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When a Promise Isn't a Promise: Public Employers' Ability to Alter Pension Plans of Retired Employees

Gavin Reinke

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I. INTRODUCTION

The economic downturn has placed enormous pressure on state budgets. The recession hit state pension funding plans for public employees particularly hard.[1] Some projections indicate that, even with as much as an 8% return on their pension fund investments, seven states' funds will be out of money by 2020, and half of states' funds will be fully depleted by 2027.[2]

State legislatures are scrambling to pass measures designed to return their pension funds to solvency.[3] Most proposals only call for decreases in the amount of pension benefits provided to future retirees, but four states have gone much further. Colorado, Minnesota, South Dakota, and New Jersey have all passed pension reforms that reduce the amount of benefits to which already-retired public employees are entitled. These reforms have serious financial consequences for those retirees. In Colorado, a retiree who received a pension of $33,264 in 2009 could lose more than $165,000 in benefits over a twenty-year period.[4] In Minnesota, a retiree receiving an annual pension of $29,076 in 2008 could lose approximately $28,000 in benefits over the next ten years.[5] In South Dakota, the average retiree could take home between $40,264.42 and $77,414.68 less in pension benefits because of the recently enacted reforms.[6] The New Jersey reforms are likely to have a similar impact.[7]

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1. *American States' Pension Funds: A Gold Plated Burden*, ECONOMIST, Oct. 16, 2010, at 11, *available at* http://www.economist.com/node/17248984.

2. *Id.*

3. *See, e.g.*, David Crane, *The $500-Billion Pension Time Bomb: The State's Staggering Unfunded Debt Stands to Crowd Out Many Popular Programs*, L.A. TIMES, Apr. 6, 2010, at A11 (discussing Governor Schwarzenegger's proposed pension reforms in California); Adrienne Lu, *Christie Wants Public Employees to Work Longer and Pay More for Health Care*, PHILA. INQUIRER, Sept. 15, 2010, at A1 (discussing proposed New Jersey public employee pension reform); Dave McKinney & Steve Contorno, *State Pension Cuts OK'd: Raises Retirement Age to 67, Ends Double-Dipping*, CHI. SUN-TIMES, Mar. 25, 2010, at 2 (summarizing pension reform passed by Illinois legislature).

4. First Amended Class Action Complaint at 8–9, Justus v. State, No. 2010-CV-1589 (Colo. Dist. Ct. Mar. 17, 2010) [hereinafter Colorado Complaint].

5. Amended Complaint at 12, Swanson v. State, No. 62-CV-10-5285 (Minn. Dist. Ct. July 2, 2010) [hereinafter Minnesota Complaint].

6. Complaint at 9, Tice v. State, No. 10-225 (S.D. Cir. Ct. June 2010) [hereinafter South Dakota Complaint].

7. Richard Pérez-Peña, *In New Jersey, Lawmakers Curb Worker Benefits*, N.Y. TIMES, June 24, 2011, at A1.

This Note analyzes the permissibility, under the U.S. Constitution, of public employee pension reforms that alter the amount of benefits to which retired employees are entitled, and proposes a solution to ensure the continued solvency of state public employee pension funds. Part II examines the underlying causes of the current pension crisis. Part III discusses current state attempts to reduce the pension benefits of retired public employees and explains the legal challenges to these reforms that are currently pending in state courts. Part IV analyzes the legal claims in more detail and explores whether pension reforms that reduce benefits for retired public employees violate substantive due process, the Takings Clause, or the Contracts Clause of the U.S. Constitution. Part V proposes that Congress encourage states to enact minimum funding requirements, similar to those in the Employee Retirement Income Security Act of 1974 ("ERISA") that govern private employee pensions, by allowing states that choose to adopt such requirements to issue tax-exempt bonds for the purpose of funding public employee pensions.

II. A DEVELOPING STORM: STATES' PUBLIC EMPLOYEE PENSION SOLVENCY PROBLEMS

Many states' public employee pension systems are severely underfunded. As of fiscal year 2008, states collectively promised $3.35 trillion in pension, healthcare, and other retirement benefits to current and retired workers.[8] However, the states had only set aside $2.35 trillion, leaving a one trillion dollar gap between benefits promised and benefits funded.[9] Although the causes of the current pension crisis are complex, a recent report compiled by the Pew Center on the States ("Pew Center") identified four major causes: "(1) the volatility of pension plan investments; (2) states falling behind in their payments; (3) ill-considered benefit increases; and (4) other structural issues."[10]

First, the investments states made to fund pensions for public employees are extremely volatile. The Pew Center's report indicates that, on average, the value of state pension plan investments decreased by a median of 25.3% in 2008.[11] Similarly, in 2009, the one

8. PEW CTR. ON THE STATES, THE TRILLION DOLLAR GAP: UNDERFUNDED STATE RETIREMENT SYSTEMS AND THE ROADS TO REFORM 1 (2010) [hereinafter PEW CTR., TRILLION DOLLAR GAP].

9. *Id.*

10. *Id.* at 23.

11. *Id.*

hundred largest public pension funds lost $165 billion because of investment declines.[12] To make matters worse, states that were heavily invested in real estate, such as California, were hurt by recent declines in the real estate market.[13] The volatility of pension fund investments also hurt states in another, less obvious way. In the 1990s, pension investments rapidly gained value, and some states used those increases to justify politically popular increases in benefits.[14] At the same time, those states lowered employee contribution rates because the outstanding returns on pension fund investments meant that their pension systems were overfunded.[15] When the economy declined in 2008 and the value of many state pension funds plummeted, the ratio of funding to actuarially calculated liability declined substantially, and state pension systems no longer had enough assets to sustain the actuarially assessed liability of past promises.[16]

Second, state legislatures failed to keep up with the payments their pension funds demanded, resulting in consistent underfunding. Actuaries calculate the amount of money that state legislatures must put into their systems in order to cover all current obligations, as well as to control, and eventually eliminate, their plans' unfunded liability.[17] This calculation produces a dollar figure that, if added to the public employee pension fund, will ensure sustainability, assuming the return on investment projections are sound. State legislatures are not, however, required to contribute that amount and often contribute less, in both good and bad economic times.[18] In tough economic times, legislatures frequently face tight budgetary constraints, and citizens often need more assistance from the government. The public employee pension fund is an easy target for budget cuts necessary to meet those demands. Even in a favorable economic climate, states have a tendency to underfund public pension

12. Dunstan McNichol, *State-Run Funds Mitigate Losses After BP Spill*, STAR-LEDGER (Newark, N.J.), June 23, 2010, at 29.

13. *See* Robert Selna, *Losses Mount for Fund; CalPERS*, S.F. CHRON., Dec. 11, 2009, at D1 (noting that real estate holdings made up 6.9% of the California Public Employees Retirement System's market value and that those holdings had declined by 48.7% in 2009).

14. *See* PEW CTR., TRILLION DOLLAR GAP, *supra* note 8, at 23 (discussing such increases in benefits in Pennsylvania).

15. *Id.* at 24. For example, in 2000, Colorado's pension system was funded at 105% of its actuarially assessed value of total promised payouts. *Id.* at 27.

16. *See id.* at 17 exhibit 8 (a map showing that, as of 2010, 21 states had funded less than 80% of their public employee pension plan obligations).

17. *Id.* at 24.

18. *Id.* at 24–25.

funds because the return on the funds' investments typically exceeds projections, and states feel justified in putting less money into the funds.[19] Largely because of these two factors, twenty-one states contributed less than 90% of their actuarially required amount between 2005 and 2010.[20] Colorado and Minnesota, two of the three states that recently decreased current retiree pension benefits, failed to make their annual required contribution in 2008. According to actuarial data, Colorado's ideal contribution to its public employee pension fund in that year was $1,141,081, but it only contributed 68% of that amount, or $779,644.[21] Between 2004 and 2010, Colorado contributed $2.4 billion less than its ideal actuarial amount to its public employee pension fund.[22] Minnesota needed to contribute $1,036,509 to its fund in 2008 to ensure sustainability, but like Colorado, fell short, contributing only 74% of that amount, or $767,295.[23] As of 2008, 30% of Colorado's actuarially calculated liability was unfunded, and nearly 19% of Minnesota's liability was unfunded.[24] South Dakota, the other state that has already passed a law reducing the amount of pension benefits retired public employees receive, fared much better, with less than 3% of its actuarial liability unfunded as of 2008.[25]

Third, many state legislatures increased benefits without regard to whether those benefits were adequately funded. In the 1990s and early 2000s, states often increased entitlements to retirement benefits instead of increasing salaries but gave little thought to how they would fund these increases.[26] These increased benefits led to increased liability on the part of state governments. For example, in the late 1990s, Colorado promised automatic cost-of-living pension increases for retirees and decreased the retirement age for employees

19. *Id.*

20. *Id.* at 24.

21. *Id.* at 4 exhibit 1.

22. *Id.* at 27.

23. *Id.* at 4 exhibit 1. Interestingly, South Dakota, one of the states that has passed a law decreasing the amount of benefits that current retirees are entitled to, met its annual actuarially calculated contribution in 2008, contributing 100% of the required amount to ensure sustainability, or $95,766. *Id.* It is unclear why South Dakota would undertake the drastic reform that they did given that their public employee pension fund is, relatively speaking, in good shape.

24. *Id.* Colorado's unfunded liability in 2008 amounted to $16,813,048 out of its total liability of $55,625,011, while Minnesota's unfunded liability in 2008 was $10,771,507 out of a total liability of $57,841,634. *Id.*

25. *Id.* In 2008, South Dakota's unfunded liability was only $182,870 out of a total liability of $7,078,007. *Id.*

26. *Id.* at 25–26.

with thirty years of service from fifty-five to fifty.[27] These increased benefits resulted in a 115% increase in Colorado's liability, while its pension fund assets only increased by 45%.[28] This failure of state legislatures to increase contributions to state pension systems in proportion to benefits is a major contributing factor to the solvency problem these funds now face.

