City and State Pensions Need to Bend before They Break

Law360, New York (February 28, 2014, 3:48 PM ET) -- One of the last bastions of defined benefit pension plans is the public sector. The facts clearly demonstrate an inability by many state and municipal governments to fund those pensions. According to the Pew Center on the States, as of fiscal year 2010, state retirement systems alone — which exclude any separate municipal systems — were collectively underfunded by $1.38 trillion.

It is for this reason that many state and municipal governments have made changes to their retirement systems in recent years. Among the types of changes that have been adopted are the following: (1) creating new, lower pension levels for more recent employees; (2) capping benefits; (3) increasing the normal retirement age; (4) reducing or eliminating cost-of-living adjustments; (5) changing the calculation for determining an employee’s final average compensation; and (6) requiring or increasing employee contributions.

Such changes have hit both states that tend to be viewed as liberal, as well as those that tend to be viewed as conservative. In 2011, Massachusetts raised its normal retirement age by five years, from 55 to 60. In 2012, California passed a law that increases the retirement age, caps payouts and increases employer contributions. That same year, New York also increased its employee contribution rate (to up to 6 percent of salary for the highest-paid public employees), increased the normal retirement age and changed the number of years to calculate average final compensation from three to five.

Even when states have been able to find the political inertia to modify their retirement systems, litigation has quickly followed. For proof of this, one needs look no further than Illinois. Illinois' pension system ranks last in the nation, with approximately $100 billion in unfunded liability. According to Pew, it is estimated that 20 percent of Illinois' revenue goes to pensions and, if left unchecked, that amount will increase to 40 percent by 2045.

In December 2013, Illinois enacted a number of pension reforms, primarily by reducing and suspending COLAs, increasing the retirement age and capping the salaries on which pensions are based. Almost immediately, various public employee unions and retiree associations filed suit challenging that the Illinois reform law was unconstitutional. As of the writing of this article, at least four lawsuits had been filed in Illinois state courts challenging Illinois’s reform efforts.

If history is any guide, those reforms may be in trouble. Illinois is one of several states that protect public employee retirement benefits in its constitution. Article XIII Section 5 of the Illinois Constitution provides: “Membership in any pension or retirement system of the State, any unit of local government or school district, or any agency or instrumentality thereof, shall be an enforceable contractual relationship, the benefits of which shall not be impaired.” Based upon that provision, Illinois courts have been extremely protective of public employee retirement benefits, going so far as to hold that the state is prohibited from reducing benefits “for economic reasons, no matter how compelling those reasons may seem.” Jorgensen v. Blagojevich, 811 N.E.2d 652, 670 (Ill. 2004).

Nevertheless, it is not enough to say that public employees have a contractual right. Rather, the question then becomes what that right protects. Generally, this question can be answered in one of two ways. Either public employees have a perpetual right to continue to earn at least the same level of benefits as the day they became employed for as long as they remain employed, or, instead, the contractual right is only to those benefits that have already been earned. Illinois courts have, in the past, ruled that the former answer is correct, holding that “the contractual relationship is governed by the actual terms of the [p]ension [c]ode at the time the employee becomes a member of the pension system.” McNamee v. State, 672 N.E.2d 1159, 1162 (Ill. 1996).

We think this is the wrong answer for the reasons given last year by the Supreme Court of Florida in Scott v. Williams, 107 So.3d 379 (Fla. 2013). In 2011, Florida made certain changes to its public employee retirement system, including eliminating COLAs on those benefits earned after the enactment of the reform legislation and by requiring public employees to contribute 3 percent of their future wages. Similar
to Illinois' constitutional provision, the challenge to the Florida legislation was based upon a Florida statute which provides that “the rights of members of the retirement system ... 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.” Fla. Stat. § 121.011(3)(d).

The Florida Supreme Court explained that this statute “was enacted to give contractual protection to those retirement benefits already earned as of the date of any amendments to the plan,” but that the state could “amend a retirement plan prospectively, so long as any benefits tied to service performed prior to the amendment date are not lost or impaired.” Scott, 107 So.3d at 388-89. The court went on to explain that the “statute does not create binding contract rights for existing employees to future retirement benefits ...” Id. at 389.

There are several reasons why this is the correct result. For one thing, this simply puts public employees on the same footing as private employees. The anti-cutback rule of the Employee Retirement Income Security Act's Section 204(g)(1) only precludes “accrued benefits” from being reduced. 29 U.S.C. § 1054(g)(1).

