New York's constitutional protection of public pensions, leaving very little room for any modifications after employment commences.

(iv) The Modified Contract Approach – The California Rule

A contractual approach that allows some modification of public pension plans was pioneered by California, and for that reason is often referred to as the "California

[37] Yeazell v. Copins, 402 P.2d 541, 544 (Ariz. 1965) (internal citations omitted).
[38] *Id.*
[39] *Id* at 545. In part, Arizona adopted this approach because its state constitution prohibits gifts between the state and individuals, thereby necessitating the rejection of a gratuity-based approach. *See id.* at 543.
[40] *Id.*

rule." The findings of these states that public pension plans are contracts between the state and participant mean that amending state pension plans may violate the contract clauses of both the federal and state constitutions.[41] As described above, this judicial approach requires (1) finding the existence of a contract, (2) determining whether the state action constitutes a substantial impairment of the contract and (3) if so, whether the change is a reasonable and necessary means of affecting an area of important public policy.

1. The Creation of a Contract

State statutes creating retirement plans typically are silent with respect to the creation of a contract. In states adopting the modified contract approach the first step must therefore be finding that a contract exists, generally through legislative intent and an examination of the surrounding circumstances. This is not an easy task, and many states that follow the California rule do not spend much time explaining how they have come to find the existence of a contract. Some courts have explicitly acknowledged the difficulty of this position. As Massachusetts has explained, "'Contract' (and related terms such as rights, benefits, protection) should be understood here in a special, somewhat relaxed sense."[42] "When…the characterization 'contract' is used, it is best understood as meaning that the retirement scheme has generated material expectations on the part of employees and those expectations should in substance be respected. Such is the content

[41] Other states adopting this approach include Colorado (see Police Pension & Relief Bd. of City & County of Denver v. Bills, 366 P.2d 581, 583-4 (Colo. 1961)), Idaho (see Nash v. Boise City Fire Dept., 663 P.2d 1105 (Idaho 1983)); Kansas (see Brazelton v. Kansas Pub. Emp. Ret. Sys., 607 P.2d 510, 518 (Kan. 1980)); Maryland (see City of Frederick v. Quinn, 371 A.2d 724 (Md. Ct. Spec. App. 1977)); Nebraska (see Halpin v. Nebraska State Patrolmen's Ret. Sys., 320 N.W.2d 910 (Neb. 1982)); Vermont (see Burlington Fire Fighters' Ass'n v. City of Burlington, 543 A.2d 686 (Vt. 1988)); Washington (see Eisenbacher v. City of Tacoma, 333 P.2d 642 (Wash. 1958)).

[42] Opinion of the Justices, 303 N.E.2d 320, 327 (Mass. 1973).

of 'contract.'"[43] The court goes on to explain that this view of contract "protects…the core of [the member's] reasonable expectations."[44] Many states agree with Massachusetts and appear to rely on the concept of reasonable expectations to find the existence of a contract.[45]

One difficulty in applying the modified contract approach is determining *when* the contract is formed and what it therefore protects. Some states have held that contractual protection does not begin until the participant has actually retired and begun receiving benefits, or is at least eligible to retire.[46] Other states have held that contractual protection begins at some point prior to retirement, but have not specified precisely when that protection begins,[47] and still other states protect retirement benefits from the time employment commences.[48]

Another problem with the modified contractual approach is that many changes to employment conditions can adversely affect a participant's pension benefit. While there has been a fair amount of litigation regarding changes to employment conditions, it is now well-settled that even where pensions are granted contractual protection, non-plan