Finally, the Pew Center report identifies several structural issues that contributed to the current public employee pension crisis. First, many public employee pension plans allow employees to retire at early ages. In California, for example, police officers and firefighters retire at an average age of fifty-four, and other government employees retire, on average, at age fifty-nine.[29] Moreover, governments historically incentivize early retirement in difficult financial times in an effort to reduce the size of the workforce but fail to account for the resulting increased liability to pension funds.[30]

Second, some states credit employee accounts when pension fund investments exceed the projected amount. For example, under Oregon's old public employee pension system, employee contributions were guaranteed an 8% annual return.[31] If the return in any given year was more than that, employees were credited the extra money.[32] Because employees had already been credited that money, as opposed to the state reserving it for years when the pension fund's investments did not generate an 8% return, the state had no way to offset the losses it incurred when the returns on its investment were less than 8%.[33] Third is the problem of "double dipping," which occurs when "retirees . . . are given their pensions and then come back to work for a new salary."[34] Pension system representatives in all fifty states predict that this will be a "significant legislative issue" over the next several years.[35]

Finally, state pension systems also suffer because of the way states calculate final salaries. Many states determine pension benefits based on an employee's salary level in his final years of employment.

27. *Id.* at 27.

28. *Id.*

29. Steve Lopez, *Pension Crisis Rings a Bell: Salary Scandal Exposes a Public Pension System off the Rails Statewide*, L.A. TIMES, Aug. 1, 2010, at A2.

30. PEW CTR., TRILLION DOLLAR GAP, *supra* note 8, at 28.

31. *Id.*

32. *Id.* Oregon has discontinued this program. *Id.* at 29.

33. *Id.* at 28–29.

34. *Id.* at 29.

35. *Id.* at 48 n.104.

In order to increase benefits, employees have "manipulated the system" to earn higher salaries in their last several years of employment by doing things such as "ensuring that overtime goes to the most senior workers, saving sick leave and getting temporary promotions or last-minute raises."[36]

This mismanagement and lack of foresight combined to produce significant shortfalls for state public employee pension funds in a very short period. In 2000, state pension plans had a $56 billion surplus, and the pension systems of more than half the states were fully funded.[37] Just eight years later, states' pension funds were collectively underfunded by more than one trillion dollars, and only four states—Florida, New York, Washington, and Wisconsin—had fully funded pension systems for public employees.[38] As a result, many states are struggling to regain control of their public pension programs and have passed reforms designed to bring their pension plans back to solvency.

III. A LEGAL BATTLE: CHALLENGES TO THE COLORADO, MINNESOTA, AND SOUTH DAKOTA PENSION REFORMS

Current retirees in Colorado, Minnesota, and South Dakota challenged those states' pension reforms on numerous state and federal constitutional grounds.[39] This Section summarizes Colorado's, Minnesota's, and South Dakota's attempts to reduce retired public employee pension benefits and provides a broad outline of the lawsuits that challenge this legislation. Then, Part IV explores the substance of those lawsuits' federal constitutional claims in more detail, as an example of the types of challenges to which similar laws passed in other jurisdictions might be subject, and analyzes the legality, under the U.S. Constitution, of state attempts to decrease pension benefits received by public employees who have already retired.

A. Colorado

On February 23, 2010, the governor of Colorado signed Senate Bill 10-001 into law. That law made several changes to the Colorado

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36. *Id.* at 29.

37. *Id.* at 16.

38. *Id.*

39. The similar New Jersey legislation, which only recently took effect, has not yet been challenged. It is therefore not discussed in detail here. The federal constitutional analysis of that legislation is analogous to the analysis below.

public employee pension system, known as the Public Employees' Retirement Association. Significantly, the bill eliminated a guaranteed 3.5% cost-of-living increase for retired state employees, replacing it with a formula that caps annual cost-of-living increases at 2%.[40]

Retired Colorado public employees who receive pensions from the Public Employees' Retirement Association sued the State in the Denver District Court, alleging that the legislature's changes to the public employee pension fund as applied to current retirees violate several provisions of the U.S. Constitution.[41] Specifically, they alleged that the reforms as applied to current retirees violate the Contracts Clause of the U.S. Constitution, embodied in Article I, Section 10.[42] They also alleged that the reforms violate the Takings Clause of the Fifth Amendment,[43] as well as the right to substantive due process provided by the Fourteenth Amendment.[44]

On June 29, 2011, the Colorado district court judge issued an order granting the State's motion for summary judgment and concluding that the plaintiffs' federal constitutional claims were meritless.[45] The judge found that the "[p]laintiffs unarguably have a contractual right to their PERA pension itself, [but] they do not have a contractual right to the specific [cost-of-living adjustment] formula in place at their respective retirement, for life without change."[46] The

40. COLO. REV. STAT. ANN. § 24-51-1002 (West 2010). The language here replaced prior language that stated, in relevant part, that the cost-of-living increase was to be "the total percent derived by multiplying three and one-half percent, compounded annually, times the number of years such benefit has been effective." COLO. REV. STAT. § 24-51-1002 (2008) (amended 2010).

41. Colorado Complaint, *supra* note 4, at 11–12.

42. *Id.* at 11. This provision states, in relevant part, "[n]o State shall . . . pass any . . . Law impairing the Obligation of Contracts . . . ." U.S. CONST. art. I, § 10, cl. 1.

43. Colorado Complaint, *supra* note 4, at 11–12. The Takings Clause prohibits the "tak[ing]" of private property "for public use, without just compensation." U.S. CONST. amend. V.

44. Colorado Complaint, *supra* note 4, at 12. The Fourteenth Amendment forbids states from "depriv[ing] any person of life, liberty, or property, without due process of law." U.S. CONST. amend. XIV, § 1. The Colorado plaintiffs also allege that the pension reforms violate article II, section 11 of the Colorado Constitution, which states that "[n]o ex post facto law, nor law impairing the obligation of contracts, or retrospective in its operation, or making any irrevocable grant of special privileges, franchises, or immunities, shall be passed by the general assembly." Colorado Complaint, *supra* note 4, at 9. The plaintiffs also argue that the reforms violate article V, section 38 of the Colorado Constitution, which states that "[n]o obligation or liability of any person, association, or corporation, held or owned by the state, or any municipal corporation therein, shall ever be exchanged, transferred, remitted, released, or postponed or in any way diminished by the general assembly, nor shall such liability or obligation be extinguished except by payment thereof into the proper treasury . . . ." *Id.* at 10.

45. Justus v. State, No. 2010-CV-1589, at *12 (Colo. Dist. Ct. June 29, 2011).

46. *Id.* at *4 (emphasis in original).

court reasoned, "[f]or four decades the [cost-of-living adjustment] formulas as applied to retirees have repeatedly changed and have never been frozen at the date of retirement."[47] Given this history, the court found that a retiree has no reasonable, investment-backed expectation of a particular cost-of-living adjustment for the duration of his retirement.[48] Thus, the legislature's adjustment of that formula does not violate the Contracts Clause of the U.S. Constitution.[49]

The court also found that "Plaintiffs' Takings Clause and Substantive Due Process claims necessarily fail because Plaintiffs' Contracts Clause [claim] fails."[50] With respect to the Takings Clause, the court reasoned, "[a]ny arguable property right . . . is premised on the notion that the Plaintiffs have a contractual right to a particular [cost-of-living adjustment] and thus fails where there is no such right."[51] Further, the court held, the law does not violate the plaintiffs' right to substantive due process because, without a contractual right to a specific cost-of-living adjustment, such a right cannot be fundamental.[52] Moreover, "the challenged legislation bears a reasonable relationship to the legitimate governmental interest of reaching a one hundred percent funded ratio for PERA within the next thirty years."[53] The legislation therefore survived rational basis review and did not offend the retirees' right to substantive due process.[54]

B. South Dakota

Prior to South Dakota's recent reforms, post-retirement annual increases for public employees were fixed at 3.1%.[55] The new law fixed the post-retirement increase in benefits at 2.1% for 2010.[56] After 2010, the annual percentage increase in post-retirement benefits is calculated based in part on the percent of the actuarial liability of the pension plan that is funded.[57] If the actuarial accrued liability funded ratio of the state's public employee pension plan is less than 80% in

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47. *Id.*
48. *Id.* at *9.
49. *Id.* at *10; *see infra* Part IV.C.1.
50. *Justus*, No. 2010-CV-1589, at *10.
51. *Id.* at *11.
52. *Id.*
53. *Id.*
54. *See infra* Part IV.A.
55. S.D. CODIFIED LAWS § 3-12-47(41) (2004) (amended 2010).
56. S.D. CODIFIED LAWS § 3-12-47(41) (2010).
57. *Id.*

any given year, the annual cost-of-living increase is fixed at 2.1%.[58] If the actuarial accrued liability funded ratio is 80% or greater but less than 90%, the annual rate of increase is based on the Consumer Price Index but must be "no less than" 2.1% and "no greater than" 2.4%.[59] If the ratio is 90% or greater but less than 100%, the annual rate of increase is also based on the Consumer Price Index but may be as high as 2.8%.[60] If the pension plan is fully funded to the extent of its calculated actuarial liability, the annual cost-of-living increase is 3.1%.[61] In the lawsuit challenging this plan, the plaintiffs project that the average retiree will take home between $40,264.42 and $77,414.68 less in pension benefits over the next twenty years as a result of these changes, assuming that the South Dakota Retirement System does not reach 100% funding.[62] Given that South Dakota's public employee pension plan was not fully funded at any point between 1988 and 2010, this is not a far-fetched assumption.[63]

The South Dakota plaintiffs make identical federal constitutional claims to those asserted in the Colorado lawsuit, alleging violations of the Contracts Clause, the Takings Clause, and the right to substantive due process guaranteed by the Fourteenth Amendment.[64] The case is presently pending in the Circuit Court for the Sixth Judicial Circuit of South Dakota, a state trial court.

C. Minnesota

The Minnesota pension reform law is structured similarly to that of South Dakota. Prior to the recently enacted reforms, most retired public employees were entitled to postretirement increases of

58. *Id.*

59. *Id.*

60. *Id.*

61. *Id.*

62. South Dakota Complaint, *supra* note 6, at 8–9. Before the changes, the average retiree would have received $1,021,101.48 in total benefits over twenty years; however, with the changes, the same retiree will receive between $943,686.80 and $980,836.86 in total benefits over twenty years.

