

# UNDERSTANDING THE LEGAL LIMITS ON PUBLIC PENSION REFORM



Amy Monahan

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A M E R I C A N   E N T E R P R I S E   I N S T I T U T E

# Understanding the Legal Limits on Public Pension Reform

For a wide variety of reasons, many states and municipalities are turning a critical eye toward their employee retirement plans. As various parties debate the merits of different reform measures, it is important to keep in mind that in many states, the law limits potential reform options.

The legal protections that apply to state employee pension benefits are a matter of state, and not federal, law. As a result, no simple answer to the question of what changes to public pension plans are permissible exists. Rather, the unique law of each state must be examined to determine what is and is not permissible. In the early 1900s, when many courts first considered the issue of whether or to what extent public pension benefits were legally protected against change, the legal consensus was that such benefits were entitled to no protection whatsoever. Pensions were considered to be mere “gratuities” from the government that could be amended or withdrawn at any time and for any reason.

Over the next several decades, however, courts changed course and overwhelmingly rejected this approach, which left employees’ pensions completely vulnerable to unilateral change. In place of the “gratuity” approach, courts have, for the most part, adopted one of two legal theories to protect public pension benefits: the property interest approach or the contract approach.

This policy brief will provide an overview of the various approaches that states take to protect public employee pensions, discussing first the protections that apply to employees who have not yet retired and then those that apply to already-retired employees. It concludes with a look at recent litigation in several states challenging public pension plan changes.

## Preretirement Changes Applicable to Current Employees

The ability of state legislatures to make changes to the pension benefits of current employees varies dramatically by state. In some states, changes are relatively unrestricted, while in other states no detrimental changes can be made to either past or future accruals unless such changes are the least drastic means of achieving an important policy goal. The first distinction among state approaches to protecting the pension benefits of current employees is whether the state follows a property- or contract-based approach.

**Property Approach.** To the extent that an employee’s rights in a public pension plan are considered property, those rights are protected under the 5th and 14th Amendments to the US Constitution from deprivation without due process of law. In addition, the 5th Amendment to the US Constitution prohibits the taking of property without just compensation. Due process has two separate components: procedural due process and substantive due process.

Procedural due process dictates the procedures the government must follow before it deprives an individual of property. Typically, the government must provide notice of the proposed change and an opportunity for the affected individual to respond. Standard legislative processes typically satisfy this requirement and, as a result, procedural due-process requirements have not limited changes to public pension plans.<sup>1</sup>

Most challenges to public pension plan changes are made on substantive due-process grounds, and a successful challenge on such grounds is difficult. As one court has explained, “To make out a substantive due process claim, a plaintiff must show a fundamental right protected by the Constitution, a deprivation of

that right, and ‘arbitrary’ and ‘outrageous’ state conduct that . . . ‘shocks the conscience.’”<sup>2</sup> To survive, the pension plan changes “need only be rationally related to a legitimate state interest.”<sup>3</sup> Courts seem skeptical that vested pension benefits involve a “fundamental right,”<sup>4</sup> and even where they assume this is true, the “rational basis” level of scrutiny that applies to public pension plan changes is easy to satisfy.

Actions to deal with state financial crises have been found to be related to legitimate state interests, as have actions to correct disparate retirement ages based on gender. Under the rational basis standard, state courts have found to be permissible plan amendments changing the retirement age for participants more than five years away from retirement eligibility, as well as changes to the definition of compensation and increasing the penalty for withdrawal before retirement age for employees not yet fully vested.

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Finally, in states where a participant’s interest in her public pension benefit is considered a property interest, challenges to changes to such plans are sometimes made under the Takings Clause of the 5th Amendment to the Constitution. To date, such challenges have been uniformly unsuccessful.<sup>5</sup> In determining whether property is taken by regulation, courts weigh three factors: (1) the economic impact of the regulation on the claimant, (2) the extent to which the regulation has interfered with distinct investment-backed expectations, and (3) the character of the governmental action.<sup>6</sup> The primary problem for pension plan participants is that, without possessing contractual rights to such benefits, courts have found that they cannot have any investment-backed expectations.<sup>7</sup> As a result, courts have found amendments to public pension plans to represent “an adjustment to the benefits

and burdens of economic life” rather than a taking of private property without just compensation.<sup>8</sup>

The end result is that in states that characterize public employee pensions as property interests, legislatures can make changes to pensions for current employees who are not yet retired, provided such changes are rationally related to a legitimate state interest. The state could not, however, arbitrarily decrease benefits without cause.

