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Public pension plan legislative and judicial roundup

Mounting public pension liabilities have triggered legislative and other state actions nationwide in an attempt to alter public employee pension rights — with accompanying legal challenges always close behind. What, if any, protection is available for public employee pensions depends on governing state law. The status of this protection is currently in flux in Rhode Island, Detroit, and Illinois. The outcome of attempts to change public employee pension rights in these three jurisdictions could inform pending and future legislation and judicial rulings in other places, and may also affect the bargaining leverage of unions representing public-sector employees in pension-related issues.

Background

Public pension plan reform is a hot topic, with many public systems still reeling from recession-related investment losses and struggling to fulfill their retirement promises. But what limits apply to legislation that would alter public employees' and retirees' pension rights? Legal protections for public pensions are a matter of state, rather than federal, law, and protections for public employees' pensions vary significantly from state to state. Even so, public pension systems sometimes — but not always — look to the experiences of, and lessons learned in, other jurisdictions.

Below is an overview of the protections available to public pension systems in the US. Following the overview are analyses of three major developments in the public pension plan world: the lawsuits challenging Rhode Island's 2011 pension reform legislation, an update on the status of Detroit's municipal pensions in light of the city's bankruptcy, and the current challenges to recently enacted pension reform in Illinois.

Legal protection for public employee pensions

In reviewing legislative and judicial action affecting public employee pensions, it's helpful to understand the legal protections that govern pension rights. As explained below, public pensions are entitled to some level of protection in all but two states.

Pensions as contracts

Most states protect public employee pensions as contracts entered into between the state or municipality and its employees. The US Constitution's contracts clause, which provides that "No state shall … pass any Law impairing the Obligation of Contracts," is the highest source of contractual protection.

Seven states (Alaska, Arizona, Hawaii, Illinois, Michigan, New York, and Louisiana) explicitly protect public employee pensions as contractual rights in the language of their constitutions. However, the level of protection differs by state. Many other states protect public pensions as a matter of contract law by way of statutes and/or judicial decisions rather than constitutional provisions. In some of these states, both accrued and future benefits are protected, whereas only accrued benefits are protected in others.

> Buck comment. There is no uniform definition of "accrued" benefits across the states. It is typically defined by a dollar amount or a formula, and may or may not include cost–of-living increases.

Where states protect public pensions as contractual rights, courts typically apply a three-part test to determine the legality of any state action to alter pensions, as follows:

- Does a contract exist and what are its parameters? When and how was the contract formed and what specific rights (i.e., accrued benefits only or future benefits) does it protect?
- Does the state action constitute a "substantial impairment" of the contractual right?
- If the impairment is substantial, does an important public purpose justify the state action? Is the state action reasonable and necessary under the circumstances? In some states, a change can be reasonable and necessary if the disadvantages of the change are accompanied by new advantages.

Pensions as property

Six states take a property-based approach to public pensions. In these states, pensions are protected, as property under the Fifth and Fourteenth Amendments to the US Constitution, from deprivation absent "due process of law." Pension changes must be related to a compelling state interest to withstand judicial scrutiny, and state action to reduce pension benefits in response to a fiscal crisis has often met this standard.

Additionally, the Fifth Amendment prohibits a governmental "taking" of property without just compensation. Thus, once a property interest in a public employee pension is found to exist, any changes to a public pension plan must comply with due process and, where property has been "taken," the property owner must be justly compensated. Where a challenge is brought under the takings clause, the court will consider three factors: (1) the economic impact of the change; (2) the extent to which the change interferes with investment-backed expectations; and (3) the character of the government action.

> Buck comment. Even in states that take a property-based approach to public pensions, challenges to pension changes typically rely on the US constitution's contracts clause in addition to due process and takings arguments.

The reliance-based approach

Minnesota is the sole state that protects pensions on the basis of "promissory estoppel," that is, public pensions are protected against reduction or other impairment only where an individual can show that he or she justifiably relied on the state's promise of benefits and was harmed by the change.

In applying this reliance-based approach, Minnesota courts use a three-part test to evaluate changes to public employee pensions:

- Was there a clear and definite promise?
- Did the state or municipality intend to induce reliance on the promise, and did such reliance occur?
- Must the promise be enforced to prevent injustice?

This test necessitates a case-by-case analysis. If all of the conditions of the test are satisfied, the court will enforce the pension promise as if it were a contract.

The gratuity approach

In Indiana and Texas, some public pensions are treated as gratuities that do not vest and are not entitled to any legal protection from change. This means that the state may amend or modify benefits at any time.

> Buck comment. The reach of the gratuity approach is limited. Indiana follows this theory only for "involuntary" or "compulsory" plans, where the participant does not have a choice between cash or a deferral. In Texas, many accruals in municipal (but not state) plans are not considered gratuities, but rather understood to be protected by the state constitution.