63. SOUTH DAKOTA RETIREMENT SYSTEM, COMPREHENSIVE ANNUAL FINANCIAL REPORT 47 (2010), *available at* http://www.sdrs.sd.gov/publications/documents/CAFR2010.pdf.

64. South Dakota Complaint, *supra* note 6, at 11–13. The plaintiffs in the South Dakota case also argue that the pension reforms in that state violate article VI, section 12 of the South Dakota Constitution, which provides that "[n]o ex post facto law, or law impairing the obligation of contracts or making any irrevocable grant of privilege, franchise or immunity, shall be passed." *Id.* at 10.

2.5% annually.[65] On May 24, 2010, the Minnesota Legislature amended this provision, limiting the annual increase to 2% for those government employees.[66] The reduction applies to employees who have already retired and continues until "the market value of assets of the retirement plan equals or exceeds 90% of the actuarial accrued liability of the retirement plan."[67]

Current retirees who receive pensions from Minnesota's public employee retirement fund sued in the District Court of the Second Judicial District of Minnesota. Those plaintiffs, like the plaintiffs in the Colorado and South Dakota cases, allege violations of Article I, Section 10 of the U.S. Constitution, as well as the Fifth Amendment's Takings Clause.[68] Significantly, however, the Minnesota plaintiffs do not allege a substantive due process violation.[69] On June 29, 2011, the Minnesota district court judge entered an order granting the State's motion for summary judgment and concluding that Minnesota's pension reform law was permissible under the U.S. Constitution.[70]

In rejecting the Contracts Clause challenge, the Minnesota court found, "[T]here is no express contract to use only the statutory [cost-of-living] adjustment formula that is in effect as of a member's retirement."[71] Moreover, the court found retirees have no implied contractual right to a particular cost-of-living adjustment because there is no indication the legislature intended to create such a right.[72] Therefore, changing the formula does not violate the Contracts Clause of the U.S. Constitution.[73] Moreover, even if there were such a contractual right, the court added, the law at issue would not substantially impair that right because "[t]he fundamental retirement benefit structure for Plaintiffs is the same both before and after enactment of the challenged legislation [and] Plaintiffs . . . remain eligible for an annual adjustment based on a statutory formula."[74]

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65. MINN. STAT. ANN. § 356.415 (West 2009), *amended by* 2010 Minn. Sess. Law Serv. ch. 359, § 78 (West).

66. 2010 Minn. Sess. Law Serv. ch. 359, § 78 (West).

67. *Id.*

68. Minnesota Complaint, *supra* note 5, at 15–16. The plaintiffs in the Minnesota case also allege violations of state constitutional law. Specifically, they allege violations of the Contracts Clause, article I, section 11 of the Minnesota Constitution and the Takings Clause, article I, section 13 of the Minnesota Constitution. *Id.* at 13–15.

69. *See infra* note 79.

70. Swanson v. State, No. 62-CV-10-05285, at *1–2 (Minn. Dist. Ct. June 29, 2011).

71. *Id.* at 16.

72. *Id.* at 19.

73. *Id.* at 21–25.

74. *Id.* at 22–23.

With respect to the Takings Clause, the Minnesota district court concluded that the plaintiffs failed to demonstrate that they have a property right to a statutory cost-of-living adjustment formula.[75] According to the court, the plaintiffs' Takings Clause challenge "rest[s] ultimately on the expectation that future adjustments would be made pursuant to a particular formula."[76] Because the court concluded this expectation was unreasonable, the court found that any Takings Clause challenge must fail.[77]

IV. UNSATISFACTORY SOLUTIONS: FEDERAL CONSTITUTIONAL ANALYSIS OF STATE SOLUTIONS TO THE PENSION SOLVENCY PROBLEM

This Section analyzes federal constitutional challenges to pension reform laws that reduce the cost-of-living adjustment to which currently retired employees are entitled in light of the recent Minnesota and Colorado decisions. First, it considers substantive due process challenges to these types of reforms. It then explores whether, despite the holdings of the Minnesota and Colorado district courts, such reforms constitute a violation of the Takings Clause of the Fifth Amendment. Finally, it analyzes the viability of arguing that these types of reforms violate the Contracts Clause of Article I, Section 10 after the Colorado and Minnesota decisions.

A. Substantive Due Process

In the Colorado and South Dakota lawsuits,[78] the plaintiffs allege that the state legislatures violated their substantive due process rights.[79] Plaintiffs in both lawsuits argue their pension benefits became vested property rights when they became eligible to retire.[80] At that time, plaintiffs' pension benefits included annual cost-of-living increases that were substantially higher than the cost-of-living increases they receive under the new reforms.[81] The plaintiffs

75. *Id.* at 26.

76. *Id.*

77. *Id.*

78. *See supra* Part III.A–B.

79. The Minnesota lawsuit does not include a substantive due process challenge. I speculate that this is because, as I conclude here, any substantive due process challenge to pension reform laws that alter the amount of benefits to which current retirees are entitled will almost certainly fail.

80. Colorado Complaint, *supra* note 4, at 5; South Dakota Complaint, *supra* note 6, at 6.

81. *See* Colorado Complaint, *supra* note 4, at 7–9 (summarizing the decrease in the cost-of-living adjustment for retired Colorado employees, which went from 3.5% before the reforms to a

argue this reduction constitutes an arbitrary and unlawful interference with their substantive due process rights.[82] To analyze the merits of this claim, it is necessary to provide an overview of substantive due process jurisprudence. This Section first summarizes how courts analyze substantive due process claims and then applies the analysis to laws that reduce the pension benefits of public employees who have already retired.

1. Analysis of Substantive Due Process Claims

The Fourteenth Amendment to the U.S. Constitution prohibits states from "depriv[ing] any person of life, liberty, or property, without due process of law."[83] The Supreme Court has interpreted this language as guaranteeing not only procedural rights but also substantive rights.[84] Thus, the doctrine of substantive due process provides a mechanism by which courts may "invalidate . . . legislation if the content is deemed on some basis to be unsatisfactory."[85]

To determine whether a substantive due process claim has merit, it is first necessary to characterize the nature of the right purportedly violated.[86] If the right is fundamental, the policy affecting the right must survive strict scrutiny in order to be upheld.[87] In other words, the policy must be "narrowly tailored to serve a compelling state interest."[88] However, if the right is not fundamental, the court will defer to the legislature's judgment and uphold the policy so long as it is rationally related to a legitimate government purpose.[89]

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maximum of 2% after the reforms); South Dakota Complaint, *supra* note 6, at 7–8 (discussing the decrease in the cost-of-living adjustment for retired South Dakota employees, which went from 3.1% before the challenged reforms to between 2.1% and 2.8% after the reforms, depending on the level of funding of the state pension fund).

82. Colorado Complaint, *supra* note 4, at 12; South Dakota Complaint, *supra* note 6, at 13.

83. U.S. CONST. amend. XIV, § 1.

84. Eric Pearson, *Some Thoughts on the Role of Substantive Due Process in the Federal Constitutional Law of Property Rights Protection*, 25 PACE ENVTL. L. REV. 1, 2–3 (2008).

85. *Id.* at 1.

86. *See* Davida H. Isaacs, *Shifting Constitutional Sands: Can and Should Patentholders Rely on the Due Process Clause to Thwart Government Action?*, 35 FLA. ST. U. L. REV. 627, 660 (2008).

87. *Id.*; *see also* United States v. Carolene Prods. Co., 304 U.S. 144, 152 n.4 (1938) ("There may be narrower scope for operation of the presumption of constitutionality when legislation appears on its face to be within a specific prohibition of the Constitution, such as those of the first ten Amendments, which are deemed equally specific when held to be embraced within the Fourteenth.").

88. Washington v. Glucksberg, 521 U.S. 702, 721 (1997).

89. *See, e.g.*, Williamson v. Lee Optical of Okla., Inc., 348 U.S. 483, 487–88 (1955) ("[T]he law need not be in every respect logically consistent with its aims to be constitutional. It is

To determine whether a right is fundamental for substantive due process purposes, the Supreme Court looks to whether the right is " 'deeply rooted in this Nation's history and tradition,' . . . and 'implicit in the concept of ordered liberty,' such that 'neither liberty nor justice would exist if [the right was] sacrificed.' "[90] The Court also cautions that the asserted right must be carefully described.[91]

Generally, economic rights are not fundamental. In *West Coast Hotel Co. v. Parrish*, which exemplifies the Court's traditionally deferential review of substantive due process challenges to economic and social legislation, the Court held that freedom to contract was not a fundamental right for substantive due process purposes.[92] In that case, the plaintiff challenged a state law establishing a minimum wage for women on substantive due process grounds.[93] Such a law implicated the right to contract because it affected whether employers and employees could agree on a wage structure. In rejecting this challenge, the Court noted that the Constitution does not explicitly guarantee a right to contract.[94] The Court further explained that the right to liberty guaranteed by the Fourteenth Amendment does not protect an absolute right to contract.[95] Instead, it protects from "arbitrary restraint, not immunity from reasonable regulations and prohibitions imposed in the interests of the community."[96] Following the decision in *West Coast Hotel*, the Court continued to uphold economic regulations against substantive due process challenges. The Court has not struck down any economic regulation on substantive due process grounds since 1937 and has continued to apply rational basis review to such cases.[97]

Under rational basis review, the Court will uphold the challenged policy so long as it is rationally related to a legitimate

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enough that there is an evil at hand for correction, and that it might be thought that the particular legislative measure was a rational way to correct it."); *Carolene Prods.*, 304 U.S. at 152 ("[R]egulatory legislation affecting ordinary commercial transactions is not to be pronounced unconstitutional unless in the light of the facts made known or generally assumed it is of such a character as to preclude the assumption that it rests upon some rational basis within the knowledge and experience of the legislators." (citing Metro. Cas. Ins. Co. v. Brownell, 294 U.S. 580, 584 (1935)).

90. *Glucksberg*, 521 U.S. at 720–21.

91. *Id.* at 721.

92. W. Coast Hotel Co. v. Parrish, 300 U.S. 379, 392 (1937).

93. *Id.* at 388.