**Contract Approach.** In many states, an employee’s right to public pension benefits is considered contractual, and therefore is protected against substantial impairment under both state and federal constitutions. This protection is provided by the Contract Clause of the United States Constitution, which states, “No State shall . . . pass any . . . Law impairing the Obligation of Contracts.” Most state constitutions contain substantially similar language. As a result, once a court finds an employee’s right to her public retirement benefits to be contractual, it is generally unconstitutional for a state to take any action that substantially impairs the employee’s benefits.

Although many states consider public pension benefits to be contractual in nature, they differ dramatically regarding their interpretation of when the contract is created and therefore what it protects. In some states, the contract is considered to be formed on the employee’s first day of employment, thereby protecting the employee against any detrimental changes in her pension plan benefits from the moment she begins work. At the other end of the spectrum are states that find a contract to exist only once the employee has retired and begun receiving benefits under the plan. In those states, it may be possible to make changes freely before an individual’s retirement. Somewhere in the middle are states that find a contract to exist once an employee has satisfied the minimum service requirements to receive a pension.

One of the most interesting aspects of the contractual approach is how courts go about determining that a contract exists. The United States Supreme Court has stated that legislation should not be held to create a contract unless it is entirely clear that the legislature

intended to bind itself in the future. This is referred to as the “unmistakability doctrine.” Some states have amended their constitutions to specifically provide that public pension benefits shall be considered contractual in nature, and no controversy exists in those states regarding whether a contract is created. Other states include statements in the legislation creating state retirement plans specifying that such statutes are intended to form a contract. Again, such actions make a court’s job relatively easy.

But in many states, neither the state constitution nor the relevant statutes contain language explicitly granting contractual rights. In these states, courts are left to infer whether the legislature intended to create a contract when it passed laws granting public employees’ retirement benefits. They do so by examining the facts and circumstances of the case and often conclude that by providing retirement benefits that an employee can earn through performing services, the state has made a unilateral offer that the employee accepts through service, thereby creating a contract under traditional contract theory principles. Even this approach is relatively uncontroversial when it is used to protect benefits that an employee has already earned. However, in several of these states, courts have held that not only are benefits already earned through service protected, but so too are benefits to be earned in the future.

Regardless of the method the court uses to reach a conclusion that a contract has been formed, once one is found to exist, the court must examine whether any change to it is constitutionally permissible under a two-step process. First, the court must determine whether the state action constitutes a substantial impairment of a contractual relationship. If the change is not a substantial impairment, it is permissible. An impairment occurs if the action alters the contractual relationship between the parties and is substantial “where the right abridged was one that induced the parties to contract in the first place” or where the impaired right was one on which there had been reasonable reliance.<sup>9</sup> In the pension context, courts typically find any decrease in the amount of retirement benefits to be a substantial impairment.

Even if a substantial impairment is found, the change to the relevant contract may nevertheless be constitutional if it is justified by an important public purpose and is reasonable and necessary. In determining whether the action is aimed at an important public purpose, courts look to see whether there is a “significant and legitimate public purpose behind the regulation, such as the remedying of a broad and general social or economic problem,”<sup>10</sup> and take into account the extent of the impairment in determining the hurdle that the state must clear in justifying the change. Where a state is seeking to impair a contract to which it is a party, a reviewing court does not completely defer to the state legislature’s determination of what is reasonable or necessary under the circumstances. Relevant in determining reasonableness is whether the circumstances that necessitated the change “were unforeseen and unintended by the legislature” at the time the contract was created.<sup>11</sup> For an action to be considered necessary, (1) no other less-dramatic modification could have been implemented at the time of the challenged change, and (2) the state could not have achieved its goals without the modification. This standard obviously involves significant judicial discretion in determining whether the state’s actions were reasonable and necessary.