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[43] *Id*. at 328.
[44] *Id.*
[45] *See, e.g.*, Police Pension & Relief Bd. of City & County of Denver, 366 P.2d at 584-85; Nash, 663 P.2d at 1107; Halpin, 320 N.W.2d at 915; Bakenhus v. City of Seattle, 296 P.2d 536 (Wash. 1956). For example, Nebraska treats public pensions as deferred compensation earned in exchange for services rendered. Halpin, 320 N.W.2d at 914. From there, the court reasons that deferred compensation creates "reasonable expectations entitled to legal protection." *Id.* These reasonable expectations are "protected by the law of contracts." *Id*. (internal citations omitted). The court then goes on the analyze a change in calculating pension benefits in terms of whether it was an impairment of contractual rights and if so whether it was reasonable and necessary to serve an important public interest. *Id.*
[46] *See, e.g.*, Jones v. Cheney, 489 S.W.2d 785, 789 (Ark. 1973) (participant's rights vest upon fulfilling service requirements); Petras v. State Bd. of Pension Trustees, 464 A.2d 894, 896 (Del. 1983) (no rights until participant vests); City of Louisville v. Bd. of Educ. of Louisville, 163 S.W.2d 23 (Ky. 1942) (no vested rights until individual is a beneficiary); Patterson v. City of Baton Rouge, 309 So. 2d 306 (La. 1975) (no vested rights prior to retirement eligibility); Atchison v. Ret. Bd. of Police Ret. Sys. of Kansas City, 343 S.W.2d 25 (Mo. 1960); Driggs v. Utah State Teachers Ret. Bd., 142 P.2d 657 (Utah 1943).
[47] *See, e.g.*, Nash, 663 P.2d at 1109 (internal citation omitted); Halpin, 320 N.W.2d at 915.
[48] Police Pension & Relief Bd. of City & County of Denver, 366 P.2d 581, Brazelton, 607 P.2d 510; Burlington Fire Fighters' Ass'n, 543 A.2d 686; Bakenhus, 296 P.2d at 539; Opinion of the Justices, 303 N.E.2d 320; Betts v. Bd. of Admin., 21 Cal. 3d 859, 863 (1978).

related changes, such as changes to salary levels or the elimination of jobs, are not protected even through such actions will affect retirement benefits.[49]

2. Impairment of Contract

Once a contract has been found to exist, the next step is to determine if the action taken by the state is a substantial impairment of that contract. Cases indicate that this is a relatively easy test to satisfy; most impairments are found to be substantial.[50] For example, benefit formula changes[51] and changes in funding sources or methodology[52] have each been found to be impairments of the pension contract.

3. Amendments Reasonable and Necessary to Serve an Important Public Purpose

States have police powers that may in certain circumstances enable them to "alter or abrogate even conventional contractual rights."[53] As a result, even in states that have adopted the modified contract approach, certain changes may be permissible even if they impair the public pension plan contract. An impairment may be constitutional if it is

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[49] Opinion of the Justices, 303 N.E.2d at 330, n. 22 (citing Hoar v. City of Yonkers, 67 N.E.2d 157 (N.Y. 1946); Gorman v. City of New York, 280 A.D. 39, 110 N.Y.S.2d 711 (N.Y. App. Div. 1952) *aff'd*, 304 N.Y. 865, 109 N.E.2d 881 (1952).); United Firefighters of Los Angeles v. City of Los Angeles, 210 Cal. Ap. 3d 1095, 1103 (Cal. Ct. App. 1989) (internal citations omitted) ("the fact that a pension right is vested will not, of course, prevent its loss upon occurrence of a condition subsequent such as lawful termination of employment before completion of the period of service designated in the pension plan.").

[50] *See, e.g.*, Nat'l Educ. Ass'n-Rhode Island by Scigulinsky v. Ret. Bd. of Rhode Island Employees' Ret. Sys., 890 F. Supp. 1143, 1162 (D.R.I. 1995). One notable exception is that changes in actuarial factors may not, in certain circumstances, be found to be substantial impairments of contract. *See* Strunk v. Pub. Employees Ret. Bd., 108 P.3d 1058 (Or. 2005); Int'l Assn. of Firefighters v. City of San Diego, 667 P.2d 675 (Cal. 1983) (permitted change in actuarial factors affected contributions to the plan, not participant benefits).

[51] *See, e.g.*, Betts v. Bd. of Admin., 21 Cal. 3d 859, 582 P.2d 614 (1978).

[52] See, e.g., Valdes v. Cory, 139 Cal. App. 3d 773, 189 Cal. Rptr. 212 (Cal. Ct. App. 1983); Bd. of Admin. v. Wilson, 52 Cal. App. 4th 1109, 61 Cal. Rptr. 2d 207 (Cal. Ct. App. 1997).