94. *Id.* at 391.

95. *Id.* at 392.

96. *Id.* (quoting Chi., Burlington & Quincy R.R. v. McGuire, 219 U.S. 549, 565 (1911)).

97. ERWIN CHEMERINSKY, CONSTITUTIONAL LAW: PRINCIPLES AND POLICIES 625 (3d ed. 2006).

government purpose.[98] Courts may infer a legitimate government purpose, even in the absence of a specific legislative declaration. Under this deferential framework, the courts must uphold a policy so long as there is any *conceivable* rational relationship between the law and a legitimate government purpose.[99] Moreover, a court may not strike down a policy simply because it believes the policy is unwise. The legislature, not the courts, judges the wisdom of adopting a particular policy. All that is required to survive rational basis review is that "there is an evil at hand for correction, and that it might be thought that the particular legislative measure was a rational way to correct it."[100]

In *Pension Benefits Guarantee Corp. v. R.A. Gray & Co.*, the Supreme Court suggested courts that analyze legislation affecting the distribution of retirement benefits should employ rational basis review. *Pension Benefits* presented a substantive due process challenge to a portion of ERISA, which Congress enacted in large part to "guarantee that 'if a worker has been promised a defined pension benefit upon retirement—and if he has fulfilled whatever conditions are required to obtain a vested benefit—he will actually receive it.' "[101] In order to effect this purpose, Congress passed a law, the Multiemployer Pension Plan Amendments Act of 1980 ("MPPAA"), that required employers who withdrew from multiemployer pension plans to pay a certain amount of money to the pension plan.[102] Specifically, the withdrawing employer was required to pay "the employer's proportionate share of the plan's 'unfunded vested benefits', calculated as the difference between the present value of vested benefits and the current value of the plan's assets."[103]

Plaintiff R.A. Gray & Co. was a member of a multiemployer pension plan and indicated its intent to withdraw from the plan.[104] After R.A. Gray indicated its desire to withdraw, Congress passed the MPPAA, which included a retroactivity provision that made it

98. *Id.*

99. *See* Williamson v. Lee Optical of Okla., Inc., 348 U.S. 483, 487 (1955) (upholding an Oklahoma law prohibiting opticians from duplicating lenses without a prescription from an optometrist or ophthalmologist because "[t]he legislature *might* have concluded that the frequency of occasions when a prescription is necessary was sufficient to justify this regulation of the fitting of eyeglasses" (emphasis added)).

100. *Id.* at 488.

101. Pension Benefit Guar. Corp. v. R.A. Gray & Co., 467 U.S. 717, 720 (1984) (quoting Nachman Corp. v. Pension Benefit Guar. Corp., 446 U.S. 359, 375 (1980)).

102. *Id.* at 724–25.

103. *Id.* at 725.

104. *Id.*

applicable to R.A. Gray.[105] The pension plan then notified R.A. Gray that it was required to pay $201,359 before withdrawing from the plan.[106] R.A. Gray filed suit, alleging the retroactive application of the law to R.A. Gray violated R.A. Gray's right to substantive due process, because it was "arbitrary and irrational, and because it impaired the collective-bargaining agreements that Gray had signed."[107]

In upholding the retroactive application of the MPPAA, the Court noted that it presumes economic legislation is constitutional, and that the plaintiff carries the burden of showing "that the legislature has acted in an arbitrary and irrational way."[108] As long as the retroactive application of the MPPAA was "justified by a rational legislative purpose," it would not violate substantive due process.[109] Significantly, the Court noted its "cases are clear that legislation readjusting rights and burdens is not unlawful solely because it upsets otherwise settled expectations."[110] The Court found it "eminently rational for Congress to conclude that the purposes of the MPPAA could be more fully effectuated if its withdrawal liability provisions were applied retroactively."[111] Therefore, the retroactive application of the MPPAA did not violate R.A. Gray's substantive due process rights.[112]

2. Application of the Substantive Due Process Analysis to Pension Reform Lawsuits

A court should apply rational basis review to laws that reduce retired public employee pension benefits. It is unwise to treat public employees' rights to a defined amount of pension benefits as fundamental. Such a ruling would not be in accord with Supreme Court precedent.[113] *R.A. Gray & Co.* strongly suggests courts analyze legislation affecting pension plans as economic legislation for substantive due process purposes. The right to a predetermined pension is analogous to the right to contract that the Supreme Court held was not fundamental in *West Coast Hotel*. Like the right to

105. *Id.* at 726.
106. *Id.* at 725.
107. *Id.* at 725–26.
108. *Id.* at 729.
109. *Id.* at 730.
110. *Id.* at 729.
111. *Id.* at 730.
112. *Id.* at 734.
113. *See supra* Part IV.A.1.

contract, it does not appear in the text of the Constitution. Nor is there any evidence that granting pensions to public employees is " 'deeply rooted in this Nation's history and tradition,' . . . and 'implicit in the concept of ordered liberty,' such that 'neither liberty nor justice would exist if they were sacrificed.' "[114] State governments did not begin to offer pensions to their employees until the early twentieth century.[115] As late as 1961, five states still did not provide pensions for public employees.[116] A public employee's right to any pension benefits, let alone his right to a specific level of annual cost-of-living adjustments, is not a fundamental right. Perhaps for these reasons, neither the Colorado nor the South Dakota plaintiffs even attempt to assert a fundamental right.

The Colorado and South Dakota plaintiffs argue that with regard to state employee pension reduction, the legislatures made arbitrary decisions.[117] Plaintiffs argue that even under deferential rational basis review, the legislatures' decisions to modify the terms of pension agreements violate substantive due process.[118] They are wrong.

Laws that reduce the amount of benefits to which retired public employees are entitled satisfy rational basis review because they are rationally related to the achievement of a legitimate government purpose. For example, the Colorado legislature titled its law, "An Act Concerning Modifications to the Public Employees' Retirement Association Necessary to Reach a One Hundred Percent Funded Ratio Within the Next Thirty Years."[119] Given this title, along with the fact that, at the end of fiscal year 2008, Colorado's public employee pension plan was only 70% funded, it is reasonable to infer that the legislature intended Senate Bill 10-001 to help return Colorado's public employee pension system to solvency.[120] This is unquestionably a legitimate government purpose.[121] Moreover, decreasing the rate of the annual cost-of-living adjustments to which both current and future retirees

114. Washington v. Glucksberg, 521 U.S. 702, 720–21 (1997) (citations omitted).

115. Olivia S. Mitchell, *The Future of Public Employee Retirement Systems*, *in* THE FUTURE OF PUBLIC EMPLOYEE RETIREMENT SYSTEMS 1, 9 (Olivia S. Mitchell & Gary Anderson eds., 2009).

116. *Id.* at 10.

117. *Id.*

118. Colorado Complaint, *supra* note 4, at 12; South Dakota Complaint, *supra* note 6, at 13.

119. Act of Feb. 23, 2010, ch. 2, 2010 Colo. Legis. Serv. 2 (West).

120. PEW CTR., TRILLION DOLLAR GAP, *supra* note 8, at 17 exhibit 8.

121. *See, e.g.*, Leheny v. City of Pittsburgh, 183 F.3d 220, 226 (3d Cir. 1999) (legislating to maintain "fiscal integrity" of a government benefits system is a legitimate government purpose); Flaherty v. Giambra, 446 F. Supp. 2d 153, 159 (W.D.N.Y. 2006) (reducing costs so as to reduce the burden on taxpayers is a legitimate government purpose).

are entitled is rationally related to this purpose. By decreasing the rate of the annual cost-of-living adjustment, the state must pay less money each year to the beneficiaries of the public employee pension system. The savings will become greater over time, as the reduced rates cause the principals on which the cost-of-living adjustments must be paid to become smaller than they would have been had the cost-of-living adjustment not been decreased.

While a legislature could reduce its pension liability by only decreasing the cost-of-living adjustment for employees who are not yet vested in the pension system, the fact that it chooses not to do so is not fatal to the substantive due process inquiry. When applying rational basis review to substantive due process claims, courts need not concern themselves with the precise means by which the legislature chooses to act.[122] Moreover, to the extent that the law applies retroactively because it changes the benefits to which already vested employees are entitled, the substantive due process analysis is the same. As the Supreme Court explained in *R.A. Gray & Co.*, retroactive economic legislation survives a substantive due process challenge where "the retroactive application of the legislation is itself justified by a rational legislative purpose."[123]

Here, the Colorado legislature could have rationally concluded that applying the reduction in the rate of the cost-of-living adjustment to employees who were already vested in the retirement system would better help achieve the goal of fully funding the public employees' pension fund. The language quoted above from *R.A. Gray & Co.* is instructive: "[L]egislation readjusting rights and burdens is not unlawful solely because it upsets otherwise settled expectations."[124]

Similarly, the South Dakota pension reform law does not violate plaintiffs' rights to substantive due process. Although there is no indication in either the legislative history or the text itself of the South Dakota law that the legislature adopted the pension reforms to ensure that the public employee pension fund remains solvent, there is ample evidence to conclude this was conceivably the legislature's motivation. The legislature was most likely aware of the recent Pew Center report and the problems facing public employee pension funds in other states, and it is not a stretch to assume the legislature was

122. *See* Williamson v. Lee Optical of Okla., Inc., 348 U.S. 483, 488 (1955) ("The day is gone when the Court uses the Due Process Clause of the Fourteenth Amendment to strike down state laws . . . because they may be unwise, improvident, or out of harmony with a particular school of thought.").

123. Pension Benefit Guar. Corp. v. R.A. Gray & Co., 467 U.S. 717, 730 (1984).

124. *Id.* at 729 (internal quotations omitted).

motivated by a desire to ensure that South Dakota's public employee pension fund become fully funded. The law's coupling of the rate of the annual cost-of-living adjustment to which public employees are entitled with the level of funding of the pension system as a whole implies such an intent.[125]

Even if this intent cannot be conclusively proven, the South Dakota law survives a substantive due process challenge. The South Dakota legislature could have plausibly concluded that tying the rate of annual cost-of-living adjustments to the level of funding of the pension system as a whole was a rational way to achieve a legitimate government purpose, namely ensuring that the state public employee pension fund remains solvent. South Dakota's law therefore survives substantive due process review.

