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Public Pension Plan Reform: The Legal Framework

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1. Introduction

Public pension 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 (Costrell and Podgursky 2009). Interest in reforming public pension plans is significant, driven both by the high costs associated with such plans and concerns about a changing labor market, where it is no longer the norm to remain employed by a single employer for a thirty year career. This paper provides an overview of the legal limitations on the ability of states to amend their existing pension plans with respect to current participants. 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 Historically, public pensions in this country were viewed as mere gratuities that could be withdrawn or amended by the state at any time. Unsatisfied with a legal rule that allowed states to freely abrogate pension obligations, the vast majority of states have rejected the gratuity theory and instead protect public pensions under contract or property rights theories. Under

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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 (Munnell, Aubry and Muldoon 2008).

nearly all interpretations, these theories protect previously accrued pension benefits. In many cases, they are also interpreted to protect future pension accruals, although the extent of the protection of future accruals varies significantly by state. This article will first briefly describe federal regulation of retirement plans, before describing the different approaches to public retirement plan protection adopted by the states. Finally, the article critiques the various theories of state pension protection and suggests a different approach that states should take in balancing the interests of participants and the state.

2. 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 (29 U.S.C. sec. 1003(b)(1) (2000)). Governmental plans include any 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" (29 U.S.C. sec. 1002(32) (2000)). As a result, public pension plans are exempt from ERISA's provisions, and need only comply with federal tax code requirements.

The tax code specifies requirements employer-provided retirement plans must meet in order to qualify for favorable federal tax treatment, such as nondiscrimination requirements, vesting and benefit accrual requirements, and various rules regarding plan distributions (I.R.C. sec. 401(a)). Participants in plans that meet these requirements are not taxed on the benefits that accrue under such plans until such amounts are distributed. In addition, employers who sponsor qualifying plans are allowed an immediate deduction from their taxable income for contributions to such plans, even though such amounts are not included in an employee's taxable income until many years later.

One requirement plans must meet to qualify for this favorable tax treatment is that the plan not be amended in any way that decreases the accrued benefit of any participant (I.R.C. sec. 411(d)(6)). 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.[3] In other words, changes to private retirement plans are permitted, as long as they operate prospectively. State plans, however, are specifically exempted from the anti-cutback rule (I.R.C. sec. 411(e)(1)). The functional result is that each state's law is responsible for setting the applicable limits on changes to its own public pension plans. An overview of the principle approaches taken by the states to such regulation are discussed in more detail below. As we will see, state approaches are generally far less clear than the federal approach, often provide less flexibility than the federal approach, and are often administratively unwieldy.

3. 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 (*Public Employee Pensions in Times of Fiscal Distress* 1977). 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. In some cases, the

[3] 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 (29 U.S.C. sec.1054 (2000)).

shift away from the gratuity approach was policy-driven. Courts simply could not tolerate the absurd result of the gratuity approach, which allowed states to retroactively amend or terminate pension benefits at any time and for any reason. In other states, the move away from the gratuity approach was required by state constitutional provisions that prohibit the state from making gifts to individuals. After all, if the state constitution prohibits state gifts to individuals, and pensions are gifts, paying a pension benefit would be unconstitutional and the state, even if it desired to do so, could not pay the benefit (see, e.g., Yeazell v. Copins, 402 P.2d 541 (Ariz. 1965)). States generally protect public pensions under either a contract-based theory or a property-rights theory, while one state 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 (*Public Employee Pensions in Times of Fiscal Distress* 1977). This approach has been rejected by a majority of states either on policy grounds, or because of state constitutional requirements prohibiting a state from making a gift to an individual. Today it is followed only by Indiana (Ballard v. Bd. of Tr. of Police Pension Fund of Evansville, 324 N.E.2d 813, 815 (Ind. 1975)) and Texas (Kunin v. Feofanov, 69 F.3d 59, 63 (5th Cir. 1995)).[4] In Indiana, the gratuity approach is followed only with respect to involuntary or compulsory plans, where the employee

[4] Even though the gratuity approach grants Texas significant flexibility in amending its state retirement plans, recent changes to the Texas Employee Retirement System were made only for new hires in the system. Benefits remain unchanged for current system members (see 2009 Texas H.B. 2559).

has no choice regarding whether to contribute to the plan or keep the compensation (*Ballard*, 324 N.E.2d at 815).[5]

b. Public Pensions as Contracts

In rejecting the gratuity approach to public pensions, many states have embraced public pension plans as contractual in nature. In some states, a constitutional provision specifically provides that public pension plans create a contract between the state and participant. In other states, courts have inferred legislative intent to create a contract through an examination of the relevant facts and circumstances.[6]

When a state's constitution provides explicit protection to state pension plans, that state's courts must interpret what protection is granted by the state constitution and apply it. In states where a contract for pension benefits is created by statute or implied by facts and circumstances, courts must analyze any proposed changes to public pension plans under the Federal Constitution's Contract Clause or the relevant state constitution's contract clause.[7] The Contract Clause prohibits a state from passing a law that impairs existing contracts, whether public or private (U.S. Const. art. I, sec. 10, cl. 1; U.S. Trust Co. v. New Jersey, 431 U.S. 1, 17 (1977)). Because most state constitutional contract clauses mirror the Federal Constitution's Contract Clause, the legal analysis is generally the same whether the state or federal constitutional clause

[5] Arkansas strongly hints that it may also follow the gratuity approach with respect to involuntary plans (see Robinson v. Taylor, 29 S.W.3d 691 (Ark. 2000)).
[6] It is possible for a statute to contain explicit language regarding the creation of a contractual relationship (see, e.g., N.J. Stat. Ann. §43:13-22.33 (2009)), but this is quite rare.
[7] In most states, there is a state constitution contract clause that mirrors the federal constitutional language. For example, Article I, section 9 of the California constitution provides, in part, "A…law impairing the obligation of contracts may not be passed."

is at issue.[8] 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" (*U.S. Trust Co*., 431 U.S. at 17, n.14). The second step in a Contract Clause analysis is to determine whether the state action constitutes a substantial impairment of a contractual relationship (ibid., p. 23). An impairment occurs if it alters the contractual relationship between the parties (Allied Structural Steel Co. v. Spannaus, 438 U.S. 234, 240 (1978)) 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 and especial reliance" (Baltimore Teachers' Union v. Mayor and City Council of Baltimore, 6 F.3d 1012, 1017 (4th Cir. 1993)). If the answer to step two is affirmative, the change to the relevant contract may still be constitutional if it is justified by an important public purpose and if the action undertaken to advance the public interest is reasonable and necessary (*U.S. Trust Co*., 431 U.S. at 25). A reviewing court does not completely defer to the state legislature's determination of what is reasonable or necessary in the circumstances (ibid.). In determining reasonableness, it is relevant whether the circumstances that necessitated the change "were unforeseen and unintended by the legislature" when the contract was formed (ibid., p. 27). In order for an action to be considered necessary, (1) no other less drastic modification could have been implemented and (2) the state could not have achieved its goals without the modification (ibid., pp. 29-30).