[53] Opinion of the Justices, 303 N.E.2d at 329.

reasonable and necessary to serve an important public purpose.[54] Reasonableness is to be judged in the light of whether the prior state contractual obligations "had effects that were unforeseen and unintended by the legislature" when the "contract" creating those obligations and rights was created.[55] To be considered necessary, the state must establish that (1) no less drastic modification could have been implemented to accomplish the state's goal; and (2) that the state could not have achieved its public policy goal without the modification.[56]

Among states that follow the modified contract approach, most interpret the reasonable and necessary requirement as allowing certain changes under a test specific to public pension plans. As California courts have explained,

> the employee does not obtain, prior to retirement, any absolute right to fixed or specific benefits, but only to a substantial or reasonable pension… 'An employee's vested contractual pension rights may be modified prior to retirement for the purpose of keeping a pension system flexible to permit adjustments in accord with changing conditions and at the same time maintain the integrity of the system. Such modifications must be reasonable, and it is for the courts to determine upon the facts of each case what constitutes a permissible change. To be sustained as reasonable, alternations of employees' pension rights must bear some material relation to the theory of a pension system and its successful operation, *and changes in a pension plan which result in disadvantage to employees should be accompanied by comparable new advantages.* '[57]

In analyzing whether the comparable new advantage standard has been met, California courts have stated that, "[t]he comparative analysis of disadvantages and compensating advantages must focus on the particular employee whose own vested

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[54] U.S. Trust Co. of New York, 431 U.S. at 2. *Id.* at 25. *See also* Home Bldg. & Loan Ass'n v. Blaisdell, 290 U.S. 398 (1934) ("The question is…whether the legislation is addressed to a legitimate end and the measures taken are reasonable and appropriate to that end.").
[55] U.S. Trust Co. of New York, 431 U.S. at 31.
[56] *Id.* at 29-30.
[57] Betts, 21 Cal. 3d at 864 (internal citations omitted). *See also* Burlington Fire Fighters' Ass'n, 543 A.2d at 690 ("An employee's vested pension rights may, therefore, be modified prior to retirement if such modifications are reasonable, since it allows the pension system to adapt to changing conditions.").

pension rights are involved."[58] California courts have also clarified that "[t]he saving of public employer money is not an illicit purpose if changes in the pension program are accompanied by comparable new advantages to the employee."[59]

There are very few cases involving state pension plans that have found a contractual impairment that is permissible because it is reasonable and necessary to serve an important public purpose. The vast majority of cases involving contractual impairment find no such justification. Those cases that have found contractual impairments to be reasonable and necessary to serve an important public purpose typically do not involve major changes that are detrimental to participants. For example, in Buchholz v. Storsve,[60] the application of the Uniform Probate Code to modify the beneficiary designation under the state retirement plan was held to be an impairment of contract that was justified as reasonable and necessary, on the grounds that uniform estate administration served an important public purpose. In Maryland Teachers Association v. Hughes,[61] the court found that the creation of a multi-tiered retirement system that protected currently accrued retirement benefits was permissible because of findings that the state retirement system was "financially threatened" and that changed circumstances had led to the need to amend the system. A California case upheld a state law that capped the salary on which a widow's pension was based, where the widow was granted cost-of-living increases, because the change merely substituted one type of fluctuation for another. In particular, the court found that the cost-of-living increase satisfied the retirement law's goal of allowing pension income to keep pace with increases in cost-of-

[58] Betts, 21 Cal. 3d at 864 (internal citations omitted).
[59] Claypool v. Wilson, 4 Cal. App. 4th 646, 665-66, 6 Cal. Rptr. 2d 77 (Cal. Ct. App. 1992).
[60] Buchholz v. Storsve, 740 N.W.2d 107 (S.D. 2007).
[61] Maryland State Teachers Ass'n, Inc. v. Hughes, 594 F. Supp. 1353 (D. Md. 1984).

living.[62] The court stated "[a]lthough detrimental when measured by the literal words of the original fluctuation provision, the 1966 amendment had no effect upon its objective…The 1966 restriction preserved the basic character of the earned benefit but withheld a windfall unrelated to its real character."[63]

Another case upholding a pension modification involved eliminating the ability of certain participants to earn increased pensions in the future.[64] In explaining the application of the contractual approach to reductions in the ability to earn increased pensions in the future, the court explains "[h]is contractual right to such a pension has not been impaired by legislation which, operating prospectively, merely withdraws any right or option to earn a bonus by continuing in employment after he has become eligible for retirement."[65] The court goes on to state, "There is no merit in the contention that the city is estopped to make any changes in the pension system after one has entered its service in reliance thereon."[66]