The rule for private employees is that while employers cannot reduce benefits that have already been earned, if employers seek to impose different compensation standards into the future, the employer is free to do so and it is then up to the employee whether or not she wishes to continue her employment. Employees generally do not have the legal right to continue receiving the same level of compensation that was provided in the past. See Central Laborers' Pension Fund v. Heinz, 541 U.S. 739, 747 (2004) (“[E]mployers are perfectly free to modify the deal they are offering their employees, as long as the change goes to the terms of compensation for continued, future employment ...”).

The rule adopted thus far by the Illinois courts not only provides public employees with a right to their accrued benefits, but also gives them a protected interest in benefits that they have not yet even earned. In fact, the Illinois rule creates the illogical result of protecting employees’ right to benefits they could earn in the future, even while their rights to continued employment are not protected.

The effect of the Illinois rule is to allow one legislature that enacts a certain level of benefits to permanently bind future legislatures to provide at least that level of benefits to public employees, regardless of the financial condition of the state or municipal government and the health of the pension system. As the Florida court held, if state and municipal governments could not prospectively modify their retirement benefits, the result would be to “impose on the state the permanent responsibility for maintaining a retirement plan which could never be amended or repealed irrespective of the fiscal condition of this state. Such a decision could lead to fiscal irresponsibility.” Scott, 107 So.3d at 388.

That is ultimately the conundrum that state and municipal governments face if they are barred from prospectively changing their pension benefits. With trillions of dollars in unfunded liabilities, if governments cannot modify their retirement systems then the money has to come from somewhere else. At that point, the only options are only to raise revenue — in other words taxes — or to decrease spending elsewhere. Setting aside the desirability of doing so, it seems obvious that raising taxes is politically unfeasible in most states.

In the end, if states cannot modify their retirement systems, the result will be cutting spending and services elsewhere. Indeed, drastic cuts could be needed. Consider, for example, that, absent reform, Illinois is projected to see its percentage of revenue spent on pensions increase from 20 to 40 percent over the next 30 years.

Not only could such severe cuts harm the public at large by taking away needed services but, ironically, a likely impact would be to see a loss of some of the government jobs that provide the pensions at issue. In a classic example of a pyrrhic victory, public employees may preserve benefits at the expense of their jobs. Indeed, this may already be happening. Even as unemployment declines among the private sector, according to the U.S. Bureau of Labor Statistics, as of January 2014, the number of Americans employed by state and local governments remains down more than 9 percent from their 2008-2009 highs.

Municipal governments will face the same options if they cannot prospectively change their retirement obligations, namely by raising taxes or, more likely, cutting spending — which would probably include
reducing the number of public employees.

However, municipalities have another option not available to the states: bankruptcy. Last year, the Detroit became the largest Chapter 9 bankruptcy case in American history. On Dec. 5, 2013, the U.S. Bankruptcy Court for the Eastern District of Michigan held that Michigan’s “constitutional provisions prohibiting the impairment of contracts and pensions impose no constraint on the bankruptcy process,” and that “[b]ecause under the Michigan Constitution, pension rights are contractual rights, they are subject to impairment in a federal bankruptcy proceeding.” In re City of Detroit, Mich., No. 13-53846, 2013 (Bankr. E.D. Mich. Dec. 5, 2013). In other words, Detroit may be able to do in bankruptcy court what it might not have been able to do in state court and reduce its pension obligations.

Assuming this decision stands, the result will be that if municipalities are barred from prospectively changing their public employee retirement benefits, they may have no choice but to file for bankruptcy and get out of their pension obligations that way. Indeed, precluding modest legislative reforms may result in the unintended consequence of harsher changes in bankruptcy, including reductions to already accrued benefits. Thus, this provides just one more reason why it may not be in the interests of public employees to vigorously oppose prospective changes to benefits.

In sum, allowing state and municipal governments to prospectively amend retirement benefits — while protecting benefits that have already been earned — merely places public employees in the same footing as private employees. In the absence of that flexibility, state and municipal governments will be forced to cut spending elsewhere in order to continue funding pension benefits at the same levels. The result would not only be to harm the public at large, but also public employees themselves through layoffs and the breaking of contracts in municipal bankruptcies.

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