[8] One notable exception is Oregon, which uses a slightly different legal test in applying its own contract clause than the standard three-part test used in federal contract clause analysis (see Oregon State Police Officers Ass'n v. State, 918 P.2d 765 (Or. 1996)).

As will be discussed in more detail below, once a state's pension system is found to be contractual in nature, it is relatively easy to establish impairment of that contract, while it is quite difficult to establish that the impairment is reasonable and necessary to achieve an important public purpose. As a result, a contractual approach to public pension protection often significantly limits a state's pension reform options. However, state courts adopting a contractual approach to public pension protection differ greatly in (1) when a contract is deemed to be created and (2) what is included in the "contract." The end result is that, even among states adopting a contract-based approach, the changes to public pension plans that can legally be made differ significantly from state to state. It is important to note that no matter what the exact contours of the contractual approach taken by a given state, the state *always* retains the power to amend the contract in accordance with the state's police power.[9] The subsections below review the primary approaches taken by states that have adopted contract-based pension protections.

i. Constitutional Protection of Past and Future Benefit Accruals

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. 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 (N.Y. Const. art. V, sec. 7; Ill. Const. art. XIII,

[9] "Police power" refers to the "inherent and plenary power of a sovereign to make all laws necessary and proper to preserve the public security, order, health, morality, and justice. It is a fundamental power essential to government, and it cannot be surrendered by the legislature or irrevocably transferred away from government" (Black's Law Dictionary (8th ed. 2004)). A state cannot divest itself of police power, but such power is tempered by the requirements of the contract clause (Higginbotham v. City of Baton Rouge, 183 So. 168 (La. 1938), *aff'd by* 306 U.S. 535 (1939); Allied Structural Steel Co. v. Spannaus, 438 U.S. at 241)).

sec. 5). Unlike federal retirement plan protections for private employer plans, which protect only the benefit accrued to date, this type of state protection is significantly more generous. Once an employee is eligible to participate in the retirement plan, her retirement benefit cannot be less than it would be if calculated under the terms of the plan as they existed on the date of initial eligibility for the plan.[10] The reservation of the right to amend the plan does not permit the state in these circumstances to change the terms of the plan in any way that diminishes benefits (Civil Serv. Employees Ass'n Inc., Local 1000 v. Regan, 525 N.E.2d 1 (N.Y. 1988)). For example, adopting new actuarial factors for use in calculating benefits is impermissible if the result for a single participant is that she receives fewer dollars than she would have received under the actuarial factors in place at the time of her initial eligibility for the plan (Birnbaum v. New York State Teachers' Ret. Sys., 152 N.E.2d 241 (N.Y. 1958)). However, in interpreting this constitutional protection, New York courts have held that it does not protect changes in employment conditions, nor changes to statutes or regulations that may incidentally have an adverse effect on benefits payable upon retirement (Lippman v. Bd. of Educ. of the Sewanhaka Cent. High Sch. Dist., 487 N.E.2d 897 (N.Y. 1985)). 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 not be diminished or impaired."

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[10] See, e.g., McCaffrey v. Bd. of Ed. of E. Meadow Union Free Sch. Dist., 48 A.D.2d 853 (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 Tr. of Police Pension Fund of Niles, 390 N.E.2d 1281 (Ill. App. Ct. 1979).

(Alaska Const. art. XII, sec. 7 (emphasis added)). While the language is specific to accrued benefits, Alaskan courts have interpreted the provision to protect the benefits of employees from the time they are employed and enrolled in the system (Hammond v. Hoffbeck, 627 P.2d 1052, 1057 (Alaska 1981); Municipality of Anchorage v. Gallion, 944 P.2d 436 (Alaska 1997)). As a result, Alaska's constitutional protection has been interpreted in a manner similar to New York's (see, e.g., Sheffield v. Alaska Pub. Employees' Ass'n, 732 P.2d 1083 (Alaska 1987)). 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" (*Hammond,* 627 P.2d at1057). 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 have been entitled to under the benefit formula in effect as of the employee's date of hire.[11]

Arizona approved a constitutional amendment in 1998 that provides "Membership in a public retirement system is a contractual relationship…and public retirement system benefits shall not be diminished or impaired" (Ariz. Const. art. 29 sec. 1). While the text of the amendment is not clear regarding exactly what is protected, court rulings prior to the adoption of this amendment suggest that it is likely intended to protect pension benefits from the date employment commences and covers both past and future benefit accruals (Yeazell v. Copins, 402 P.2d 541 (Ariz. 1965)). No court, however, has ruled on the exact protections offered by Arizona's constitution.

[11] When Alaska converted its state retirement plan from a defined benefit system to a defined contribution system, it did so for new hires only (see 2005 Alaska S.B. 141, codified at Alaska Stat. sec.14.25.001 et seq.).

Reform options in New York, Illinois, Alaska, and Arizona are 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 at their date of enrollment. The only possibility for changing existing employees' retirement benefits would be to have each such employee voluntarily agree to plan changes, or for changes to be made pursuant to the state's inherent police power.[12]

ii. Constitutional Protection of Past Benefit Accruals

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, section 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." Hawaii's constitution contains substantially similar language (Haw. Cont. art. XVI, sec. 2). While this is the same language that is contained in the Alaskan constitution, 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 (Ass'n of Prof'l & Technical Employees v. City of Detroit, 398 N.W.2d 436 (Mich. Ct. App. 1986); Kaho'ohanohano v. State,

[12] See, e.g., Vill. of Fairport v. Newman, 90 A.D.2d 293, 295-6 (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 (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.

162 P.3d 696 (Haw. 2007)). As a result, in Michigan and Hawaii retirement benefits related to service already performed cannot be diminished, but plan amendments can be made prospectively.

Louisiana also constitutionally protects accrued benefits of state public pension plan participants, but the Louisiana Supreme Court has interpreted accrued benefits to mean “in the sense of due and payable; vested” (Smith v. Bd. of Tr. of La. State Employees’ Ret. Sys., 851 So.2d 110, 1105 (La. 2003) (internal citations omitted)). As a result, the conservative interpretation of Louisiana’s constitutional protection is that it protects only past benefit accruals, and only once a participant is vested under the plan.

iii. Non-Constitutional Contract Protection

The majority of states that protect public pensions under a contract theory do not have a constitutional provision to rely upon, but rather imply the existence of a contract from the surrounding circumstances or rely on statutory language establishing a contractual relationship between the state and pension plan participants.[13] Often, courts focus on the fact that pension benefits are a form of deferred compensation in finding that a contract exists. Deferred compensation arrangements lead to reasonable expectations on the part of participants and such reasonable expectations are protected under the law of contracts (Halpin v. Nebraska State Patrolmen’s Ret. Sys., 320 N.W.2d 910, 914 (Neb. 1982)). Alternatively, courts have found a contract to exist because pension benefits are part of the bargained-for consideration of the employment relationship (Bakenhus v. City of Seattle, 296 P.2d 536 (Wash. 1956)). Finding that a contract exists does not end the inquiry. State are free to modify the terms of a contract to

[13] Many public employees are unionized and have agreed-to benefit provisions contained in a collective bargaining agreement. In such circumstances, the collective bargaining agreement serves as the contract and any unilateral state changes to the terms are analyzed under the state and federal contract clauses.

which it is a party, provided that such modification is permissible under the state and federal contract clauses.[14] The Supreme Court has interpreted the contract clause to prohibit only substantial impairments of contract and, even then, substantial impairments may be constitutional where they are reasonable and necessary to achieve an important public purpose. While all states that protect public pensions under contract principles apply the same general legal standard, they reach significantly different results based on when the contract is deemed to be formed and what terms and conditions the contract is found to include.