Challenges to Rhode Island's 2011 pension legislation

On February 14, 2014, state officials and public-sector unions reached a proposed settlement to resolve legal challenges to Rhode Island's sweeping 2011 public pension legislation, known as the Rhode Island Retirement Security Act (RIRSA). However, that agreement fell through on April 11, 2014, and the parties are now set to go to trial in the fall. Public employee pensions in Rhode Island are protected by statute as a matter of contract law, which is the basis for the challenges to the 2011 legislation.

The 2011 Rhode Island Retirement Security Act

The Employees Retirement System of Rhode Island (ERSRI or the "system"), a defined benefit plan for state employees and teachers, faced serious funding problems leading up to the passage of RIRSA. In fiscal year 2010, ERSRI's unfunded liability was $6.8 billion, and the system had a funded ratio of 48.4%.

The Rhode Island legislature passed RIRSA in November 2011 and was set for implementation on July 1, 2012. The major provisions of RISRA are as follows:

- **Raising the retirement age.** The normal retirement age is raised from 65 to 67 for most non-vested employees and new hires. Vested employees receive credits toward early retirement based on number of years of service. Employees near normal retirement can retire early with a reduced benefit.
- **Suspending cost-of-living (COLA) adjustments.** Automatic, annual COLA adjustments are suspended until the system becomes 80% funded. Interim COLA increases are paid at 5-year intervals, based on investment returns.
- **Shifting employees from a defined benefit plan to a hybrid defined benefit-defined contribution plan.** Teachers and state and municipal employees become participants in the new defined contribution portion of the plan effective July 1, 2012.
- **Changing the structure of contributions.** Employees contribute both to the defined benefit and defined contribution portions of the system. Employers make actuarially-determined contributions to the defined benefit portion and contribute 1% of members' salaries to the defined contribution portion.

RIRSA was projected to reduce the system's unfunded liability to about $4.8 billion and bring it to a funded status of approximately 60%. It is widely considered to be among the most far-reaching pension reform laws for state-based plans ever enacted in the US, largely because it alters the future benefits of current employees as well as new employees' benefits. Few state legislatures have attempted, let alone succeeded at, this politically difficult move.

Challenges and proposed settlement

In June 2012, six public-sector unions and retiree coalitions filed lawsuits against the state challenging RIRSA as a violation of their contractual pension rights. In January 2013, the court ordered the parties into mediation.

The February 14, 2014 settlement, reached after the year-long mediation process, left intact the basic structure of RIRSA. However, it softened the law's effect on system members in several ways, including by lowering the retirement age for certain employees, providing for intermittent COLA calculations and payments every four years, retaining a defined benefit plan only option for members with 20 or more years of service, and increasing employer contributions for employees with 10-20 years of service.

Overall, the terms of the settlement were projected to raise the state's unfunded pension liability to $5 billion. An actuarial firm hired by the state estimated that the settlement preserved 95% of the savings originally expected from RIRSA.

The settlement was conditioned on approval by the memberships of the unions and retiree coalitions. Five of the six groups initially voted to approve the settlement, but the police group voted to reject it — which sent the parties back to mediation. Earlier this month, however, mediation talks broke down generally, and the judge set a September trial date. In response, the state attempted to have the court dismiss these legal challenges, but the court held that a contractual relationship existed between the state and the plaintiffs, and, therefore, the plaintiffs' claims could proceed.

Many public plan stakeholders have touted RIRSA as a model for pension reform and will undoubtedly be watching to see if the parties are able to come to another agreement in anticipation of a September trial.

Detroit's municipal pensions still at risk

On December 3, 2013, the US bankruptcy court in Detroit allowed the city to proceed with its plan to restructure under Chapter 9 of the US Bankruptcy Code, notwithstanding the Michigan state constitution's prohibition on the impairment of public employee pension rights. (See our December 19, 2013 *For Your Information* for a detailed analysis of this ruling and its possible implications.) The city estimates that its two pension funds — the General Retirement System (GRS) and the Detroit Police and Fire Retirement System (DPFRS) — are underfunded by about $3.5 billion.

Mediation and funding pledges

In the wake of the bankruptcy court's ruling, the city continued negotiations through a federal mediator with its creditors, including the Retirees Committee that was appointed in August 2013 to represent the city's approximately 23,500 retirees.

Meanwhile, several philanthropic organizations pledged $465 million over 20 years to fund the city's pensions and thereby preserve the collection of the Detroit Institute of Arts, a city-owned museum whose holdings were threatened with liquidation as part of the bankruptcy process. Additionally, Michigan State Governor Rick Snyder proposed that the state commit up to $350 million over 20 years to help mitigate Detroit's pension-related losses. This funding would have to be approved by the Michigan state legislature.