In Amundsen v. Public Employees' Retirement System,[67] the California Court of Appeals allowed a public pension amendment that changed the requirements for retirement from age 55 and at least $500 in retirement contributions to include a minimum of five years of service. This delayed the plaintiff's anticipated retirement date

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[62] Lyon v. Flournoy, 271 Cal. App. 2d 774, 785 (Cal. Ct. App. 1969).
[63] *Id.* at 787 (citing Home Bldg. & Loan Ass'n, 290 U.S. 398 for idea that lawmakers "chose to confine beneficiaries to the gains 'reasonably to be expected from the contract' and to withhold 'unforeseen advantages' which had no relation to the real theory and objective of the fluctuation provision. Such a choice is…not the impairment of a contract."). *But see* United Firefighters of Los Angeles v. City of Los Angeles, 210 Cal. Ap. 3d 1095, 1113 (Cal. Ct. App. 1989) (holding that an amendment that capped cost-of-living adjustments on pensions for future years of service was not reasonable and lacked any material relation to the theory of a pension system or its successful operation).
[64] Houghton v. City of Long Beach, 164 Cal. Ap. 2d 298 (Cal. Dist. Ct. App, 1958).
[65] *Id.* at 308.
[66] *Id* at 310 (the court then goes on to note that the plaintiff entered service in 1921 and the city's pension plan was first put into effect in 1925, so there was no basis for estoppel for the individual plaintiff concerned).
[67] Amundsen v. Pub. Employees' Ret. Sys., 30 Cal. App. 3d 856, 106 Cal. Rptr. 759 (Cal. Ct. App. 1973).

by one year. In upholding the change, the court found that the amendment bore a material relation to the theory of a pension system and its successful operation.[68] The court also found that the disadvantage created by the amendment was offset by a comparable new advantage – a decreased amount of required employee contributions and a substantially higher pension upon retirement after five years of service.[69]

While the preceding cases illustrate some limited success in amending the terms of a public pension plan under the modified contract approach, the majority of cases indicate that it is very difficult in the absence of comparable new advantages to prove that the changes made to a state retirement plan are the "least drastic solution available.[70]

4. Net Result under Modified Contract Approach

Under the modified contract approach, the ability of states to modify their pension plans for current employees varies directly with the time at which a contract is deemed to exist. For states that find a contract to exist at the time of employment, states have little ability to amend their pension plans for current employees or retirees. Essentially, they can only do so if they will be providing a pension benefit that is at least equal to that which they would have earned under the plan in effect at their time of hire. States that find a contract to exist only after the participant is eligible for retirement under the plan have significantly more flexibility to make changes, as presumably large numbers of current employees would not yet be protected under a contract approach. Unfortunately, in states that do not have clear guidelines as to when a contract is deemed to exist, it is unclear what pension modifications would be permitted.

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[68] *Id*. at 858.
[69] *Id.*
[70] *See, e.g*., Andrews v. Anne Arundel County, Md., 931 F. Supp. 1255, 1265 (D. Md. 1996) *aff'd*, 114 F.3d 1175 (4th Cir. 1997).

(c) Promissory Estoppel

Minnesota has joined the majority of states in rejecting the gratuity approach. However, instead of embracing a contract approach they find that the interest that public employees have in their pension is "best characterized in terms of promissory estoppel."[71] In explaining why it chose promissory estoppel over convention contract analysis, the court explained "A conventional contract approach, with its strict rules of offer and acceptance, tends to deprive the analysis of the relationship between the state and its employees of a needed flexibility."[72] Promissory estoppel, on the other hand, serves to imply a contract where none in fact exists. "The effect of promissory estoppel is to imply a contract from a unilateral or otherwise unenforceable promise coupled by detrimental reliance on the part of the promisee."[73] In applying promissory estoppel, the court must determine what has been promised by the state and to what degree and to what aspects of the promise has there been reasonable reliance on the part of the employee.[74] The court goes on to explain that "estoppel applies only to avoid injustice."[75] Even where promissory estoppel applies, the promise remains subject to the state's police power, as is true with contractual rights.[76] It is therefore somewhat difficult to distinguish Minnesota's promissory estoppel approach from the more conventional contract approach. The Minnesota Supreme Court explains the distinction:

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[71] Christensen v. Minneapolis Mun. Employees Ret. Bd., 331 N.W.2d 740, 747 (Minn. 1983).
[72] *Id.*
[73] *Id*. at 748. The court also cites the Restatement (Second) of Contracts, which defines the doctrine as "A promise which the promisor should reasonably expect to induce action or forbearance on the part of the promissee…and which does induce such action or forbearance is binding if injustice can be avoided only the enforcement of the promise." *Id*. at 749.
[74] *Id*. at 749
[75] *Id.*
[76] *Id*.