A. The Existence and Scope of a Contract

The first step in applying a contract clause analysis is to determine whether a contract exists and what terms and conditions it includes. The importance of these determinations cannot be overstated. If a contract is found to exist only when a participant retires and begins receiving benefits, a state would be free to amend its pension plan for all participants not yet retired. On the other hand, if the contract is found to be formed at the time employment commences, any detrimental plan changes could likely only apply to new hires.

1. Is There a Contract?

State statutes creating retirement plans typically are silent with respect to the creation of a contract. 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 adopt a contractual approach do not spend much time explaining how they have come to find the existence of a contract. Courts typically do not have difficulty in rejecting the gratuity approach as absurd, but their reasoning often seems less surefooted when it comes to

[14] This is true even in states where courts have held that pension plan contracts cannot be modified. A state always retains the ability to modify a contract under its police power (see U.S. Trust Co. v. New Jersey, 431 U.S. 1, 23 (1977) (internal citations omitted)).

establishing 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" (Opinion of the Justices, 303 N.E.2d 320, 327 (Mass. 1973)). "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 of 'contract.'" (ibid., p. 328). The court goes on to explain that this view of contract "protects…the core of [the member's] reasonable expectations." (ibid.). Many states agree with Massachusetts and appear to rely on the concept of reasonable expectations to find the existence of a contract.[15]

2. When is the Contract Formed?

Once a contract is found to exist, the next question is *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.[16] Other states have held that contractual protection begins at some point prior to retirement, but have not specified precisely when that protection begins,[17] and still other states protect retirement benefits from the time employment commences.[18] The relationship between the time

[15] See, e.g., Police Pension & Relief Bd. of Denver, 366 P.2d 581, 584-85 (Colo. 1961); Nash v. Boise City Fire Dept., 663 P.2d 1105, 1107 (Idaho 1983); Halpin v. Nebraska State Patrolmen's Ret. Sys., 320 N.W.2d 910, 915 (Neb. 1982); Bakenhus v. City of Seattle, 296 P.2d 536 (Wash. 1956).

[16] 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); Atchison v. Ret. Bd. of Police Ret. Sys. of Kansas City, 343 S.W.2d 25 (Mo. 1960) (no rights until age and creditable service requirements met and participant has applied for and was granted a pension) (internal citations omitted); Driggs v. Utah State Teachers Ret. Bd., 142 P.2d 657 (Utah 1943) (rights vest upon completing all conditions precedent to receipt of pension).

[17] See, e.g., Nash v. Boise City Fire Dept., 663 P.2d 1105, 1109 (Idaho 1983); (internal citation omitted); Halpin v. Nebraska State Patrolmen's Ret. Sys., 320 N.W.2d 910, 915 (Neb. 1982)

[18] See, e.g., Police Pension & Relief Bd. of Denver, 366 P.2d 581 (Colo. 1961);, Brazelton v. Kansas Public Employees Ret. Sys., 607 P.2d 510 (Kan. 1980); Burlington Fire Fighters' Ass'n v. City of Burlington, 543 A.2d 686

of contract formation and the protection of benefit accruals that results will be discussed further below.

3. What Terms and Conditions Does the Contract Include?

Generally the pension contract includes the statutory provisions relevant to the retirement plan at issue. It is sometimes found to include longstanding administrative practices related to the retirement plan (See, e.g., Washington Fed. of State Employees v. State, 658 P.2d 634, 687-88 (Wash. 1983)). It is well settled, however, that it does not include other conditions of employment that may affect retirement benefits, such as changes to salary levels or employment termination.[19]

B. Has the Contract Been Substantially Impaired?

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. There is relatively little guidance regarding what constitutes a substantial contractual impairment. Legislation impairs a contract if it alters the contractual relationship between the parties (Allied Structural Steel Co. v. Spannaus, 438 U.S. 234, 240 (1978)). "Legislation which deprives one of the benefit of a contract, or adds new duties or obligations thereto, necessarily impairs the obligation of the contract (Northern Pac. Ry. Co. v. State of Minnesota, 208 U.S. 583, 591 (1908)). Legislation that reduces the value of a contract has also been found to be an impairment (see, e.g., Retired Public Employees of Wash. v. Charles, 148 Wash. 2d 602, 625 (2003)). An impairment appears to be substantial

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(Vt. 1988); Bakenhus v. City of Seattle, 296 P.2d 536, 539 (Wash. 1956); Opinion of the Justices, 303 N.E.2d 320 (Mass. 1973); Betts v. Bd. of Admin., 21 Cal. 3d 859, 863 (1978).

[19] 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 (N.Y. App. Div. 1952) *aff'd*, 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.").

"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 and especial reliance" (Baltimore Teachers' Union v. Mayor and City Council of Baltimore, 6 F.3d 1012, 1017 (4th Cir. 1993)).

Cases indicate that this is a relatively easy test to satisfy; many legislative changes to public pension plans are found to be impairments. For example, benefit formula changes (see, e.g., Betts v. Bd. of Admin., 582 P.2d 614 (1978)) and changes in funding sources or methodology (see, e.g., Valdes v. Cory, 139 Cal. App. 3d 773 (Cal. Ct. App. 1983); Bd. of Admin. v. Wilson, 52 Cal. App. 4th 1109, 61 Cal. Rptr. 2d 207 (Cal. Ct. App. 1997)) have each been found to be impairments of the pension contract. Similarly, state action eliminating cost-of-living supplemental payments has been found to be a substantial impairment (Calabro v. City of Omaha, 531 N.W.2d 541 (Neb. 1995)), as has offsetting pension benefits by the amount of workers' compensation benefits received (Deonier v. State, 114 Idaho 721 (1988)).