In the end, any analysis of pension plan changes in states that follow a contract-based approach has two critical parts. The first is the determination of when a contract is formed and what it includes, which will determine exactly what is entitled to legal protection. The second critical inquiry is, assuming the state wants to substantially change a contractual benefit, whether the change is reasonable and necessary to serve an important public purpose. The first inquiry is often plan-specific, and the second inquiry is very fact-specific. As a result, it is difficult to predict what changes to pension benefits might be permissible in states that follow a contract-based approach. As a general rule, changes that are purely prospective (changes that affect not what an employee has already earned but solely what he will earn through future service) invite less judicial scrutiny than changes that affect an employee’s already-earned and vested benefits because

prospective changes are considered less substantial impairments than changes to accrued benefits.

### Postretirement Changes to Public Pension Benefits

While distinct differences exist among the states with respect to the legal protections they grant to public employee pensions preretirement, changes to a participant's benefits once she has retired will be extremely difficult to make in any state. The difference between the legal approach to pre- versus postretirement changes is that once a participant is retired, she has by definition fulfilled her side of any bargain that has been made. In contract theory terms, the participant has accepted the offer of pension benefits through performance. The protection given to pensions in this context is analogous to the legal protections given with respect to promised salary. If an employer offers an employee a specified salary and the employee accepts the offer by performing the desired work, the employee has a contractual right to the promised compensation.

It is highly likely that every state would hold that the same is true with respect to promised pension benefits, even those that use a property-based approach for preretirement changes. As a result, nearly any change to postretirement benefits would be permitted only if it was reasonable and necessary to serve an important public purpose and would invite a very high level of judicial scrutiny. Some courts, however, have provided lesser levels of protection to cost-of-living adjustments (COLAs).

One area that is worth special mention is the extent to which COLAs are protected against detrimental changes. States often have a special interest in reducing COLAs because they offer immediate cost savings, in contrast to other types of changes that may take years (or decades) to realize. In cases where COLAs are being reduced before retirement, they would typically be analyzed under either the property or contract approach outlined here, generally on the same terms as any other type of preretirement change. However, COLA reductions that affect already-retired participants are typically

analyzed under a contract analysis because the participant has already satisfied all of the conditions necessary to receive a benefit.

Courts have come to very different conclusions regarding a retiree's continuing right to a COLA. Some courts have held that COLAs are not at all protected before they are granted because no contract covers them. Often, these courts will separate the "base" pension and the COLA for purposes of analyzing legal protections. Other courts see no distinction between base benefits and their COLA adjustments and protect COLAs to the exact degree that base benefits are protected, resulting in the state's inability to reduce COLAs for current retirees unless the change is reasonable and necessary to serve an important public purpose. Court decisions regarding the ability to reduce COLAs have varied widely, making it very hard to predict whether COLA reduction is a viable reform option.

### Recent Litigation

At least eight states have recently been sued regarding detrimental changes to public employee pension benefits: Arizona, Colorado, Florida, Minnesota, New Hampshire, New Jersey, Rhode Island, and South Dakota. Only the cases in Arizona, Florida, Minnesota, and New Hampshire have come to a final conclusion. In the remaining states, the cases are still under consideration at the trial or appellate level, with the exception of the New Jersey case, which was recently dismissed from federal court on jurisdictional grounds. This section will provide a brief update on the recent cases for which trial court decisions, at least, have been reached, illustrating the wide variety of approaches state courts use to analyze public pension changes.

**Arizona.** In 2011, the Arizona legislature passed a law that increased the proportionate share of the annual contribution to be paid by public employees into the Arizona State Retirement System. Since the plan's inception, the statute provided that employers and employees would each pay half of the required annual contribution. The legislation at issue changed the

formula to provide that employers would pay 47 percent of the required contribution and employees 53 percent. Because this affected only the relative share of contributions borne by employees and not the overall level of funds going to the plan, it did not improve the funded status of the plan.

Arizona's constitution specifically protects public employee pensions by providing that "membership in a public retirement system is a contractual relationship that is subject to Article II, §25, and public retirement system benefits shall not be diminished or impaired."<sup>12</sup> The trial court in this case quickly concluded that the legislation changing the employees' share of the required contribution is an unconstitutional impairment of the state's contract with its employees that is not justified by any significant and legitimate public purpose. The court reasoned that increased contribution requirements are the same as a reduction in benefits provided under the plan. This decision was not surprising given Arizona's specific constitutional provision protecting benefits, along with the fact that the detrimental change could not be justified as necessary to improve plan funding levels given that the overall level of funding was unaffected by the change. The state did not appeal the ruling, making the decision of the trial court final.