Given that courts will likely evaluate any legislation affecting the level of benefits to which a currently retired individual is entitled under rational basis review and that preserving public employee pension fund solvency is a legitimate government purpose, substantive due process challenges to such laws fail. In fact, a Colorado district court correctly rejected a substantive due process challenge to this type of pension reform, concluding that the right to a particular pension benefit is not a fundamental right and that the law was rationally related to a legitimate government purpose. Because of the extremely deferential review of substantive due process challenges to economic legislation, any substantive due process challenge to this type of pension reform will fail. Thus, plaintiffs should look to other areas of the Constitution.

B. Takings Clause

The Takings Clause of the Fifth Amendment prohibits taking "private property . . . for public use, without just compensation."[126] Although the Takings Clause, like the rest of the Bill of Rights, did not originally limit the power of state governments, the Supreme Court held the Fourteenth Amendment incorporated the Takings Clause to the states.[127] To show a taking, the plaintiff must first establish the

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125. *See* S.D. CODIFIED LAWS § 3-12-47(41) (2010) (describing the various methods of calculating the rate of the annual cost-of-living adjustment based on the level of funding of the public employee pension fund).

126. U.S. CONST. amend. V.

127. Chi., Burlington & Quincy R.R. v. Chicago, 166 U.S. 226, 233–34 (1897).

government's action infringed on his property interest.[128] Next, the plaintiff must show that the detriment to his property interest was caused directly by the government's conduct.[129] Once these two threshold elements have been established, a court must determine whether the government's taking was for a "public use."[130] If the taking was not for a public use, the government action cannot be sustained, regardless of whether the plaintiff was compensated for the loss.[131] If the taking was for public use, then the court must determine whether the government paid "just compensation" to the person whose property interest it violated.[132]

In the lawsuits challenging the Colorado, Minnesota, and South Dakota pension reforms, the plaintiffs allege vested members of the public employee pension plans have a property interest in continuing to receive their pensions at the rates specified by statute at the time they began receiving benefits.[133] The plaintiffs contend the pension reform laws that decrease the amount of compensation to which they are entitled constitute takings under the Fifth Amendment, as incorporated to the states by the Fourteenth Amendment, because they amount to government infringement on the plaintiffs' property interests without just compensation.[134]

1. Property Interest

To successfully challenge pension reform laws under the Takings Clause, a plaintiff must first establish he has a property interest in receiving pension benefits at the pre-reform cost-of-living adjustment level. The Supreme Court held that property interests "extend well beyond actual ownership of real estate, chattels, or money."[135] At least two states—Connecticut and New Mexico—recognize a property interest in public employee pension benefits.[136]

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128. Robert Meltz, *Takings Law Today: A Primer for the Perplexed*, 34 ECOLOGY L.Q. 307, 317 (2007).

129. *Id.* at 321.

130. *See id.* at 326 ("If [a taking] is not [for public use], the government act is void regardless of whether compensation is paid.").

131. *Id.*

132. CHEMERINSKY, *supra* note 97, at 640.

133. Colorado Complaint, *supra* note 4, at 11; Minnesota Complaint, *supra* note 5, at 16; South Dakota Complaint, *supra* note 6, at 12.

134. Colorado Complaint, *supra* note 4, at 12; Minnesota Complaint, *supra* note 5, at 16; South Dakota Complaint, *supra* note 6, at 12.

135. Bd. of Regents of State Colls. v. Roth, 408 U.S. 564, 572 (1972).

136. *See* Amy B. Monahan, *Public Pension Plan Reform: The Legal Framework*, 5 EDUC. FIN. & POL'Y 617, 638–39 tbl.1 (2010) (summarizing the legal protections granted by each state to

Despite this property interest, Takings Clause challenges to modifications of public employee pension systems have uniformly failed.[137]

The recent Colorado and Minnesota cases are no different. In those cases, the district courts concluded retirees do not have a property interest to a specific cost-of-living adjustment formula.[138] Thus, those courts concluded, the Colorado and Minnesota pension reform laws do not violate the Takings Clause of the U.S. Constitution.

Despite this holding, a plaintiff challenging a similar pension reform law would be wise to include a Takings Clause challenge. Because state law determines whether a property interest exists, the Colorado and Minnesota decisions have no precedential value outside of those states. The rest of this Section explains how a plaintiff might argue that a reduction in an annual cost-of-living adjustment as applied to current retirees violates the Takings Clause once a state court finds a plaintiff has a property right to a fixed cost-of-living adjustment.

2. Detriment to the Property Interest Caused by Government Conduct

Because legislative reform of the pension benefits to which public employees are entitled does not constitute a physical deprivation of property, to succeed on a Takings Clause claim, the plaintiffs must be able to demonstrate that the deprivation of pension benefits caused a regulatory taking. The Supreme Court articulated the framework of such a claim in *Pennsylvania Coal Co. v. Mahon*. The Court explained that a showing of physical occupation of one's property by the government is not a prerequisite to a successful Takings Clause challenge. Rather, a plaintiff may establish a taking by demonstrating that the government's regulation of his property

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public employee pensions); *see also* N.M. CONST. art. XX, § 22D ("Upon meeting the minimum service requirements of an applicable retirement plan created by law for employees of the state . . . , a member of a plan shall acquire a vested property right . . . ."); Pineman v. Oechslin, 488 A.2d 803, 810 (Conn. 1985) ("[T]he statutory pension scheme establishes a property interest on behalf of all state employees in the existing retirement fund . . . .").

137. Monahan, *supra* note 136, at 637. *But see* Pierce v. State, 910 P.2d 288, 304 (N.M. 1995) (suggesting that "public retirement plans create a property interest upon vesting" that "may not be taken without just compensation," but deciding the case on other grounds); Copeland v. Copeland, 575 P.2d 99, 102 (N.M. 1978) (noting in dicta that "[a] retirement right that has 'vested' is a property right" that is entitled to Constitutional protection).

138. Justus v. State, No. 2010-CV-1589, at *11 (Colo. Dist. Ct. June 29, 2011); Swanson v. State, No. 62-CV-10-05285, at *26 (Minn. Dist. Ct. June 29, 2011).

impermissibly infringes on the plaintiff's property interest.[139] Since that landmark decision, the Court articulated the framework under which it analyzes regulatory takings claims, applying a three-factor test:

> [W]e have eschewed the development of any set formula for identifying a "taking" forbidden by the Fifth Amendment, and have relied instead on ad hoc, factual inquiries into the circumstances of each particular case. To aid in this determination, however, we have identified three factors which have "particular significance": (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."[140]

Courts can apply this three-factor analysis to public employee pension reform laws that decrease the amount of benefits to which retirees are entitled. The first factor considers the economic impact the challenged law has on the plaintiffs. This factor weighs in favor of finding a governmental taking, because pension reform laws that reduce the amount of benefits a current retiree will receive adversely affect those retirees economically.[141] Moreover, in the four such laws that have already been passed, there are no features that mitigate the loss of promised earnings, further contributing to a finding that these types of legislative actions have an adverse economic impact on current retirees.[142]

The second factor requires courts to analyze "the extent to which the regulation has interfered with distinct investment-backed expectations" of the plaintiffs.[143] To constitute a reasonable investment-backed expectation, a plaintiff must be able to demonstrate that he has more than "a mere unilateral expectation or an abstract need" for the property in question.[144] In *Pineman v. Fallon*, the Second Circuit held that a showing of a contractual right to a benefit is necessary to show a frustration of reasonable investment-based expectations.[145] This is potentially problematic because, in states that recognize property rights to pension benefits,

139. Pa. Coal Co. v. Mahon, 260 U.S. 393, 415 (1922).

140. Connolly v. Pension Benefit Guar. Corp., 475 U.S. 211, 224–25 (1986) (citations omitted).

141. For examples of allegations that these types of pension reforms result in substantial economic harm to current retirees from the ongoing Colorado, Minnesota, and South Dakota lawsuits, see *supra* notes 4–6 and accompanying text.

142. *See Connolly*, 475 U.S. at 225–26 (noting that provisions that moderate or mitigate the economic impact can lead to a finding that a plaintiff's economic interest is not sufficiently affected).

143. *Id.* at 224–25.

144. Webb's Fabulous Pharmacies, Inc. v. Beckwith, 449 U.S. 155, 161 (1980).

145. Pineman v. Fallon, 842 F.2d 598, 603 (2d Cir. 1988).

courts have traditionally declined to recognize that a pension creates a contractual obligation.[146] Although that decision appears to foreclose any Takings Clause challenge, *Pineman v. Fallon* is distinguishable because its reasoning depends on having plaintiffs who are not yet vested in the pension system.[147]

To convince a court that a retiree has a reasonable investment-backed expectation of the specific cost-of-living formula in place when he retired, a plaintiff should argue that public employees who have already become vested in a retirement system have more than a unilateral expectation in continuing to receive benefits in the manner they were promised when they became vested in the system. Although the recent Minnesota district court opinion rejected such a claim, at least one state court appears amenable to it. In *Pierce v. State*, the New Mexico Supreme Court considered the constitutionality of a repeal of state income tax exemptions that retirees received through public employee pension plans.[148] The court held that the legislation did not violate the Takings Clause because "there [was] no vested right to receive pension benefits free from tax."[149] The court found, however, that "public retirement plans create a property interest [in the amount of pension benefits promised] *upon vesting*" that is protected by the Takings Clause of the U.S. Constitution.[150] Hence, "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."[151] Thus, for that court, the critical distinction in whether there is a reasonable investment-based expectation in a specified formula for calculating the cost-of-living adjustment is whether the employee is vested in the system. Unlike the removal of the tax exemption in *Pierce*, which did not affect the amount of pension benefits that the retiree received but only the amount of tax he was required pay, a decrease in the cost-of-living adjustment directly alters the amount of benefits to which vested employees are entitled.[152] Thus, those retirees arguably have a

146. *See, e.g.*, Pineman v. Oechslin, 488 A.2d 803, 808–09 (Conn. 1985).