Typically, changes to pension plans that are found to not substantially impair the pension contract do not involve changes that were expected to have an effect on participant benefits or on the rights and responsibilities of employers. [20] Examples of changes that were found to not rise to the level of substantial impairments include reducing the amount of employer contributions to

[20] For example, while changes in actuarial factors that reduce benefits have been found to be an impermissible impairment of contract, changes in actuarial factors affecting employer contributions, not benefit calculations, have been found to be permissible (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)). One case that does not meet this characterization is Lyon v. Flournoy, 271 Cal. App. 2d 774 (Cal. App. 1969). In that case, a widow was receiving a pension that was calculated based on the current salary for state legislators and, as such, was increased when legislator's salaries increased. After the widow began receiving benefits, the state passed a law dramatically increasing state legislators' salaries, but stating that the newly increased salary levels could not be used to increase pension payments. Instead, current retirees would have benefits adjusted according to cost of living indexes. The court found the change was not a substantial impairment of the pension contract, in large part because the widow could be found to have no reasonable expectation of the windfall that would result if the newly increased salaries applied to pension payments. This case is consistent with later Supreme Court precedent that provides "state regulation that restricts a party to gains it reasonably expected from the contract does not necessarily constitute a substantial impairment" (Energy Reserves Group, Inc. v. Kansas Power & Light Co., 459 U.S. 400, 411 (1983)).

the pension plan where there was no evidence that doing so would render the pension system actuarially unsound (Retired Public Employees of Wash. v. Charles, 148 Wash.2d 602, 627 (Wash. 2003)), investing pension assets in a state prison construction project (State ex rel. West Virginia Reg'l Jail & Corr. Facility Auth. v. West Virginia Investment Mgmt. Bd., 508 S.E.2d 130 (W. Va. 1998)),[21] and accounting changes (State ex rel. Ira Dadismon v. Capterton, 413 S.E.2d 684 (W. Va. 1992)). Additional cases found that state law changing the default rules for plan beneficiary designations did not result in a substantial impairment of the pension contract (Buchholz v. Storsve, 740 N.W.2d 107 (S.D. 2007)) and that state pension plan reform that protected accrued benefits and allowed participants a choice of continuing to accrue benefits under the old formula or moving to a new accrual structure did not substantially impair the pension contract (Maryland State Teachers Ass'n v. Hughes, 594 F. Supp. 1353 (D. Md. 1983)).

C. Is the Impairment Reasonable and Necessary to Satisfy and Important Public Purpose?

Even where a contract exists and has been substantially impaired by legislation, such legislation may nevertheless be constitutional if it is reasonable and necessary to serve an important public purpose (U.S. Trust Co. v. New Jersey, 431 U.S. 1, 2, 25 (1977)).[22] 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 (ibid., p.31). In determining reasonableness, the degree of impairment is taken into account (ibid., p. 27). 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) the state could not have achieved its public policy goal without the

[21] In the case cited, the court found that the investment did not implicate the plan's ability to pay promised benefits.
[22] 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").

modification (ibid., pp. 29-30). According to the Supreme Court, “a State is not free to impose a drastic impairment when an evident and more moderate course would serve its purposes equally well” (ibid., p. 30). Saving money is not, by itself, sufficient justification. As the Supreme Court has explained:

> Merely because the governmental actor believes that money can be better spent or should now be conserved does not provide a sufficient interest to impair the obligation of contract. If a State could reduce its financial obligations whenever it wanted to spend the money for what it regarded as an important public purpose, the Contract Clause would provide no protection at all. (ibid., p. 26)

For example, in *Calabro v. City of Omaha*, 531 N.W.2d 541 (Neb. 1995), the City of Omaha sought to eliminate a supplemental pension plan that paid cost-of-living increases to participants. The Supreme Court of Nebraska found such a change to be an unconstitutional impairment of contract, even where third-party financial reports warned that “continued funding of the supplemental benefit would cause serious fiscal problems for the city.” (Calabro v. City of Omaha, 531 N.W.2d at 552). In reaching its conclusion, the court focused on the fact that the same third-party financial reports emphasized the need for a new, alternative funding source for the benefits, not the elimination of the plan. As a result, the court was unconvinced that terminating the plan was the “only viable alternative for correcting its alleged fiscal woes” (ibid.).

California, and several other states that have adopted California’s approach, 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, alterations 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.'* (Betts v. Bd. of Admin., 21 Cal. 3d 859, 864 (1978) (internal citations omitted) (emphasis in original)).

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 pension rights are involved" (ibid. (internal citations omitted)). 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" (Claypool v. Wilson, 4 Cal. App. 4th 646, 665-66 (Cal. Ct. App. 1992)). This approach muddies the waters a bit, because it essentially sets up two tests for determining whether a contractual impairment is nevertheless constitutional: it may be constitutional if it is reasonable and necessary to achieve an important public purpose under "standard" contract clause jurisprudence, or it may be constitutional as reasonable and necessary under the California standard where disadvantages are accompanied by comparable new advantages. Case law under both standards is explored below.

1. Standard Contract Clause Cases

Justifying an impairment under the general "reasonable and necessary to achieve an important public purpose" standard is quite difficult. Most cases that rely on this standard are trying to rely on a state's dour financial situation to justify reductions in pension benefits or costs. For example, many states had historically exempted retirement benefits of state workers from state income tax. Following a Supreme Court ruling that held that states could not discriminate against federal employees by providing this favorable tax treatment only to state employees, many states amended their tax provisions to make retirement benefits for state workers taxable. Such a change was found by North Carolina to be a significant impairment of the pension contract that was not reasonable and necessary to achieve an important public purpose (Bailey v. State, 500 S.E.2d 54 (N.C. 1998)). In particular, the court found that taxing state retirement benefits was not "necessary" because there were numerous ways the state could have complied with the Supreme Court ruling, such as exempting the retirement benefits of federal employees from taxation (ibid.).

Other examples where a substantial impairment has been found not to be reasonable and necessary include a case where a city, faced with potential bankruptcy, eliminated a cost-of-living supplemental benefit plan. While the bankruptcy threat was well documented, the court held the change to be unnecessary, relying heavily on a third party report detailing the city's financial trouble that did not mention or suggest eliminating the benefit as a solution (Calabro v. City of Omaha, 531 N.W.2d 541 (Neb. 1995)). Sometimes proposed changes are unconstitutional because they fail the "important public purpose" prong of the test. In one case, a law change that prevented re-hired employees from receiving retirement payments that were previously allowed in an effort to prevent so-called "double-dipping"[23] was held to be a substantial impairment that was not justified as satisfying an important public purpose (Wiggs v. Edgecombe County, 643 S.E.2d 904 (N.C. 2007)). On the whole, these cases suggest that it is difficult to prove that the changes made to a state retirement plan are the least drastic solution available (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)).

[23] "Double-dipping" refers to an individual drawing retirement benefits while at the same time receiving a salary from an employer that participates in the retirement system.