**Colorado.** In Colorado, retirees challenged actions by the state legislature that reduced the COLA retirees were eligible to receive. The plaintiffs included individuals who had retired under Colorado's public employee retirement system at a time when there was a guaranteed 3.5 percent COLA in place. This COLA had been in place since 2001. The Colorado District Court held that the statute granting COLAs contained no clear and unambiguous evidence that retirees were entitled to an unchanged COLA for the duration of their benefits.

In further support of its decision, the court highlighted the fact that COLAs had previously been changed on multiple occasions and therefore those in the system could have no reasonable expectation of an unchanged COLA. The court's ruling is surprising both because the court appeared to break from earlier

Colorado decisions that found pension benefits to be contractually protected prior to retirement and because the change could be characterized as a retroactive change to benefits, which is the type of change that invites the most scrutiny under a contract clause analysis.<sup>13</sup>

In October 2012, the Colorado Court of Appeals reversed the trial court, finding that plaintiffs did have a contractual right to their COLAs but remanding the case for further consideration of whether the impairment of plaintiffs' contract rights was nevertheless permissible because it was reasonable and necessary to serve an important public purpose.<sup>14</sup> The case is currently pending before the Colorado Supreme Court.

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**Florida.** Litigation is currently ongoing in Florida regarding two changes to its state retirement system that affect current employees. Effective in 2011, the plan was amended to require, for the first time, that employees contribute to it. The contribution rate was set at 3 percent of salary. In addition, the plan was amended to eliminate the COLA for years of service earned after the date of amendment.

Florida is unusual in that the statutory language establishing the current state employees' plan addresses the contractual issue directly and provides that "the rights of members of the retirement system established by this chapter are declared to be of a contractual nature, entered into between the member and the state, and such rights shall be legally enforceable as valid contract rights and shall not be abridged in any way."<sup>15</sup> The legislature was therefore abundantly clear about the creation of a contract. The Florida Supreme Court has interpreted this language as protecting only benefits that have been accrued and has stated that it does not prevent the legislature from "altering benefits which accrue for future state service."<sup>16</sup>

Despite the previous Florida Supreme Court decision stating that public pension benefits could be altered with respect to future state service, the trial court in this case found that the state had created a contract that protected both contribution levels and COLA adjustments for years of future service. In explaining its decision, the court distinguished the prior Florida Supreme Court ruling on prospective changes by taking the position that the changes at issue in the current case were not related to “benefits which accrue for future state service,” or individual components of future accruals within the plan; rather, the changes were qualitative.<sup>17</sup> As the court explains, “Absolutely nothing in [the prior Florida Supreme Court decision] can be read as authorizing the legislature to change the fundamental nature of the plan itself.”<sup>18</sup>

After finding that a contract existed that included the right to have a noncontributory plan and unchanged COLAs, the trial court found it easy to conclude that the 2011 legislation was a substantial contract impairment that was not justified by an important public purpose. The trial court drew attention to the fact that the challenged legislation decreased the amount employers must contribute to the plan by more than half at the same time that it increased employee contributions. In addition, the court noted that the plan was operating “well above the 80% funding ratio recommended by experts” and was regarded as one of the healthiest public pension funds in the United States.

Although the state of Florida claimed to be facing a budget shortfall, the court noted that the legislature’s appropriations for 2011–12 left more than \$1 billion in general revenue unspent for the year. The court further explained that a significant budget shortfall is insufficient to justify the changes, given that “other reasonable alternatives existed” to preserve the contract. As the court explained, “All indications are that the Florida Legislature chose to effectuate the challenged provisions of Senate Bill 2100 in order to make funds available for other purposes.”

The state appealed the decision to the Florida Supreme Court, which overruled the trial court and reiterated its prior holding that the statutory language

protected only accrued benefits.<sup>19</sup> Because the changes at issue were prospective in nature and did not impair what an employee had already earned, the court found the changes permissible.