> Promissory estoppel…focuses on the reasonableness of the employee's reliance to create a contractual obligation, while the contract clause assumes the existence of a contract and determines whether the state may alter its terms, based on the reasonableness of the state's actions when balanced against the employee's interests.[77]

Minnesota courts require three elements to be present in order to prevent a public pension plan modification under a theory of promissory estoppel: (1) the existence of a clear and definite promise, (2) the promisor intended to induce reliance, and such reliance occurred, and (3) the promise must be enforced to prevent injustice.[78] This test necessitates case by case analysis and potentially difficult fact finding in order to establish reliance by the participant or beneficiary. While some pension modifications would clearly be permitted under this approach, it is not entirely clear which ones and under what circumstances.

(d) Property Interest/Due Process of Law Approach

A handful of states have rejected a contract-based approach to public pensions in favor of a property-based approach.[79] Under a property-based approach, public pensions are entitled to protection from "arbitrary legislative action under the due process provisions of our state and federal constitutions."[80] In rejecting a contract approach,

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[77] *Id.* at 750.

[78] Hous. & Redevelopment Auth. of Chisholm v. Norman, 696 N.W.2d 329, 336 (Minn. 2005). The Minnesota Supreme Court clarified that, where an actual contract exists, such as a collective bargaining agreement, a contract-based approach, rather than promissory estoppel, is the appropriate framework to analyze claims for benefit. *Id* at 337.

[79] Connecticut, Wisconsin, Wyoming, Maine and Ohio courts have all ruled that public pension plans create protectable property interests. *See* Pineman v. Oechslin, 488 A.2d 803, 810 (Conn. 1985), Ass'n of State Prosecutors v. Milwaukee County, 544 N.W.2d 888, 889 (Wisc. 1996); Bilda v. Milwaukee County, 722 N.W.2d 116 (Wis. Ct. App. 2006) (recognizing a property interest in the security of the retirement system); Peterson v. Sweetwater County Sch. Dist. No. One, 929 P.2d 525, 530 (Wyo. 1996) ("legitimate retirement expectations may constitute property rights that may not be deprived without due process of law."); Spiller v. State, 627 A.2d 513, 515 (Me. 1993). *See also* Parker v. Wakelin, 123 F.3d 1 (1st Cir. 1997); State ex rel. Horvath v. State Teachers Ret. Bd., 697 N.E.2d 644 (Ohio 1998).

[80] Pineman, 488 A.2d at 810.

courts have been critical of creating or implying creation of a contract through the passage of legislation where the statute does not contain a clear statement of legislative intent to do so.[81] As the Maine Supreme Court explained, "a statute will not be presumed to create contractual rights, binding future legislatures, unless the intent to do so is clearly stated."[82] They further explained, "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."[83] In addition, one court noted the oddity of taking the position that a statutory pension plan gives rise to contractual rights, while permitting unilateral modification of the contract by the state under certain circumstances.[84] The court points out that if "promises" are sufficient to create a contractual relationship between state and employee, "the state would be powerless to reduce the pay or shorten the tenure of any state employee without posing a possible contract clause violation."[85] However, courts adopting a property rights approach have noted that employees have legitimate retirement expectations, and that these expectations may constitute property rights that the legislature cannot deprive them of without due process of law.[86]

While there are not many cases involving pension plan amendments in states that adhere to a property interest approach, there does appear to be much more flexibility for states to make modifications under this approach than is true under a contractual approach. Only if the state legislature is found to have acted arbitrarily or irrationally will a violation of due process be found.[87] Under this standard, states have found plan

