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LEGAL CONSTRAINTS ON CHANGES IN STATE AND LOCAL PENSIONS

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Introduction

State and local government pension reform has become a front-burner issue in the wake of the economic crisis, which sharply reduced funded ratios for most plans. Policymakers have responded primarily by raising employee contributions for all workers and/or reducing benefits for new workers. One option that has largely been off the table is reducing *future* benefits for current workers. The reason is that many states face legal constraints on their ability to make such changes. These constraints not only tie the hands of pension reformers but also accord public employees greater protections than their private sector counterparts.

This *brief* provides a comprehensive overview of the legal environment in which state and local plans operate with respect to benefit protections for current workers. The analysis relies on a thorough review of secondary sources and consultations with plan legal counsels.

The *brief* is organized as follows. The first section covers the major types of legal protections that apply to public pension benefits. The second section suggests an approach for increasing the flexibility of plan sponsors to alter benefits. The final section concludes that it may be less difficult to make such changes than the conventional wisdom suggests.

Pension Protections for Current Workers

The existing legal constraints on changing future benefits for current workers were a reaction to a period when pensions were viewed as a gratuity that the state

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could withdraw or change at any time. Since federal laws regulating pensions do not apply to public sector plan changes, states were responsible for determining their own benefit protections for public sector workers.[1] The legal approaches to protect public pensions vary across states.

Most states protect pensions under a contracts-based approach. The Federal Constitution's Contract Clause and similar provisions in state constitutions prohibit a state from passing any law that impairs existing public or private contracts. To determine whether a state action is unconstitutional under the Contract Clause, the courts apply a three-part test. First, they determine whether a contract exists. This process determines when the contract is formed and what it protects. Second, the courts determine whether the state action constitutes a substantial impairment to the contract. If the impairment is substantial, then the court must determine whether the action is justified by an important public purpose and if the action taken in the public interest is reasonable and necessary. This approach sets a high bar for changing future benefits, presenting a serious obstacle to pension reform.

A handful of states that protect pensions under the contract theory also have state constitutional provisions that expressly prevent the state from reducing benefits that participants expected at the time of employment. Illinois and New York have such a provision. Alaska has language that specifically applies only to accrued benefits, but the courts have interpreted the provision to protect all benefits from the time participants enroll. Arizona's language is less clear, but prior court rulings suggest that the protection extends to future as well as accrued benefits. In these states, changing benefits for existing employees is virtually impossible without amending the state constitution. In contrast, Hawaii, Louisiana, and Michigan have constitutional provisions that have been interpreted as protecting only benefits earned to date.

Table 1 categorizes the states by the extent to which core benefit accruals are protected and the legal basis for that protection.[2] It is necessary to separate core benefits from the cost-of-living adjustment (COLA) because recent court decisions suggest that the two components merit different treatment. Most states that protect core benefits under the contract theory do not have a state constitutional provision, but rather have statutes that expressly adopt the contract theory or judicial decisions that have ruled the relationship to be contractual. Interestingly, for 13 states the protections apply only once benefits are vested.[3] Eight states protect benefits only once the employee is eligible for retirement.[4] While New Jersey and Rhode Island have been classified in Table 1 as states where future benefits may be protected, they have changed future core benefits for current employees and have court cases pending regarding these changes.

California and several other states that fall in the contract group have attempted to introduce some flexibility by expanding the interpretation of the third part of the three-part test for Contract Clause constitutionality – that the change be "reasonable and necessary." Under the expanded test, the change could be reasonable and necessary either if it achieves an important

Table 1. Legal Basis for Protection of Public Pension Rights under State Laws

Legal basis	Accruals protected			
	Past and future	Past and maybe future	Past only	None
State constitution	AK, IL, NY	AZ	HI, LA, MI	
Contract	AL, CA, GA, KS, MA, NE, NV, NH, ND, OR, PA, TN, VT, WA, WV	CO, ID, MD, MS, NJ, RI, SC	AR, DE, FL, IA, KY, MO, MT, NC, OK, SD, UT, VA	
Property	ME, WY	CT, NM, OH	WI	
Promissory estoppel[a]	MN			
Gratuity				IN, TX[b]

[a] Promissory estoppel is the protection of a promise even where no contract has been explicitly stated.
[b] This gratuity approach applies only to state-administered plans. Accruals in many locally-administered plans are protected under the Texas constitution.
Sources: Cloud (2011); Monahan (2010); National Conference on Public Employee Retirement Systems (2007); Mumford and Pareja (1997); Reinke (2011); Staman (2011); Simko (1996); and consultations with plan legal counsels when accompanied by a decisive court ruling.

public purpose – the conventional test – or if the disadvantages are accompanied by new advantages. In the end, however, the ability to modify pensions in these states hinges on when the contract is deemed to exist. States where the contract is found to exist at the time a worker is hired have little freedom to change benefits. States where the contract is found to exist at retirement have considerably more flexibility.