The only public pension plan cases identified that found substantial impairments to be reasonable and necessary to serve an important public purpose were in cases where the court first held that no substantial impairment occurred. They then went on to discuss, even if the changes were substantial impairments, whether they were reasonable and necessary. These cases were previously mentioned in the substantial impairment discussion. One involved changing the default rules for designating a beneficiary under the public pension plan. The court found that the change was reasonable and necessary and served the important public purpose of uniform estate administration (Buchholz v. Storsve, 740 N.W.2d 107 (S.D. 2007)). In the other case, public pension plan reform that protected participants' accrued benefits and gave them choices regarding whether to continue accruing benefits under the old formula or switch to the new formula, was reasonable and necessary due to the system's threatened financial position and changing financial conditions that did not exist at the time the system was implemented (Maryland State Teachers Ass'n v. Hughes, 594 F. Supp. 1353 (D. Md. 1983)).[24]

2. Comparable New Advantages Cases

The "comparable new advantages" standard is applied on a participant-by-participant basis (Amundsen v. Public Employees' Ret. Sys., 30 Cal. App. 3d 856 (Cal. App. 1973)). It is not always entirely clear in judicial decisions applying this standard whether they are in fact finding that a contractual impairment does not exist because disadvantages have been offset by comparable new advantages, or whether they are holding that a substantial impairment exists but that it is justified as reasonable and necessary. Regardless, the functional result is the same. In

[24] For an example of a contractual impairment outside the public pension plan context that was found to be reasonable and necessary, see Buffalo Teachers Federation v. Tobe, 464 F.3d 362 (2nd Cir. 2006). In that case, a repeal of a contractually agreed to wage increase was found to be reasonable and necessary where the city was in severe financial crises, and had both raised taxes and laid off hundreds of employees prior to suspending the wage increase.

states that use the “comparable new advantage” standard, changes that satisfy the standard are permissible.

Often, but not always, the comparable new advantage is an increased pension amount. For example, in one case the court found that changing retirement eligibility requirements to include five years of service, where there had previously been no length of service requirement, was offset by the fact that required employee contributions had been decreased and the participant would, in the end, receive a substantially higher pension (ibid.). In another case, the court found that a new requirement that pension participants contribute two percent of salary to the plan was offset by the fact that the change would result in an insolvent plan becoming solvent (Houghton v. City of Long Beach, 330 P.2d 918 (Cal. App. 1958)).

iv. Net Result under Contract Approach

The contract approach does not provide a great amount of clarity in identifying which pension modifications may legally be made. There does appear to be consensus that the benefits of individuals who have already retired may not be diminished or impaired. The legal situation is less clear for currently employees. Under the 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. This protection appears to apply to both accrued benefits and the rate of future accruals, although this is less than clear in many states. Essentially, in states that find a contract is formed upon commencement of employment, the state can only change the terms of the pension plan if the change provides a pension benefit that is at least equal to the benefit the participant would have earned under the plan in effect at their time of hire or if the change is justified as reasonable and necessary to achieve an important public purpose. 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.

c. Promissory Estoppel

Minnesota has joined the majority of states in rejecting the view that public pensions are mere gratuities. However, instead of embracing a contract approach it finds that the interest that a public employee has in her pension is "best characterized in terms of promissory estoppel" (Christensen v. Minneapolis Mun. Employees Ret. Bd., 331 N.W.2d 740, 747 (Minn. 1983)). Promissory estoppel is a legal principle providing that a promise that is otherwise not legally binding "may nonetheless be enforced to prevent injustice if the promisor should have reasonably expected the promisee to rely on the promise and if the promisee did actually rely on the promise to his or her detriment" (Black's Legal Dictionary, 8th ed. 2004). 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" (Christensen v. Minneapolis Mun. Employees Ret. Bd., 331 N.W.2d at 747). 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" (ibid., p. 748). 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 the employee has reasonably relied (ibid., p. 749). The court goes on to explain that “estoppel applies only to avoid injustice” (ibid.). Even where promissory estoppel applies, the promise remains subject to the state’s police power, as is true with contractual rights (ibid.).[25] 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:

> 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. (ibid., p. 750)

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 (Hous. & Redevelopment Auth. of Chisholm v. Norman, 696 N.W.2d 329, 336 (Minn. 2005)).[26] This test necessitates case by case analysis and potentially difficult fact finding in order to establish reliance by the participant or beneficiary. If the conditions for promissory estoppels are satisfied, the terms of the promise are then enforceable as a contract and a state’s actions must be permissible under state and federal contract clauses in order to be upheld. This approach is theoretically more appealing than a

[25] “Police power” refers to the inherent and plenary power of a sovereign to make all laws necessary and proper to preserve the public security, order, health, morality, and justice. It is a fundamental power essential to government, and it cannot be surrendered by the legislature or irrevocably transferred away from government (Black’s Law Dictionary, 8th ed. (2004)). This is the reason why contracts may be amended, even though the Contract Clause states that the government may not impair contracts (see U.S. Trust Co. v. New Jersey, 431 U.S. 1, 23 (1977) (internal citations omitted)).

[26] 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 (Hous. & Redevelopment Auth. of Chisholm v. Norman, 696 N.W.2d 329, 337 (Minn. 2005)).

traditional contract-based approach, in that it acknowledges that a contract has not actually been formed and is grounded instead in justifiable reliance. However, the detailed, case-by-case fact finding that it necessitates makes this approach undesirable as a practical matter.

d. Public Pensions as a Property Interest

A handful of states have rejected a contract-based approach to public pensions in favor of a property-based approach.[27] To the extent that rights in a public pension plan are considered property, they are protected under the Fifth and Fourteenth Amendments to the U.S. Constitution from deprivation without due process of law. In addition, the Fifth Amendment to the U.S. Constitution prohibits the taking of property without just compensation. Before examining the application of these constitutional provisions to public pension plans, this section will first provide a brief overview of the grounds on which states recognizing a property interest find that public pensions do not create contractual rights.

In rejecting a contract approach to public pension plan protection, 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 (Pineman v. Oechslin, 488 A.2d 803, 808 (Conn. 1985)). 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" (Spiller v. Maine, 627 A.2d 513, 515 (Me. 1993)). They further explained, "to

[27] Connecticut, Wisconsin, Wyoming, Maine, New Mexico 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); Pierce v. State, 910 P.2d 288 (New Mexico 1995). 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). Just to confuse matters, some states find that pension rights are contractual, and that these contractual rights are protectable property rights.

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" (ibid.). The Supreme Court of Connecticut 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" (*Pineman*, 488 A.2d at 809). 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 (see, e.g., ibid., p. 810).

The Supreme Court has found that protected property interests extend well beyond traditional forms of property such as real estate, chattels, or money. (Bd. of Regents v. Roth, 408 U.S. 564 (1972)). The Court further explains, "to have a property interest in a benefit, a person clearly must have more than an abstract need or desire for it. He must have more than a unilateral expectation of it. He must, instead, have a legitimate claim of entitlement to it" (ibid., p. 577). Several state courts have found that state laws establishing public pension plans create such a legitimate claim of entitlement, and benefits under such plans are therefore entitled to constitutional protection as property (see, e.g., Pineman v. Oechslin, 488 A.2d 803 (Conn. 1985); Pierce v. State, 910 P.2d 288 (N.M. 1995) (property interest is created when participant vests and "matures" once participant has attained the age necessary to begin receiving benefits)).