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[81] *Id* at 808.
[82] Spiller, 627 A.2d at 515. *See also* Parker, 123 F.3d 1.
[83] *Id.*
[84] Pineman, 488 A.2d at 808-09.
[85] *Id* at 809.
[86] *See, e.g., id*. at 810.
[87] Pineman v. Fallon, 662 F. Supp. 1311 (D. Conn. 1987) *aff'd*, 842 F.2d 598 (2d Cir. 1988).

amendments changing the retirement age for participants more than five years away from retirement eligibility to be permissible,[88] as well as changes to the definition of compensation, raising the retirement age, and increasing the penalty for withdrawal prior to retirement age.[89]

IV. Discussion: An Argument For a More Efficient and Equitable Standard for Public Pension Amendments

It is difficult to look at current state protections of public pension plans and feel satisfied with the underlying theories espoused. Leaving aside state constitutional protections specific to public pensions, which were enacted by the citizens of a state and presumably reflect voter intent, the court-developed protections based on the implied existence of a contract are problematic. First, the implied contract is unilateral. The state is making a unilateral offer to the employee which is accepted by performance of the employee's job. There is no other bargained-for consideration on the part of the employee. However, the unilateral contract is then held incapable of unilateral amendment, even with respect to service not yet performed. This is based on the notion, presumably, that once the offer is made and performance begun, the offeror may not interfere with the offeree's ability to accept the offer.[90] The difficulty of this position is that it would seem to require that the employee be permitted to remain employed until the pension is earned, something clearly not required under the terms of at-will employment. This type of protection is not provided to the general employment relationship, and it is clear that other aspects of the employment relationship may be altered. States may

[88] *Id.*
[89] Spiller, 627 A.2d 513.
[90] *See* Restatement (Second) of Contracts §54 (1981).

change salary levels, the availability and type of fringe benefits offered, and generally terminate the entire employment arrangement at will.[91] Yet under the contract theory embraced by many courts, the state cannot alter the terms of the contract as it applies to pension benefits, even prospectively. It is not clear why everything else in the employment relationship is subject to unilateral change, while yet-to-be-earned retirement benefits are not. Courts following the contract approach often focus on protecting the reasonable expectations of employees. It is difficult to accept that an employee has reasonable expectations with respect to retirement benefits not yet earned where the state is free to terminate her employment or drastically reduce her salary at any time.

One issue specific to public school employees is whether tenured status sufficiently alters an individual's reasonable expectations so as to change the contract analysis above. In many school districts, K-12 educators are granted tenure after three years of continuous service.[92] Once granted tenure, teachers can generally lose their employment only for cause, or if the school district implements some type of reduction in force.[93] The ability of a school district to change salaries and employment conditions following the grant of tenure varies based on the jurisdiction and particular circumstances.[94]

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[91] Where a collective bargaining agreement is in place, the state may be limited in changes it can make to employment conditions. However, a collective bargaining agreement is an actual (not implied) contract.
[92] RAEGEN MILLER & ROBIN CHAIT, TEACHER TURNOVER, TENURE POLICIES, AND THE DISTRIBUTION OF TEACHER QUALITY 15 (2008), *available at* http://www.americanprogress.org/issues/2008/12/pdf/teacher_attrition.pdf. In some states, the word "tenure" is no longer used, but teachers retain the same due process rights as are normally granted under a tenure system. M.J. Stephey, *Tenure*, TIME, Nov. 17, 2008.
[93] MILLER & CHAIT, *supra* note 92, at 15. For example, a reduction in force might occur if a school district is permanently closing a school or otherwise reducing capacity.
[94] For example, while a reduction in salary for an individual teacher is generally prohibited, salaries for all teachers or for all teachers in a given classification could be reduced. *See, e.g.*, Mo. Rev. Stat. §168.104(2).