147. *See Fallon*, 842 F.2d at 602 (noting that the modifications there were being challenged because they put employees who would vest within five years in a better position than employees who would vest in more than five years).

148. Pierce v. State, 910 P.2d 288, 292 (N.M. 1995).

149. *Id.* at 304.

150. *Id.* (emphasis added).

151. *Id.* (quoting Copeland v. Copeland, 575 P.2d 99, 102 (N.M. 1978)).

152. *Cf. id.* at 302 ("Although the substantive right to receive benefits confers a property right upon vesting, the tax exemptions are not contained within the provisions defining the substantive rights of employees to receive benefits.").

reasonable investment-based expectation in the annual cost-of-living increase at the rate in place when they retired.

The third factor courts must consider in determining whether a regulatory taking is present is the character of the governmental action. In an early formulation of this factor, the Supreme Court explained that a taking "may more readily be found when the interference with property can be characterized as a physical invasion by government . . . than when interference arises from some public program adjusting the benefits and burdens of economic life to promote the common good."[153] One permissible consideration is "a balancing of the public interest advanced by the government measure[d] against the burden on the property owner."[154] At least one federal court of appeals has interpreted this requirement to mean that, to establish a regulatory taking, the plaintiff must show that "the government has improperly shifted a public burden to a small class of private parties."[155]

Here, the primary justification for reducing the rate of annual cost-of-living increases to which public employees are entitled is the states' desires to return their public employee pension systems to solvency.[156] Although this may seem like a public program designed to promote the common good, the plaintiffs fall within a small group of people who must carry a greater share of the public burden in decreasing the unfunded liability of the public pension reform plans. In many instances, states took money out of public employee pension funds (or the actuarially required contributions were not met) because state officials decided it was in the public's best interest to use that money elsewhere. While only public employees would be harmed by the depletion of these funds, other citizens benefitted at the expense of public employees by enjoying otherwise impossible programs.[157] The legislatures in many states chose to fund other programs at the expense of the public employee retirement fund.

Because of this choice, public employee retirement funds in many states are in bad shape.[158] The problem from a Takings Clause perspective is that the legislatures' current solutions unfairly place the burden of funding those additional programs on public employees

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153. Penn Cent. Transp. Co. v. City of New York, 438 U.S. 104, 124 (1978).

154. Meltz, *supra* note 128, at 342.

155. Cienega Gardens v. United States, 331 F.3d 1319, 1328 (Fed. Cir. 2003) (citing Armstrong v. United States, 364 U.S. 40, 49 (1960)).

156. *See supra* notes 119–125 and accompanying text.

157. *See id.*

158. *See id.*

by forcing them to accept decreased pension benefits. Therefore, the government's conduct deprives retirees of any property interest they might have in the cost-of-living provisions of their pensions.[159]

3. Public Use

Assuming the plaintiffs can establish a regulatory taking, the next element a court must consider is whether such a taking is for public use. If the taking is for private, and not public use, then the government is not justified in taking the property and must return it to the plaintiffs.[160] The Supreme Court has interpreted the public use requirement broadly. As long as a taking is rationally related to a legitimate government interest, that taking is for public use.[161] In *Berman v. Parker*, for example, the Court held that the District of Columbia's use of its eminent domain power to acquire some dilapidated properties with the intent of selling or leasing them to private parties for development constituted a public use for Takings Clause purposes.[162] If selling blighted property to private developers constitutes public use, then reducing the amount of benefits retirees receive from public employee pension funds for the purpose of making those funds solvent must also be a public use. Such a reduction is rationally related to a legitimate public interest.[163]

4. Just Compensation

Under the Takings Clause, when a government entity takes a private individual's property for public use, it must provide just compensation. In order to determine the amount of compensation that is just, the relevant inquiry is the loss in value the private property owner suffers, not the gain the government receives.[164] Thus, just compensation is typically calculated as "the fair market value of the property on the date it is appropriated."[165]

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159. *See Cienega Gardens*, 331 F.3d at 1328 (finding a taking where federal law altered plaintiffs' ability to pre-pay mortgages).

160. CHEMERINSKY, *supra* note 97, at 662.

161. *Id.*

162. Berman v. Parker, 348 U.S. 26, 33 (1954).

163. *See supra* Part IV.A.

164. CHEMERINSKY, *supra* note 97, at 664.

165. Kirby Forest Indus., Inc. v. United States, 467 U.S. 1, 10 (1984). Exceptions to using fair market value to determine the amount of compensation that the government must pay arise only in limited circumstances, specifically "when market value [is] too difficult to find, or when its application would result in manifest injustice to owner or public . . . ." *Id.* at 10 n.14 (alteration in original) (quoting United States v. Commodities Trading Corp., 339 U.S. 121, 123 (1950)).

Here, the fair market value of the property that the plaintiffs lost is easily calculated. To determine the amount of compensation to which a current retiree is entitled, one need only subtract the amount of benefits the retiree received after the reform from the amount of benefits the pension recipient would have received under the pre-reform annual cost-of-living adjustment. This calculation will produce a dollar figure that represents the fair market value of the property the government took from the plaintiffs as a result of the challenged legislative action.

Based on the foregoing analysis, there is a strong possibility that plaintiffs challenging reductions in the pension benefits provided to currently retired employees will be able to establish a Takings Clause violation. There is, however, one caveat. A necessary prerequisite to succeeding on a Takings Clause claim is judicial recognition that public employee pensions create a property right. State law determines whether such a right exists. The Minnesota and Colorado courts that considered challenges to recent public employee pension reforms refused to find one. However, those decisions rested on an interpretation of state law. Therefore, they are of no precedential value in other states. Only two states—New Mexico and Connecticut—have explicitly held that vested employees (those eligible for retirement and those who have already retired) have a property right to the level of benefits provided at the time they became vested.[166] Nevertheless, a plaintiff seeking to challenge a law that reduces the amount of benefits that vested retirees in a state's public employee retirement system will receive should include a Takings Clause challenge in his lawsuit.

C. Contracts Clause

Article I, Section 10 of the U.S. Constitution states that "[n]o State shall . . . pass any . . . Law impairing the Obligation of Contracts."[167] During the early 1800s, the Supreme Court interpreted the Contracts Clause as a significant limitation on the power of state governments.[168] However, the Supreme Court greatly cabined the

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166. N.M. CONST. art. XX, § 22D ("Upon meeting the minimum service requirements of an applicable retirement plan created by law for employees of the state . . . , a member of a plan shall acquire a vested property right . . . ."); Pineman v. Oechslin, 488 A.2d 803, 810 (Conn. 1985) ("[T]he statutory pension scheme establishes a property interest on behalf of all state employees in the existing retirement fund . . . .").

167. U.S. CONST. art. I, § 10 cl. 1.

168. CHEMERINSKY, *supra* note 97, at 631.

scope of these decisions during the New Deal era. *Home Building & Loan Ass'n v. Blaisdell* involved a Contracts Clause challenge to the Minnesota Mortgage Moratorium Law, which temporarily prevented mortgage companies from foreclosing on properties in the state because of the Great Depression.[169] Although the law interfered with a contractual obligation between two private parties, the Court upheld it, holding that Contracts Clause protection "is not . . . absolute . . . and is not to be read with literal exactness like a mathematical formula."[170] The Court reasoned that states' obligation to "safeguard the vital interests of [their] people" must be "read into contracts as a postulate of the legal order."[171] Therefore, "[t]he economic interests of the State may justify the exercise of its continuing and dominant protective power notwithstanding interference with contracts."[172] In order to determine whether a state law unconstitutionally impairs the right of two private parties to contract, the Court uses an inquiry similar to rational basis review of economic legislation for substantive due process purposes.[173] In *Blaisdell*, the Court explained that an exercise of the government's police power does not offend the Contracts Clause, even if it impairs contractual obligations between two private parties, so long as "the legislation is addressed to a legitimate end and the measures taken are reasonable and appropriate to that end."[174]

Although *Blaisdell* contemplates very deferential review of Contracts Clause challenges to legislation, the Court has indicated that heightened scrutiny is appropriate in cases that implicate impairments of the obligation of contracts to which the government is a party.[175] *United States Trust Co. of New York v. New Jersey* instructs that plaintiffs must establish the following elements to succeed on a Contracts Clause claim involving an unconstitutional impairment of the government's contractual obligations: (1) there is a contract between the government and the plaintiffs; (2) the challenged law impairs an obligation of that contract; and (3) the impairment is not reasonable and necessary to serve an important public purpose.[176] In that case, the Court considered a Contracts Clause challenge to the

169. Home Building & Loan Ass'n v. Blaisdell, 290 U.S. 398, 415–16 (1934).
170. *Id.* at 428.
171. *Id.* at 434–35.
172. *Id.* at 437.
173. *See supra* Part IV.A.
174. *Blaisdell*, 290 U.S. at 438.
175. United States Trust Co. v. New Jersey, 431 U.S. 1, 25–26 (1977).
176. *Id.* at 17, 21, 25–26.

repeal of a law that prohibited using money earned from tolls on highways controlled by the Port Authority of New Jersey and New York to subsidize passenger rail service.[177] The repeal adversely affected Port Authority bondholders, because the purpose of the law had been to pledge the toll revenue as security on the bonds that the Port Authority had issued.[178] The United States Trust Company of New York brought suit on behalf of all holders of the bonds, alleging that the repeal of the law limiting the use of the toll revenue violated the Contracts Clause of the U.S. Constitution.[179]

The Court first considered whether the statute that limited the power of the Port Authority to spend the revenues it earned through toll collection constituted a contract between the State and the Port Authority's bondholders. The Court held, "[A] statute is itself treated as a contract when the language and circumstances evince a legislative intent to create private rights of a contractual nature enforceable against the State."[180] The Court found that "[t]he intent to make a contract is clear from the statutory language: 'The 2 States covenant and agree with each other and with the holders of any affected bonds. . . .' "[181] Having found a contract, the Court considered whether the repeal of the statute constituted an impairment of that contract. Because the State had not attempted to compensate the bondholders for any loss in value of the bonds, the Court concluded that the repeal was an impairment of a contractual obligation.[182]