Six states have adopted a property-based approach for protecting pensions. To the extent that pension benefits are considered property, they cannot be taken away without due process according to the Fifth and Fourteenth Amendments to the Constitution. Most of the challenges to state action have not been successful. Courts have generally found amendments to public pension plans to be "an adjustment to the benefits and burdens of economic life" rather than the taking of private property without just compensation.[5] Thus, state officials have much more freedom to adjust pensions in states that have taken the property-based approach to pension rights.

For the vast majority of states, however, changing future benefits for current employees is extremely difficult. The exception, as noted above, appears to be the COLA. In four cases – Colorado, Minnesota, New Jersey, and South Dakota – a modification of the COLA was challenged in court, and the court upheld the change. The early decisions in Colorado and Minnesota laid out the rationale for allowing COLA suspensions.[6] In Colorado, where the decision is currently under appeal, the judge found that the plaintiffs had no vested contract right to a specific COLA amount for life without change and that the plaintiffs could have no reasonable expectation to a specific COLA given that the General Assembly changed the COLA formula numerous times over the past 40 years. In Minnesota, the judge ruled both that the COLA was not a core benefit and that the COLA modification was necessary to prevent the long-term fiscal deterioration of the pension plan. Both these decisions clearly imply that core benefits are protected.

Expanding the Flexibility to Change Pension Benefits

The protection of future accruals of core benefits serves to lock in any benefit expansions, limiting policymakers' ability to respond to changing economic conditions. For example, employees covered by the California Public Employees' Retirement System (CalPERS) will continue to earn full benefits at age 55, an age introduced in a benefit expansion during the heady days of the 1990s. Few argue that core benefits earned to date based on such an age should be changed. Current workers accepted public employment with the understanding that they were accruing pension benefits at a certain rate, and remained employed with that understanding. But future benefits, much like future payroll, should be allowed to vary based on economic conditions. That is, public officials should be able to change future benefits for current CalPERS workers.

Such increased flexibility for public employers would accord their employees the same protections as workers in the private sector. The Employee Retirement Income Security Act of 1974 (ERISA), which governs private pensions, protects accrued benefits but allows employers to change the terms going forward.[7]

In Illinois and New York, such a change would require a constitutional amendment. In other states, the challenge is to narrow the definition of the contract. Here the burden would fall on the legislature and the courts. First, enacting legislation that the contract is created when the employee performs the service, would establish an ERISA-type standard.[8] Second, if this legislation is challenged, the courts would then need to be persuaded to adopt a more flexible standard in light of changed conditions, just as they once abandoned the gratuity theory in favor of a contract-based approach. In fact, adopting a more flexible version of the contract approach would be less dramatic than shifting theories.

More flexibility to change public pensions could make reforms fairer.

As noted above, New Jersey and Rhode Island have taken the first step by passing legislation that reduces core benefits for current workers. But the courts have yet to rule on the legality of these changes. A failure to permit such changes, however, would have serious consequences. First, limiting pension reductions to new workers reduces pension costs only slowly over time. Second, exempting current workers from cuts creates a two-tiered compensation system under which workers doing similar jobs would receive different amounts based solely on when they were hired. Such an outcome could undermine morale among employees and raise challenges for managers. Finally, allowing public employees to enjoy greater protections than their private sector counterparts is perceived by many as unfair.

Conclusion

Currently, policymakers grappling with underfunding in state and local pension plans are constrained in their ability to fairly share the burdens of reform, with sacrifices falling much more heavily on new workers than on current workers. Changing the status quo will likely require both legislative action and legal argument. In many states, a key challenge is narrowing the current definition of the employer-employee contract to establish that the contract is created when the employee performs the service. Such a standard would be much clearer than the morass of provisions that currently exists across the states, would enable state officials to undertake needed reforms, and would put public sector workers on an even footing with those in the private sector.

Establishing an ERISA-type standard, which would need to happen on a state-by-state basis, should be achievable because the protection accorded pension benefits is less embedded in state constitutions and more open to interpretation than commonly perceived. At a minimum, when sponsors institute changes for new employees, they should adopt the ERISA approach to cover these employees going forward.

Endnotes

1 The Employee Retirement Income Security Act of 1974 (ERISA), which governs plans in the private sector, does not cover state and local plans at all. While the Internal Revenue Code does specify – for public plans as well as private plans – the requirements that plans must meet to qualify for favorable tax treatment, it specifically exempts state plans from the "anti-cutback" rule, which precludes amendments that would decrease benefits already accrued.