Once a property interest has been found to exist, any changes to a public pension plan must comply with the requirements of the due process and, to the extent the property is "taken" the owner must be provided with 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 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 (see, e.g, Pierce v. State, 910 P.2d 288 (New Mexico 1995)).

Most challenges to public pension plan changes are made on substantive due process grounds, and successful challenge on such grounds is difficult. As one court has explained, "in order 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'" (Walker v. City of Waterbury, 601 F. Supp.2d 420, 424 (D. Conn. 2009) (internal citations omitted)). To survive, the pension plan changes "need only be rationally related to a legitimate state interest" (Parker v. Wakelin, 937 F.Supp. 46, 58 (D.Me. 1996)). Courts seem skeptical that vested pension benefits involve a "fundamental right" (see, e.g., *Walker*, 601 F.Supp. at 425), and even where they assume that vested pension benefits involve a fundamental right, the "rational basis" level of scrutiny that applies to public pension plan changes is easy to satisfy. Actions to deal with state financial crises easily have been found to be related to legitimate state interests (see ibid.), as have actions to correct disparate retirement ages based on gender (Pineman v. Fallon, 842 F.2d 598 (2^{nd} Cir. 1988)). Under this standard, state courts have found plan amendments changing the retirement age for participants more than five years away from retirement eligibility to be permissible (ibid.), as well as changes to the definition of compensation, and increasing the penalty for withdrawal prior to retirement age for employees who had not yet fully vested (Spiller v. Maine, 627 A.2d 513 (Me. 1993)).

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 Fifth Amendment to the Constitution. To date, such challenges have been uniformly unsuccessful.[28] 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 (Penn Cent. Transp. Co. v. City of New York, 438 U.S. 104, 124 (1978)). 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 (Parker v. Wakelin, 937 F.Supp. 46 (D. Me. 1996; Pineman v. Fallon, 842 F.2d 598 (2nd Cir. 1988)). 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 (ibid.).[29]

e. Summary of State Protections

The table below briefly summarizes the legal protections granted by many states to public pension plans. It is by necessity a general summary of state approaches and cannot account for the many factual variations that may arise in public pension cases.

State	**Which Accruals are Protected?**	**Legal Basis**	**Representative case**

[28] 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 v. State, 910 P.2d 288, 304 (N.M. 1995)). The court did not, however, rule on such grounds.
[29] None of the cases involved changes to a participant's benefit once they had retired and begun receiving benefits. Presumably changes to participants already receiving benefits could be successfully challenged under the takings clause.

Alaska	Past and future[30]	State constitution	Municipality of Anchorage v. Gallion, 944 P.2d 436 (Alaska 1997).
Arizona	Past; likely future as well, but untested.	State constitution	None
Arkansas	Past	Contract, once participant is vested under plan terms	Jones v. Cheney, 489 S.W.2d 785 (Ark. 1973).
California	Past and future	Contract, upon commencement of employment	Betts v. Bd. of Admin., 21 Cal. 3d 859, 863 (1978).
Colorado	Unclear[31]	Contract, at some time prior to eligibility for retirement	Police Pension & Relief Bd. of Denver, 366 P.2d 581 (Colo. 1961).
Connecticut	Unclear[32]	Property	Pineman v. Oechslin, 488 A.2d 803 (Conn. 1983).
Hawaii	Past	State constitution	Kaho'ohanohano v. State, 162 P.3d 696 (Haw. 2007)
Illinois	Past and future	State constitution	Kraus v. Bd. of Trustees of Police Pension Fund of Niles, 390 N.E.2d 1281 (Ill. App. Ct. 1979)
Indiana	Unclear[33]	Gratuity approach for involuntary plans; contract approach for	Bd. of Tr. of the Pub. Employees' Ret. Fund v. Hill, 472 N.E.2d 204

[30] The reported cases in Alaska dealing with the protection of future accruals all pre-date Alaska's adoption of a defined contribution plan for state employees. However, based on the language in the relevant decisions it seems likely that Alaskan courts would also find the rate of future accruals to be protected in the defined contribution plan, which would prevent Alaska from reducing such rate for any current participants.

[31] Cases have not addressed the distinction between past and future benefits to a sufficient degree to be able to summarize. Colorado courts have held that prior to eligibility to retire, plan changes can be made if the changes "strength or better" the retirement plan, or if they are actuarially necessary (Police Pension & Relief Bd. of Denver, 366 P.2d 581, 584-85 (Colo. 1961)).No cases have been found applying this standard to changes in future benefit accruals.

[32] No Connecticut cases have dealt with changes to past and future rates of accrual. Presumably, state action to diminish past, vested accruals would be impermissible under the property approach and changes to future accruals would be permitted provided the state action was not arbitrary or irrational. However, no Connecticut cases have directly addressed this issue.

[33] In Indiana, benefits from involuntary plans are not protected until the participant retires. In voluntary plans, which are given contractual protection, it is unclear when the contract is formed and therefore whether future accruals are protected.

		voluntary plans	(Ind. 1985).
Kansas	Past and future	Contract, upon commencement of employment	Singer v. City of Topeka, 607 P.2d 467 (Kan. 1980).
Louisiana	Past	State constitutional protection once vested	Smith v. Bd. Of Tr. of La. State Employees’ Ret. Sys., 851 So.2d 1100 (La. 2003)
Massachusetts	Past and future	Contractual, upon commencement of employment	Opinion of the Justices, 303 N.E.2d 320, 327 (Mass. 1973).
Michigan	Past	State constitution	Ass'n of Prof'l & Technical Employees v. City of Detroit, 398 N.W.2d 436 (Mich. Ct. App. 1986).
Minnesota	Fact-specific	Promissory estoppel	Christensen v. Minneapolis Mun. Employees Ret. Bd., 331 N.W.2d 740, 747 (Minn. 1983).
Nebraska	Past and future	Contract, upon commencement of employment	Calabro v. City of Omaha, 531 N.W.2d 541 (Neb. 1995).
New Mexico	Past, unclear whether protection applies to future accruals	Property, once vested	None
New York	Past and future	State constitution	Birnbaum v. New York State Teachers' Ret. Sys., 152 N.E.2d 241 (N.Y. 1958).
North Carolina	Past	Contract, once vested	Faulkenberry v. Teachers’ & State Employees’ Ret. Sys. Of N.C., 483 S.E.2d 422 (N.C. 1997).
Oklahoma	Past; some informal indication that prospective changes would be permitted	Contract, once vested	Taylor v. State and Education Employees Group Insurance Program,

	in some circumstances		897 P.2d 275 (Okla. 1995).
Oregon	Past and future	Contract, upon commencement of employment	Oregon State Police Officers Ass'n v. State, 918 P.2d 765 (Or. 1996).
Texas	None[34]	Gratuity	Kunin v. Feafanov, 69 F.3d 59 (5th Cir. 1995).
Vermont	Past and future	Contract, upon making mandatory contributions to the plan	Burlington Fire Fighters' Ass'n v. City of Burlington, 543 A.2d 686 (Vt. 1988).
Washington	Past and future	Contract, formed at the time of employment	Bakenhus v. City of Seattle, 296 P.2d 536 (Wash. 1956).
West Virginia	Past and future	Contract, prior to eligibility for retirement	Booth v. Sims, 456 S.E.2d 167 (W.Va.1994).