However, this finding did not end the inquiry. As the Court explained, "a finding that there has been a technical impairment is merely a preliminary step in resolving the more difficult question whether that impairment is permitted under the Constitution."[183] While the Court allows a state legislature to impair the contractual obligation of two private parties so long as it acts rationally to further a legitimate government purpose,[184] it imposes a more exacting standard when the state legislature acts to impair its own contractual obligation, because "[i]f 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

177. *Id.* at 3.
178. *Id.* at 9.
179. *Id.* at 3.
180. *Id.* at 17 n.14.
181. *Id.* at 18.
182. *Id.* at 19.
183. *Id.* at 21.
184. Home Building & Loan Ass'n v. Blaisdell, 290 U.S. 398, 438 (1934).

protection at all."[185] Therefore, the *United States Trust Co.* court held that a government may only impair its own contractual obligations when "it is reasonable and necessary to serve an important public purpose."[186] Moreover, when a law impairs a government's own contractual obligations, "complete deference to a legislative assessment of reasonableness and necessity is not appropriate . . . ."[187] Thus, although it is somewhat unclear what standard of review the Court applies to Contracts Clause cases where the government impairs its own contractual obligations, the use of the word "necessary," coupled with the lack of deference to the state legislature's judgment and the insistence on an "important" governmental purpose, suggest that the Court is applying some form of heightened scrutiny.[188]

Applying heightened scrutiny to the facts of *United States Trust Co.*, the Court concluded the repeal of the restriction on spending Port Authority toll revenue violated the Contracts Clause, noting that "the States could have adopted alternative means of achieving their twin goals" without impairing their contractual obligations to the holders of the Port Authority bonds.[189] Thus, the Court indicated it was amenable to striking down legislation impairing the government's contractual obligations when the plaintiffs can demonstrate the government had alternative means of achieving the same goal without interfering with government contracts with private parties.

The plaintiffs in the Colorado, Minnesota, and South Dakota cases assert that those states' pension reform laws, as applied to current retirees, violate the Contracts Clause of the U.S. Constitution, because they cannot satisfy the heightened standard set forth in *United States Trust Co.* The plaintiffs first argue that the statutes that create pensions for public employees create contractual obligations between the states and those employees once the employees become vested in the system.[190] Second, they allege that the legislative pension reforms that adjust the method of calculating the annual cost-of-living adjustment and result in plaintiffs receiving less

185. *United States Trust Co.*, 431 U.S. at 26.

186. *Id.* at 25.

187. *Id.* at 26.

188. *See* CHEMERINSKY, *supra* note 97, at 639 (suggesting that the Court is applying strict scrutiny).

189. *United States Trust Co.*, 431 U.S. at 30.

190. Colorado Complaint, *supra* note 4, at 10; Minnesota Complaint, *supra* note 5, at 15; South Dakota Complaint, *supra* note 6, at 12.

benefits each year than they would have received under the prior law constitute an impairment of these contractual obligations.[191] Finally, the plaintiffs allege that this impairment is neither reasonable nor necessary to achieve the states' objectives of returning their public employee pension funds to solvency.[192]

1. Is There a Contract?

To determine whether such a Contracts Clause claim has merit, it is first necessary to determine whether there is a contract between the state government and the public employees with regard to the amount of pension benefits to which they are entitled. According to a recent study of public employee pensions, constitutional, statutory, or case law in thirty-five states supports a finding that public employees have a contractual right to the pension benefits in place at the time they retire.[193] In those states, the next step will be to determine whether the statutorily provided formula for calculating the rate of the annual cost-of-living adjustment is included in the contract. There is a strong argument that it is. As the Supreme Court explained in *United States Trust Co.*, courts presume that "contracting parties adopt the terms of their bargain in reliance on the law in effect *at the time the agreement is reached*."[194] One can thus argue that the law in effect at the time the employees' rights became vested, including the cost-of-living adjustment, became part of the contractual agreement between the state government and the employees. This makes sense because retirees rely on the current cost-of-living adjustment rates when planning financial decisions as they enter retirement.[195]

Although this is a strong argument based directly on the language of a U.S. Supreme Court decision, the Colorado and Minnesota district courts rejected it. They concluded that, while public

191. Colorado Complaint, *supra* note 4, at 10; Minnesota Complaint, *supra* note 5, at 15; South Dakota Complaint, *supra* note 6, at 12.

192. Colorado Complaint, *supra* note 4, at 10; Minnesota Complaint, *supra* note 5, at 15; South Dakota Complaint, *supra* note 6, at 12.

193. *See State Constitutional Protections for Public Sector Retirement Benefits*, NAT'L CONFERENCE ON PUB. EMP. RET. SYS., http:// www.ncpers.org/Files/News/03152007RetireBenefit Protections.pdf (last visited Aug. 17, 2011) (finding support for such protection in Alabama, Alaska, Arizona, Colorado, Delaware, Florida, Georgia, Hawaii, Idaho, Illinois, Kentucky, Louisiana, Maryland, Michigan, Mississippi, Missouri, Montana, Nebraska, Nevada, New York, North Carolina, North Dakota, Oklahoma, Oregon, Pennsylvania, Rhode Island, South Carolina, South Dakota, Tennessee, Utah, Vermont, Virginia, Washington, West Virginia, and Wisconsin).

194. *United States Trust Co.*, 431 U.S. at 19 n.17 (emphasis added).

195. For example, a retiree might choose to invest less money than he otherwise would in reliance on the promise that the value of his pension would continue to increase at a fixed rate.

employees have a contractual right to their pensions, they do not have a contractual right to a specific cost-of-living adjustment, because the formulas those states use to calculate such an adjustment have frequently changed in the past.[196] This finding, however, is not fatal to Contracts Clause challenges to other states' pension reform laws. The finding of a lack of a contractual right is merely an interpretation of state law and therefore has no precedential value outside of those two states. Retired public employees challenging similar pension reform laws should therefore still argue that they have a contractual right to the specific cost-of-living adjustment in place at the time they retired. The rest of this Section assumes that a court will find such a right and analyzes whether the impairment of that right violates the Contracts Clause of the U.S. Constitution.

2. Impairment of the Contractual Obligation

Assuming a contract to continue to provide the specific cost-of-living formula in place at the time of retirement exists between a state and its public employees, the next question is whether a change to that formula impairs that contractual obligation. In *United States Trust Co.*, the Supreme Court found there was a contractual impairment, because the State did not make any effort to compensate the bondholders for any decrease in value of the bonds that resulted from the repeal of the restrictions on spending the toll revenue.[197] Given this finding, it is difficult to see how a court could conclude that a pension reform law that reduces the amount of benefits to which current retirees are entitled would not impair a contractual obligation. Like the state government in *United States Trust Co.*, the state governments at issue here did not attempt to compensate plaintiffs for the reduced annual cost-of-living adjustment. This lack of compensation constitutes an impairment of contract of exactly the kind that justifies the heightened scrutiny that *United States Trust Co.* applies to cases in which the government passes a law impairing its own contractual obligations.[198]

The Minnesota district court's finding that the pension reform law does not constitute a contractual impairment because "[t]he

196. Justus v. State, No. 2010-CV-1589, at *4–5 (Colo. Dist. Ct. June 29, 2011); Swanson v. State, No. 62-CV-10-05285, at *19–20 (Minn. Dist. Ct. June 29, 2011).

197. *United States Trust Co.*, 431 U.S at 19.

198. *See id.* at 26 ("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.").

fundamental retirement benefit structure for Plaintiffs is the same both before and after enactment of the challenged legislation" is at odds with *United States Trust Co.* and should be rejected by other courts.[199] First, because the Minnesota court also concluded that no contractual right to a specific cost-of-living adjustment exists under state law, its analysis of whether a change to that right would constitute an impairment is merely dicta and has no precedential value. More importantly, just because retirees continue to receive an annual cost-of-living adjustment does not mean any contractual right they have to such a benefit has not been impaired. In *United States Trust Co.* itself, the U.S. Supreme Court found a contractual impairment where the repeal of a law reduced the value of bonds held by the plaintiffs.[200] The fact that the plaintiffs still held the bonds, or that the bonds still had some value, did not mean that the government had not impaired the contractual obligation. Rather, any decrease in the value of those bonds as a result of the change in the law created an impairment of a contractual obligation. Thus, any decrease in the future value of a retiree's pension fund as a result of the change in the law should similarly constitute such an impairment.

3. Permissibility of the Impairment

A court must next determine whether that impairment is allowed under the Contracts Clause. *United States Trust Co.* provides the test: "[A]n impairment may be constitutional if it is reasonable and necessary to serve an important public purpose."[201] States pass laws that reduce the amount of benefits to which current retirees drawing funds from the public employee retirement systems are entitled for the purpose of returning the state public employee pension funds to solvency. This may be an important public purpose, but even if it is, the laws are not both reasonable and necessary to that purpose. There are less restrictive alternatives that the state governments

199. Swanson v. State, No. 62-CV-10-05285, slip op. at 23 (Minn. Dist. Ct. June 29, 2011). Notably, the Colorado district court did not similarly so hold. Rather, it simply found that no contractual right to a specific cost-of-living adjustment existed, and did not consider whether, had such a right existed, it would have been impaired by legislature's changing of the statutory cost-of-living adjustment formula. *See* Justus v. State, No. 2010-CV-1589, slip op. at 10 (Colo. Dist. Ct. June 29, 2011) (holding that the court need not consider "the second and third parts of the *DeWitt* test"). The second part of the *DeWitt* test requires the court to examine whether "a change in the law impairs [a] contractual relationship." *In re* Estate of DeWitt, 54 P.3d 849, 858 (Colo. 2002).

200. *United States Trust Co.*, 431 U.S. at 19.

201. *Id.* at 25.

could implement to achieve the same result. In other words, states could institute policies that would return their public employee pension funds to solvency without impairing their contractual obligations to employees who have already vested in the systems. For example, states could raise taxes and use the increased revenue to fully fund the public employee pension funds to the extent of their actuarially calculated liability. Alternatively, states could reduce the amount of pension benefits that they will give employees who have not yet become vested in the systems. The latter would be permissible because there would not yet be a contract between unvested employees and the states. Thus, impairment of the obligation of the government's contract with vested public employees is not "necessary" to return the states' public employee pension funds to solvency. Therefore, assuming that a contractual right to a specific cost-of-living adjustment exists, the Contracts Clause of the U.S. Constitution prohibits this type of modification.