**Minnesota.** The state of Minnesota was sued for changes made to its state retirement plans in 2009 and 2010. Specifically, retirees sued to challenge a reduction in their COLAs. While state law had previously provided a 2.5 percent COLA, the legislation reduced COLAs to 2, 1.5, or 1 percent, depending on the plan, but only until a plan’s funding level reached 90 percent. Other pension reforms were enacted at the same time and included changes to contribution rates, vesting periods, annuity formulas, and interest rates. These other changes were not at issue in the lawsuit.

In ruling on the COLA change, the court found no evidence that the legislature intended to create a contract with respect to specific COLA amounts. The court went on to explain that even if a contract did exist, the change to the COLAs in this case was not substantial, characterizing the reduction at issue in the case as “technical” or “minimal.”<sup>20</sup> In addition, the court explained that even if COLAs were protected by contract and the change was properly considered substantial, the change was nevertheless permissible as a “reasonable and appropriate exercise of legislative authority.”<sup>21</sup> The court noted that the state had the responsibility to respond to the plans’ suboptimal funding and that it did so through a “comprehensive package of amendments that spread the burden and sacrifice of stabilizing the plans across all members, the State, and the taxpayers.”<sup>22</sup> As a result, the court was unwilling to intrude on legislative judgment on the matter. The retirees decided not to appeal the trial court’s ruling, so the decision of the trial court is final.

**New Hampshire.** The New Hampshire Supreme Court recently issued a ruling in a case brought by a group of retired judges challenging changes made in 2003 to the New Hampshire Judicial Retirement Plan. When the plaintiffs in the case became state judges, they were eligible to receive 75 percent of the “currently effective annual salary of the office from which the [judge]

retired.”<sup>23</sup> The legislature subsequently amended the statute to adopt a new plan design that, among other things, provided that “under no circumstance shall any service retirement allowance pursuant to this section exceed 75% of the member’s final year’s salary.”

The new statutory provisions also provided the retirement board with discretion to award COLA benefits to the retired judges up to an aggregate amount of \$50,000 per year or more with the approval of the legislature. This was the first time the New Hampshire Supreme Court had the opportunity to rule on whether a public retirement plan creates a contract between a public employee and the state and, relying heavily on cases from other states, held that it does indeed create a contract as of the first day of employment.

The court characterized public pension benefits as a part of compensation for services rendered, which then created implied contracts between the state and employees. However, the court did provide that although the legal protection began on the first day of employment, pensions could nevertheless be modified if compensating benefits were provided to offset the detrimental changes. After finding a contract to exist, the court had little difficulty deciding that the changes at issue were substantial, but it sent the case back to the trial court to determine whether any benefits offset the detrimental changes made to the plan. The court did not reach the issue of whether the changes were reasonable and necessary to serve an important public purpose.

**Rhode Island.** In a recent Rhode Island case, plaintiffs challenged 2009 legislative changes to the state retirement system that applied to individuals with 10 years or more of contributory service. The changes at issue included increasing the minimum retirement age, reducing the percentage allowances for any service completed on or after the effective date of the change, changing the salary taken into account from the highest three years to the highest five years, and decreasing COLA adjustments for those who were not yet eligible to retire. The trial court has ruled only on the issue of whether a contract exists between the employees and the state, which the court notes is not an issue that

Rhode Island courts had previously ruled on with respect to employees who are vested but not yet retired.

Before deciding the contractual issue, the court importantly pointed out that pursuant to a prior decision of the Rhode Island Supreme Court, no separate analysis applies to a base pension benefit versus a COLA. Rather, the court explained, a “COLA and a pension are one and the same.”<sup>24</sup> In analyzing the contractual issue, the court found that while the statute is not explicit about the existence of a contract, the facts and circumstances supported the finding of a contract. The court explained that the state offered to provide the benefits in return for service and that acceptance was supported by employees’ adequate consideration, creating an implied contract under standard contract theory. The court did note that while these employees have only partially performed (because they have not yet retired), it found their performance to be “substantial,” thereby preventing the state from revoking its offer. The court has not yet ruled on whether the changes at issue are substantial and whether, if they are, they are nevertheless permissible as reasonable and necessary to serve an important public purpose.