Tentative agreements on pension and COLA cuts

On February 21, 2014, Emergency Manager Kevyn Orr filed a comprehensive bankruptcy reorganization plan of adjustment detailing Detroit's offers to its creditors that outlined major benefit cuts for the city's active employees as well as retirees, along with incentives in the form of smaller benefits cuts designed to encourage a "timely settlement" of these issues.

Specifically, under the plan of adjustment as initially proposed then later revised, most of Detroit's retirees would face a 34% decrease in their pension benefits, with retired police and firefighters facing decreases of 14%. However, the boards recently reached tentative deals requiring much more modest decreases of 4.5% pension cuts and the elimination of COLA increases for GRS retirees, and COLA reductions (but no pension cuts) for DPFRS retirees. These tentative agreements are subject to a vote of active employees and retirees in the coming months

Appeal

Meanwhile, on February 21, 2014, the Sixth Circuit Court of Appeals granted permission for the city's pension funds to file a direct appeal of the December 3, 2013 bankruptcy court's ruling but refused to grant an expedited appeal. Thus, the timetable for the court's consideration of this issue is uncertain.

Moving forward

The status of Detroit's municipal pension liabilities remains unclear. A quick ruling from the Sixth Circuit might affect the tentative agreement on proposed pension and COLA cuts.

Illinois pension reform legislation and subsequent challenges

Illinois operates five public retirement systems. Collectively, they have an unfunded liability of nearly $100 billion, one of the largest funding shortfalls of any state public pension system in the country. At the same time, the Illinois constitution provides some of the strongest protections available nationwide for pension benefits, describing participation in any state retirement system as "an enforceable contractual relationship, the benefits of which shall not be diminished or impaired."

Illinois passed pension reform legislation at the end of last year, the constitutionality of which is now being challenged by public-sector unions.

Legislation overhauls the state's public pension system

On December 5, 2013, Illinois governor Pat Quinn signed into law S.B. 1, a measure designed to bring Illinois's five public pension systems to fully funded status within 30 years and reduce the state's long-term pension obligations by $160 billion.

The legislation creates a number of structural changes to Illinois's public pension systems, as described below:

- **Retirement age increase.** Retirement age will increase on a graduated scale for workers age 45 and younger. For each year a member is under age 46, the retirement age will be increased by four months (up to five years total).
- **COLA changes.** Automatic annual COLAs for retirees are replaced with a new formula that is based on a retiree's years of service and is adjusted annually to the CPI. Active employees will skip COLAs at certain age intervals.
- **Pensionable salary caps.** Salary for purposes of determining pensions is capped beginning in 2013 and adjusted annually by the lesser of 3% or half of the increase in the CPI.
- **New funding schedule.** The legislation sets up an "actuarially sound" funding schedule set to achieve full funding by 2044.
- **Supplemental state contributions.** Illinois will make supplemental contributions of $364 million to the system in fiscal year 2019, and $1 billion annually thereafter through 2045 or until the system reaches full funding. Illinois will also contribute 10% of the annual savings resulting from the legislation itself beginning in fiscal year 2016 until the system is fully funded.
- **Funding guarantee.** The retirement systems may file a case in the Illinois Supreme Court if the state fails to make pension payments or the supplemental contributions discussed above, as required under the legislation.

- **No collective bargaining on pensions.** Employees and unions will be barred from bargaining over pension benefits.
- **Defined contribution option.** Certain active employees will be permitted to opt into a defined contribution plan, with their previous defined benefit plan credits frozen if they select this option.
- **Employee contributions.** Employee contributions for certain participants are decreased by 1%.
- **Prohibitions on "gaming" the system.** Employees of nongovernmental organizations may not receive state pensions. Sick leave and vacation time cannot be used to increase pensionable salary and years of service.

The new COLA formula is expected to yield the largest savings of all of the changes listed above.

Unions' lawsuit

On January 28, 2014, a coalition of Illinois labor unions representing public employees known as "We are One" filed a lawsuit arguing that S.B. 1 violates Illinois constitutional protections for public employee pensions. The lawsuit seeks an order voiding the legislation, and asks for an injunction barring the state from implementing the law while the matter is being litigated. With the unions having threatened litigation throughout the legislative process, the lawsuit came as no surprise.

The lawsuit cites the pension calculations of lead plaintiffs to demonstrate the legislation's detrimental effect on pension benefits. Unless the court orders a stay while the lawsuit is pending, the S.B. 1 changes will go into effect on June 1, 2014.

Moving forward

It is unclear what, if any, weight the Illinois court will give the Detroit bankruptcy court's decision regarding the constitutionality of pension changes. The Detroit decision is not legally binding on the Illinois court, but may still serve as helpful precedent if the court is inclined to uphold the legislation.

In closing

Many other states and municipalities are debating legislation to reform their struggling pension systems, and other lawsuits are pending in connection with enacted legislation. The Colorado Supreme Court, for example, is currently considering the constitutionality of a reduction of the state retiree COLA. We continue to monitor proposed legislation as well as judicial developments in this area.

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