The tenured educator's job security potentially complicates the reasonable expectation analysis. First, once a teacher has been granted tenure, do they have a reasonable expectation to continue in their employment until retirement? This is perhaps best answered empirically, by studying how often tenured teachers are terminated, and may vary significantly by district or state. Additionally, once a teacher is granted tenure, do they have a reasonable expectation that their salary will not be diminished? In most jurisdictions the salary of an individual, tenured teacher cannot be reduced, but broader salary reductions can be made. Finally, assuming that a tenured teacher has a reasonable expectation of continued employment and salary level, does that translate into a reasonable expectation of continued accrual of pension benefits on the same terms as those in place at the time of the grant of tenure? Perhaps, but we risk circular reasoning here; what is the basis for the pension expectation? If it is solely through an implied contract created through legislation and its surrounding circumstances, then employment and salary stability would be irrelevant. And where employment and salary are subject to change, the expectation would seem to be that other forms of compensation could be amended prospectively, including pension benefits. As a result, while tenured status may change reasonable expectations, in circumstances where employment can be terminated and compensation can be prospectively amended, tenured status does not appear to undercut the above argument regarding expectations for future retirement benefit accrual. Perhaps this argument becomes more difficult to make as a teacher gains seniority, because in most school districts any reductions in force must be made in reverse order of seniority. However, even very senior teachers would be subject to across-the-board salary reductions. This problem yet again illustrates the difficulty of protecting public

pensions based on reasonable expectations; it is very difficult to determine at exactly what point an individual has reasonable expectations to continue accruing pension benefits until retirement.

Protecting public pensions based on promissory estoppel seems to focus on the correct issue, which is the legitimate expectations of plan participants, without straining to find the existence of an actual contract. However, the approach is cumbersome to administer as it requires individual factual finding of actual reliance. This creates uncertainty, inefficiency and expense and seems for that reason to be an undesirable model for other states to follow.

Property rights theories potentially provide too little protection for participants in public pension plans. Under a property rights theory, the government may not reduce the participant's property rights in his or her pension without due process of law. However, all that due process requires is that the state's action not be arbitrary or irrational. This standard appears to allow significant changes to public pension plans, provided there is a legitimate purpose for the amendment. The exact contours of this protection are difficult to discern. It may be the case that reducing a participant's accrued benefit would be deemed arbitrary or irrational, but this is not certain. For example, a state's dire financial circumstances might provide sufficient justification under a property rights theory to allow not only prospective, but also a retroactive amendment to pension benefits.

The more logical and theoretically sound approach is that taken by the federal government, which is to protect retirement benefits that have already been earned by services rendered. Retirement plan participants clearly have reasonable expectations that they will receive, at retirement, their currently accrued benefit. Given that such

participants cannot be certain that they will remain employed by the state for any specific period of time, and certainly not until retirement age, it is disingenuous to suggest that they have a reasonable expectation not only to their benefit accrued to date, but that they will continue to grow into their retirement benefit under the currently in-effect benefit formula. Even in the case of tenured public school teachers, who perhaps have a greater expectation of remaining employed until retirement than the average employee, if salary levels are unprotected, the teacher's expectations with respect to future pension benefits would seem to be similarly subject to modification. The approach taken by the federal government, which guarantees that retirement benefits already earned will not be diminished, but that prospective changes can be freely made, protects a participant's reasonable expectations without sacrificing employer flexibility. States would be wise to adopt such an approach, which would provide much needed clarity to the public pension arena, clearly delineating the changes that can be made to such plans and those that cannot.

V. Conclusion

The legal regulation of public pension plans leaves much to be desired. The gratuity approach fails to adequately protect plan participants, the contract-based approach fails to give states needed flexibility to adapt their plans to changing circumstances, promissory estoppel is too individualized to be administratively feasible, and the property rights approach appears to give participants too little protection.

An approach that protects only currently accrued benefits has the advantages of being clear and allowing flexibility in response to changing conditions. State courts

could adopt such an approach under a contract theory by holding that a contract is formed when the participant performs service, but that it creates a contract on an ongoing basis (as service is performed). More specifically, courts could focus on reasonable expectations as a rationale for finding a contract to exist, but be clear that a participant has a reasonable expectation only in their currently accrued benefit. Even in the case of tenured educators, if other terms and conditions of their employment can be prospectively changed, it seems logical that their future pension accruals could be modified as well. This approach would leave states free to set new contract terms for services not yet rendered and would be entirely consistent with the current focus on reasonable expectations. This approach has the added advantage of being more clear and explicit than current jurisprudence, and also not fact-specific or individualized.

It is time for state courts to clean up their public pension plan jurisprudence. While rejecting the gratuity theory made abundant sense, current iterations of contract theory have left many states in an untenable position of being unable to amend their pension plans even with respect to future employee service. Just as the gratuity theory and property-based theories give states too much leeway, current contractual approaches to public pensions give states too little flexibility to adapt their plans to changing conditions. It is time for states to find a reasonable middle ground.

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