4. Discussion: The Shortcomings of Current Theories

Each of the current theories used by state courts to protect public pensions – property rights, contractual rights, and promissory estoppel – are each deeply problematic. Construing a participant's right to pension benefits as a property right potentially provides too little protection for participants in public pension plans. States often adopt a property rights approach to public pensions where they cannot find evidence in the statute, legislative history, or surrounding circumstances that the legislature intended to create a contract. Where no contract can be found to exist, a court that desires to protect public pension benefits is left either to characterize the interest as a property interest, or protect participants based on promissory estoppel. Under the Constitution, property rights cannot be diminished or impaired without due process of law, and

[34] There is an exception for certain non-statewide public retirement systems. The accrued benefits in such systems are protected by a constitutional amendment (see Tex. Const. art. XVI, sec. 66).

may not be taken without just compensation. However, all that substantive due process requires is that the state's action not be arbitrary or irrational (see, e.g, Flemming v. Nestor, 363 U.S. 603 (1960)).[35] This standard appears to allow significant changes to public pension plans, provided there is a rational basis for the amendment. The exact contours of this protection are difficult to discern. For example, a state's dire financial circumstances might provide a sufficiently rational basis under a property rights theory to allow not only prospective, but also a retroactive amendment to pension benefits. While characterizing the right to pension benefits as a property right may prevent the state from taking a retiree's benefits without just compensation, changes to the benefits of current participants can be relatively freely made.

While property-based protections do too little to protect public pension benefits, characterizing a public pension statute as a contract that begins at the time employment commences often provides greater protection than is reasonable. 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. In general, courts must infer the existence of a contract from the legislative history and surrounding circumstances. As previously mentioned, most courts that find a contract to exist do not spend much time on this fundamental, threshold issue. They tend to start with a premise that few would dispute: when an employer makes an offer of employment that includes both salary and deferred compensation in the form of pension benefits, the contract of employment includes both the salary and deferred compensation. When an employee accepts the offer of employment by performing services, the employer is bound to pay the promised salary and promised benefits. What is surprising is that courts find that the contract,

[35] Procedural due process is of little help in public pension cases, because it typically requires only notification of a change that might affect an individual's right, and the opportunity to be heard (see, e.g., Fuentes v. Shevin, 407 U.S. 67, 80 (1972). Standard legislative processes typically satisfy procedural due process requirements.

as it relates to pension benefits, is of an indefinite duration. In other words, the employer's offer of pension benefits is deemed to be binding for as long as the employee remains employed. It is the duration of the pension contract, then, that is problematic. Even though an offered salary is clearly part of the employment contract, and an employer cannot fail to pay a promised salary once services have been rendered, an employer is not prevented from changing the salary prospectively, prior to the time services as performed. Why is the result different for pension benefits?

Courts often focus on the concept of reasonable expectations when finding a contract to exist. The idea is that the employer promised certain pension benefits in exchange for services, the employee rendered the services, and now reasonably expects the promised pension. Again, this idea is non-controversial with respect to pension benefits for services already performed. But it does not explain why the rate of future benefit accruals would be protected. How can an individual have a reasonable expectation to future benefit accruals if they cannot have a reasonable expectation regarding the factors that determine the amount of that benefit, such as salary level and length of employment? Any reasonable expectation of a pension would have to be limited to the structure of the plan itself, rather than the dollar amount of any resulting pension. In other words, while you can't have any expectation of what your salary will be from year to year, and you can't have any expectation of how many years you will be employed, you do have a reasonable expectation that for every year you are employed you will accrue a certain percentage of your salary in the form of deferred pension benefits. This seems to be both an odd expectation to have, and an odd expectation to legally protect, when the economic value of the benefit can vary so dramatically. While no court has directly acknowledged this, it may be that the early, precedential cases finding a contract to exist at the time employment commences and to be of open duration were a response to the perceived injustice of long vesting periods in public pension plans.[36] For example, assume an individual was hired when a state pension plan required 20 years of service in order to be eligible for a benefit. Further assume that when the individual has worked for the state for 15 years, the state amends the terms of the pension plan to provide for a significantly reduced rate of accrual than that which was in place when the individual was hired. Even if the benefit accrued in years 1 – 15 is preserved, the individual is forced to continue working for 5 years in order to become eligible for any pension benefit at all. Even if the current compensation package is far inferior to what the employee could achieve by seeking employment elsewhere, she will likely agree to the new terms in order to avoid forfeiting the deferred compensation she earned in years 1 – 15. By finding a contract to exist at the time employment commences for an open duration, it protects an employee from a situation like the one just described where the state can very effectively change the terms of the bargain and leave the employee with no choice but to accept the diminished employment terms or forfeit her accrued pension benefit. Today, of course, with Code requirements that specify participants in qualified retirement plans must be fully vested after no more than seven years of service (with partial vesting occurring earlier), such concerns are substantially alleviated. Discussion of reasonable expectations, then, may have arisen from a desire to protect an employee from the state's outsized power that results from long vesting periods, rather than an effort to determine what is actually reasonable for an employee to expect.

There may, however, be an exception to this view of reasonable expectations in the case of tenured teachers. Generally speaking, tenured status decreases significantly the likelihood that a teacher will be involuntarily terminated. While a tenured teacher can be fired, it can only be for

[36] Extended vesting periods were common prior to the time the qualification requirements of the Code included limitations on vesting periods.

the limited reasons specified in the applicable tenure statute. In some states, tenured status also protects salary levels (see, e.g., Mo. Rev. Stat. §168.104(2)).[37] Perhaps, then, there are some states that protect a tenured teacher's employment and salary levels to a degree sufficient to cause expectations about future pension accrual to be reasonable. The problem is that, from a legal perspective, protected employment and salary levels are not sufficient to confer protected status on the rate of pension accrual. Even if we assume that reasonable expectations are sufficient to create protectable contract interests in public pension benefits, we still have not established the basis for the reasonable expectations for pension benefits. A tenure statute might very well create reasonable expectations regarding employment and salary, but they do not speak to pension benefits. And unless there is a specific, contractual agreement regarding such benefits (such as one contained in a collective bargaining agreement) an employee with a stable job and salary still does not appear to have a reasonable expectation that a particular employee benefit will be continued unchanged throughout the duration of employment. In other words, while it seems unreasonable to suggest that an employee has a reasonable expectation that pension benefits will remain unchanged for the duration of employment when they can be terminated at any time or have their salary changed even legal protection of job and salary levels is insufficient to create a reasonable expectation of future rates of pension benefit, absent an explicit agreement to the contrary.