The trial court judge who issued this ruling is the same judge who has been assigned to hear the legal challenges to Rhode Island’s major pension reform passed in 2011. There have been no rulings yet in that case, which the judge most recently ordered to mediation.<sup>25</sup>

## Conclusion

Predicting the legal success of public pension plan changes is difficult at best. The uncertainty arises in large part because protections are determined at the individual state level, generally through judicial decisions that can turn on the very particular facts of a case. In addition, even in states with very clear and strong legal protections for public pensions, a state can always change the plan when doing so is reasonable and necessary to serve an important public purpose. In many cases, the only method to determine whether a change is permissible is to enact the desired change and wait for the results of the sure-to-follow litigation.



## About the Author

Amy Monahan is a professor and the Solly Robbins Distinguished Research Fellow at the University of Minnesota Law School.

## Notes

1. See, for example, *Pierce v. State*, 910 P.2d 288 (N.M. 1995).

2. *Walker v. City of Waterbury*, 601 F.Supp.2d 420, 424 (D. Conn. 2009). Internal citations omitted.

3. *Parker v. Wakelin*, 937 F.Supp. 46, 58 (D. Me. 1996).

4. See, for example, *Walker*, 425.

5. The New Mexico Supreme Court seemed favorably inclined toward such claims when it stated, “Any action by the legislature that serves to terminate, diminish or alter the value of pension benefits must be compensated for by providing an equal or greater benefit” (*Pierce*, 304). The court did not, however, rule on such grounds.

6. *Penn Central Transportation Co. v. City of New York*, 438 US 104, 124 (1978).

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

8. *Ibid.* None of the cases involved changes to a participant’s benefit once the participant had retired and begun receiving benefits. Once a participant has retired and is receiving benefits, it is much more likely that a successful Takings Clause claim could be made.

9. *Baltimore Teachers’ Union v. Mayor and City Council of Baltimore*, 6 F.3d 1012, 1017 (4th Cir. 1993). The US Supreme Court has said relatively little about the “substantial” standard. In *Spannaus*, it explained, “The severity of an impairment of contractual obligations can be measured by the factors that reflect the high value the Framers placed on the protection of private contracts. Contracts enable individuals to order their personal and business affairs according to

their particular needs and interests. Once arranged, those rights and obligations are binding under the law, and the parties are entitled to rely on them.” See *Allied Structural Steel Co. v. Spannaus*, 438 US 234, 245 (1978).

10. *Energy Reserves Group v. Kansas Power and Light Co.*, 459 US 400 (1983), 411–12. Internal citations omitted.

11. *United States Trust Co. of New York v. New Jersey*, 431 US 1 (1977), 27.

12. A.R.S. Const. Art. 29, §1.

13. For example, a participant who worked for the state from 2001 (when the 3.5 percent COLA was enacted) until 2010 (when the COLA was reduced) would have worked for nine years in exchange for the promise of a benefit that increased by 3.5 percent each year during retirement. If that COLA benefit is part of what an employee earns through services rendered, the change at issue in Colorado would properly be considered retroactive. The district court in Colorado at the very least implicitly disagreed with this characterization.

14. *Justus v. State*, 2012 WL 4829545 (Colo. Ct. App. 2012).

15. Laws of Florida, Ch. 74-302, §1.

16. *Florida Sheriffs Association v. Department of Administration*, 408 So. 2d 1033, 1037 (Fla. 1981).

17. *Scott v. Williams*, 2012 WL 1379453 (Fla. Cir. Ct. 2012).

18. *Ibid.*

19. *Scott v. Williams*, 107 So.3d 379 (Fla. 2013).

20. *Swanson v. State*, No. 62-CV-10-05285 (Minn. Dist. Ct. June 29, 2011).

21. *Ibid.*

22. *Ibid.*

23. *Cloutier v. State*, 42 A.3d 816 (N.H., 2012).

24. *Rhode Island Council 94 v. Carcieri*, 2011 WL 4198506 (R. I. Super. September 13, 2011).

25. Tom Mooney, “R.I., Unions Ordered to Enter into Mediation,” *Providence Journal Bulletin*, December 19, 2012, A1.