2 The sources of information used to classify each state in Table 1 appear in the Appendix. In some cases, the sources provide conflicting guidance on how to classify a given state. To offer a clear standard for the reader, the hierarchy among the sources is as follows. Preference was given to information provided by a plan's legal counsel when accompanied by a decisive court ruling. If no information was provided, Monahan (2010) was the primary source. For states not covered in Monahan and where no information was received from the plans, the National Conference on Public Employee Retirement Systems' (NCPERS) 2007 analysis was the primary source. The only exception was New Hampshire, where recent developments suggest the NCPERS information is now outdated (see *The Associated Press* 2012).

3 The 13 states that protect only vested benefits are: Alabama, Alaska, California, Connecticut, Florida, Indiana, Louisiana, New Hampshire, New Mexico, North Carolina, Ohio, Oklahoma, and Tennessee. Vesting usually occurs within five years. In Indiana, protections apply only to the state's voluntary contributory plans; accruals under the state's mandatory non-contributory plans are not protected since they are viewed as a gratuity.

4 The eight states that protect benefits only once the employee is eligible for retirement are: Arkansas, Delaware, Iowa, Kentucky, Missouri, Montana, Utah, and Virginia.

5 *Pineman v. Fallon*, 842 F.2d 598 (2nd Cir. 1988).

6 In Colorado, 2010 legislation reduced the COLA for 2010 from 3.5 percent to the lesser of 2 percent or the average of the CPI-W for the 2009 calendar year (which resulted in a zero COLA for 2010) and a maximum of 2 percent thereafter (linked to investment returns) for current and future retirees. In Minnesota, in 2010 the state reduced the COLA for the State Employees' Retirement Fund from 2.5 percent to 2 percent and for the General Employees' Retirement Plan from 2.5 percent to 1 percent. The COLA for the Teachers' Retirement Association was suspended between 2011 and 2012, and reduced from 2.5 percent to 2 percent thereafter.

7 The Pension Protection Act of 2006, which amended ERISA, allows multi-employer plans that are severely underfunded to modify certain types of previously accrued benefits that are not part of the core pension benefit (such as early retirement subsidies and disability benefits not yet in pay status). These types of ancillary benefits are outside the scope of this *brief*.

8 The ERISA standard is appealing because it would make the protections in the public sector consistent with those in the private sector. But currently accrued benefits could be protected in many ways (see Schieber 2011). For example, benefit credits earned to date could be applied to a worker's projected final salary rather than his salary at the time that the plan is terminated or the formula changed.

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APPENDIX

Appendix. Sources Used to Classify States by Legal Protection for Pensions

State	Source(s)
AL	NCPERS
AK	Mumford and Pareja; NCPERS; Staman
AZ	Monahan; NCPERS; Staman
AR	Monahan; plan legal counsel (consistent)
CA	Monahan; Mumford and Pareja; Staman
CO	Cloud; Monahan; NCPERS; Reinke
CT	NCPERS; Reinke
DE	NCPERS
FL	NCPERS
GA	NCPERS; plan legal counsel (decisive)
HI	NCPERS; Staman
ID	NCPERS
IL	NCPERS; Staman
IN	Monahan; Mumford and Pareja; NCPERS; Staman; plan legal counsel (decisive)
IA	NCPERS
KS	Monahan; Mumford and Pareja
KY	NCPERS
LA	Monahan; NCPERS
ME	Monahan; NCPERS
MD	NCPERS
MA	Monahan; NCPERS
MI	Monahan; NCPERS; Staman
MN	NCPERS; Reinke
MS	NCPERS
MO	NCPERS
MT	NCPERS
NE	Monahan; NCPERS
NV	Mumford and Pareja; NCPERS; plan legal counsel (decisive)
NH	*The Associated Press*; NCPERS
NJ	Method; NCPERS
NM	Monahan; NCPERS; Staman
NY	Monahan; Mumford and Pareja; NCPERS; Staman
NC	Monahan; NCPERS
ND	Mumford and Pareja; NCPERS
OH	Monahan; NCPERS; Staman
OK	Monahan; Mumford and Pareja; NCPERS

State	Source(s)
OR	Monahan; NCPERS
PA	NCPERS; Simko; plan legal counsel (decisive)
RI	NCPERS
SC	NCPERS
SD	NCPERS
TN	NCPERS
TX	Monahan; plan legal counsel (decisive)
UT	NCPERS
VT	Monahan; NCPERS
VA	NCPERS
WA	Monahan; NCPERS; Simko
WV	Monahan; NCPERS
WI	NCPERS
WY	NCPERS

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