This is not to argue that pension benefits are not entitled to contractual protection. Indeed, it is consistent with the theory of pensions as a form of deferred compensation to protect pension benefits already accrued. That can be done by finding a contract to exist, but specifying that the contract is formed on an ongoing basis as services are performed. When an employee accepts

[37] Generally, tenured status does not protect salary levels (68 Am. Jur. 2d Schools §196 (2009) (internal citations omitted)).

employment with a state at a certain salary level and with certain promised benefits, and then performs services in reliance thereon, she becomes entitled to the promised salary and benefits. However, the terms of the contract can be modified by either party. The state may change employment conditions such as salary or benefits, and the employee may choose whether or not to accept such changes by either continuing to work for the state or electing instead to seek employment elsewhere. Similarly, the employee may choose to terminate employment at any time if she desires a different salary and benefit package than the one being offered. However, once service has been performed in reliance on a state's offer, the state should not be free to retroactively change the terms upon which service was performed. Deferred compensation in the form of pension benefits should be protected, just as the right to receive a promised current salary is protected. Protecting public pension benefits under a contract theory can do just that, provided that courts are precise about the duration of the contract.

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.

5. What's a State to Do?

Many states are likely dissatisfied with current approaches to public pension protection because the end result is either an inability to modify future accruals, an inability to recruit and retain valued employees, or an inability to determine what changes can legally be made to public pension plans. In states whose courts have adopted a contract-based approach, the state often ends up locked into an economic relationship that cannot be adjusted for changing market conditions.[38] In states that do not find a contract to exist and instead characterize public pension plans as property, states may have a difficult time recruiting and retaining employees given that accrued pension benefits can be eliminated with relative ease prior to actual retirement. And finally, in states that use the theory of promissory estoppel to protect pension benefits, lawmakers would undoubtedly like to know, prior to the outcome of litigation, whether changes can be made to the state's retirement plan or plans. The options for changing such legal protections are explored below.

In states that protect future accruals under a constitutional provision, the only option would be a constitutional amendment changing that protection for new hires or to attempt to justify any desired plan amendments as a valid exercise of the state's police power.[39] At the other end of the spectrum, in states that fail to clearly protect even a participant's accrued benefit, either under a contract theory or a property theory, the legal reform options are somewhat less daunting. Property rights are typically relied on where a court could not find evidence that the state intended to form a contract and, similarly, contractual protections that do not protect benefits prior to retirement are found because of an absence of evidence of the creation of an earlier contract. In either case, a change to the statutory language could clarify that public retirement systems create a contract between the state and employee at the time the employee first becomes eligible to participate in the plan, and that the contract protects the monetary value of a participant's accrued benefit but not future rates of accrual. Alternatively, the state constitution could be amended to provide such protection.

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[38] Of course, given that other economic benefits of employment, such as salary and other fringe benefits, can be modified, a state can always adjust the total economic value of compensation even if it cannot change future pension benefit accruals. The problem is that it does not allow the state to structure compensation in the manner it finds most efficient. Instead, it locks in the amount of deferred compensation, and as a result might push current salary and other fringe benefits to a lower-than-ideal economic value.

[39] Alaska might be the one exception, where the language of the constitutional provision protects "accrued benefits," but courts have interpreted that language very broadly. As a result, in Alaska it might be possible to argue successfully in state court that previous interpretations of "accrued benefits" are incorrect and should be overturned.

In states that find a contract to exist at the time employment commences or shortly thereafter, advocates for reform can challenge as inaccurate previous characterizations of the contract. Advocates would need to convince the court that, to the extent a contract is formed, it is formed on an ongoing basis to protect accrued benefits, not the rate of future accruals. This argument could be strengthened by making the distinction that past holdings often dealt with public pension plans with vesting periods significantly longer than is permitted today. Advocates could also argue that, given the number of times the average American is expected to change jobs during her working life, it is disingenuous to suggest that she has a reasonable expectation of continued future benefit accruals. An ongoing contract would therefore protect the reasonable expectations of participants.

There is some hope that courts will respond to changing market conditions because this is what happened when states rejected the previously adopted gratuity approach to move to contract or property-based theories. In rulings rejecting the gratuity approach, courts focused on the changing pension landscape. The Minnesota Supreme Court noted, "In the past the gratuity theory may have been justified by the fact that promised benefits were insignificant in amount….But times have changed…pension coverage has increased while at the same time, particularly in the last two decades, increasing numbers of public employees are reaching retirement age and finding that pension funding is not always adequate to provide what has been promised" (Christensen v. Minneapolis Mun. Ret. Bd., 331 N.W.2d 740, 746 (1983)). In rejecting the gratuity approach, the court continued:

> [Referring to public pensions as a bounty springing from the graciousness and appreciation of sovereignty] is at best quaint, and at worst, demeaning. Retirement plans are now an accepted and expected part of one's employment, whether public or private. To attract and retain good employees, employers need to provide competitive retirement programs. (ibid.)

Advocates for reform could similarly argue for jurisprudential changes based on changing conditions. Public sector plans have not kept pace with the market as a whole, in large part because state jurisprudence has fixed such plans in time. By holding states to pension plan structures that were conceived many years ago in different financial and labor market conditions, we are significantly impeding the ability of the state to function efficiently and are giving public employees an advantage not found elsewhere in the labor market.

The likely success of any of these arguments would differ significantly by state, and I do not mean to suggest that distinguishing or overruling prior precedent would be an easy task. The first step would be to propose legislation that would change the rate of future benefit accruals. In some states, an advance ruling could be sought from the state's supreme court regarding the constitutionality of the change. In other states, the legislation would have to be passed, challenged by a participant, and then successfully defended by the state. Not only would the successful defense be an uphill battle, but gathering sufficient political support to propose or pass pension legislation impairing future accruals would likely be very difficult. However, given the dire financial condition of many states and many state pension plans, perhaps now is the right moment to attempt such reforms.

6. 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 often 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 exists, but be clear that a participant has a reasonable expectation only in their currently accrued benefit. 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 revisit their public pension plan jurisprudence. Just as courts recognized many years ago that the gratuity theory of pensions was premised on a reality that no longer existed, it is time for courts to once again revisit the premises that underlie both contract and property-based theories of pension protections. Retirement benefits remain an important part of an employee’s compensation and need to be protected. What needs to be protected, however, are the benefits that have already been earned with respect to services already performed. Doing less is patently unfair to employees and retroactively changes the terms of the bargain struck between employer and employee. Doing more is unfair to employers (and, perhaps, to state taxpayers), locking them into an economic bargain that cannot be changed to respond to financial or labor market conditions, even when all other aspects of the employment relationship can be renegotiated.

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