V. A RETURN TO SOLVENCY: PRESERVING PUBLIC EMPLOYEE PENSION FUNDS WITHOUT OFFENDING THE U.S. CONSTITUTION

As discussed above, there is a strong argument that proposed public employee pension plan reforms that reduce the amount of pension benefits to which current retirees are entitled violate the U.S. Constitution. Depending on whether states define public employee pension benefits as property rights or contract rights, a case can be made for a violation of either the Takings Clause or the Contracts Clause. However, it is ultimately up to state courts to determine whether a public employee has a property right or a contract right to a particular pension benefit. In Colorado and Minnesota, state courts have concluded that there are no such rights, leaving retired public employees with no recourse under the U.S. Constitution. Therefore, to ensure retired public employees are adequately protected and that the pension crisis does not repeat itself, Congress should explore the possibility of federal regulation of state public employee pension plans.

Congress already regulates private pension plans through ERISA. The purpose of ERISA is "to standardize the regulation of private pension plans, while simultaneously providing tax incentives to employers to encourage the development of employee benefit programs."[202] One objective of ERISA is to ensure that benefits plans

202. Jon G. Miller, *Is Your Client's Government Pension Safe?: Making the Case for Federal Regulation*, 2 ELDER L.J. 121, 136 (1994).

are adequately funded.[203] In order to enforce this objective, ERISA "establishes an elaborate set of rules to determine and enforce minimum funding requirements."[204] Establishing a minimum funding requirement that is applicable to state public employee pension plans would go a long way toward ensuring that states no longer consistently underfund their pension obligations.

Federal regulation of state public employee pension plans would prevent states from engaging in the bad practices that brought about the trillion-dollar shortfall between public employee pension benefits promised and public employee pension benefits funded. While states could possibly solve this problem without congressional intervention, federal legislation best ensures that all states will establish sustainable practices. To ensure pension fund solvency, states will have to either raise taxes or reduce spending in other areas in order to funnel much-needed money into the public employee pension funds. Both choices are politically unpopular, and federal legislation best ensures states will make the difficult decisions they must make in order to ensure pension fund solvency.

Members of the House of Representatives have proposed that Congress regulate state and local government pensions. The proposed bill, known as the Public Employee Pension Transparency Act, notes that "[t]here currently is a lack of meaningful disclosure regarding the value of State or local government employee pension benefit plan assets and liabilities."[205] The bill, if passed, would mandate increased disclosure "in order to adequately protect plan participants and their beneficiaries and the general public."[206] Specifically, the bill would amend the Internal Revenue Code to require that state and local government pensions file annual reports disclosing the "current liability of the plan, the amount of plan assets available to meet that liability, the amount of the net unfunded liability . . . and the funding percentage of the plan."[207] Additionally, pension plan administrators would be required to disclose the actuarial assumptions on which they based their data, as well as a contribution schedule for the current year and "alternative projections . . . for each of the next 20 plan years . . . with a statement of the assumptions and methods used in connection with [the] projections, including assumptions related to

203. *Id.* at 137.

204. *Id.* at 138; *see also* 29 U.S.C. § 1082 (2006) (describing ERISA's minimum funding standards in detail).

205. H.R. 567, 112th Cong. § 2(10) (2011).

206. *Id.* § 2(11).

207. *Id.* § 3.

funding policy, plan changes, future workforce projections, [and] future investment returns."[208] If the bill is passed, states that do not comply with the reporting requirements will be denied certain federal tax benefits.[209]

While the Public Employee Pension Transparency Act is a good start, further regulation is needed to ensure that state employees will no longer fall victim to the mismanagement of their pension funds. Specifically, Congress should enact minimum funding requirements similar to those already in place for private employers under ERISA. In the Pension Protection Act of 2006, Congress amended ERISA to require private employee pension plans to be fully funded—a plan's assets must exceed the plan's liabilities at all times, and employers must increase contributions to eliminate any shortfall.[210] Establishing a similar requirement for state employee pension funds would ensure those funds remain sustainable.

While such legislation already exists in the private sector, it is unclear whether Congress has the power to regulate the states directly in this way. The Tenth Amendment provides that "[t]he powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively, or to the people."[211] In *New York v. United States*, the Supreme Court held that "Congress may not simply 'commandee[r] the legislative processes of the States by directly compelling them to enact and enforce a federal regulatory program.' "[212] One could argue that requiring states to establish minimum funding requirements for public employee pensions impermissibly forces state governments to submit to federal regulation.[213]

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208. *Id.*

209. *Id.* The tax benefits include the exemption from gross income for interest on state or local bonds under 26 U.S.C. § 103 (2006); credits against taxable income for qualified tax credit bonds, under 26 U.S.C. § 54A (2006); credits associated with Build America bonds under 26 U.S.C. § 54AA (2006); and credits allowed to issuers of qualified bonds under 26 U.S.C. § 6431 (2006). H.R. 567 § 3.

210. *See* 29 U.S.C.A. § 1083 (West 2010) (describing the minimum required contributions that private employers must make to their pension funds).

211. U.S. CONST. amend. X.

212. New York v. United States, 505 U.S. 144, 161 (1992) (alteration in original) (quoting Hodel v. Va. Surface Mining & Reclamation Ass'n, 452 U.S. 264, 288 (1981)).

213. *See id.* at 175–76 ("On the other hand, the second alternative held out to state governments—regulating pursuant to Congress' direction—would, standing alone, present a simple command to state governments to implement legislation enacted by Congress. As we have seen, the Constitution does not empower Congress to subject state governments to this type of instruction."). One could also argue that Congress does have the power to regulate public employee pensions directly, particularly in light of the fact that *Garcia v. San Antonio*

In order to avoid these Tenth Amendment concerns, this Note suggests Congress use its taxing and spending power to incentivize states to implement the minimum funding requirements.[214] The Court approves of Congress's attempts to condition the receipt of federal funds on states' adopting federal regulatory programs, so long as the conditions imposed are: (1) "in pursuit of the general welfare"; (2) clear and unambiguous; (3) related "to the federal interest in particular national projects or programs"; and (4) not designed to "induce the States to engage in activities that would themselves be unconstitutional."[215] The conditions must also not be "so coercive as to pass the point at which 'pressure turns into compulsion.' "[216]

To encourage states to adopt the minimum funding requirements discussed above while still protecting the pensions of retired employees, Congress should offer states the power to issue tax-exempt bonds for the purpose of raising money for public employee pension funds so long as the states agree to establish the minimum funding requirements proposed above and agree not to reduce the annual cost-of-living adjustments current retirees receive.[217] Currently, bonds issued to raise money to fund public employee pensions "are fully taxable."[218] States would likely want the ability to issue tax-exempt pension bonds, because such bonds allow states to raise money to fund pension plans more inexpensively by being able to offer lower interest rates than those of any fully taxable bonds that the states presently issue.

This type of incentive avoids the constitutional concerns that direct regulation might pose. First, granting states the ability to issue

Metropolitan Transit Authority, 469 U.S. 528 (1985), which held that Congress has the power to extend the minimum wage and overtime requirements of the Fair Labor Standards Act to public employers, has never been overturned and remains good law. The extent to which the Tenth Amendment limits Congress's power to act is beyond the scope of this Note. The solution offered below assumes that the Tenth Amendment does bar direct regulation and offers a workaround. If there is no Tenth Amendment problem, Congress may simply regulate directly, exercising its Commerce Clause powers. *See* Miller, *supra* note 202, at 140 (discussing Congress's authority to regulate public employee pensions under the Commerce Clause).

214. For a defense of using the taxing and spending power to encourage regulation in ways that Congress cannot regulate directly because of the Tenth Amendment, see *New York*, 505 U.S. at 167–69.

215. South Dakota v. Dole, 483 U.S. 203, 207–08, 210 (1987) (internal citations and quotations omitted).

216. *Id.* at 211.

217. For a similar proposal, see Joshua Rauh & Robert Novy-Marx, *Pension Security Bonds: A New Plan to Address the State Pension Crisis*, ECONOMISTS' VOICE, June 2010, at 1, 2–3.

218. *Id.* at 2.

tax-exempt pension bonds is "in pursuit of the general welfare."[219] The Court typically defers to Congress's judgment when evaluating this requirement, and there is nothing to suggest that it would not do so here. This is particularly likely because issuing tax-exempt pension bonds allows states to raise money to fund public employee pensions more inexpensively than they currently are able to raise, reducing the amount of pension funding taken from other areas (such as the reduction of services).

Second, the conditions with which states would be required to comply are clear and unambiguous. A state would simply have to agree to comply with the minimum funding requirement for public employee pensions. It would also have to agree not to reduce the annual cost-of-living adjustment for retired public employees. The state would therefore be able to knowingly decide whether to opt in to the regulations or to forego the opportunity to issue tax-exempt bonds.[220] Third, the conditions proposed "bear [a] relationship to the purpose of the federal spending."[221] The purpose of the regulations is to ensure that state governments adequately support their public pension obligations without unjustly burdening retired public employees, and granting the exemption enables states to do so in a way that is economically feasible. Fourth, the incentive does not induce states to engage in unconstitutional activity—nothing in the Constitution prohibits states from establishing minimum funding requirements for public employee pensions. Finally, the conditions are not so coercive as to be impermissible. Should a state choose not to opt in to the minimum funding requirements, the worst-case scenario is the continuation of the status quo. States will still be able to issue pension bonds, but those bonds would be fully taxable. Additionally, states choosing to opt out would still be able to use other methods to raise money to fund pension obligations.[222]

Even if Congress is not able to force the states to establish minimum funding requirements for public employee pension plans directly, Congress can still persuade states to opt in to regulations in this area. Congress may exercise its taxing and spending power to

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219. *Dole*, 483 U.S. at 207.

220. *See id.* ("[W]e have required that if Congress desires to condition the States' receipt of federal funds, it 'must do so unambiguously . . . , enabl[ing] the States to exercise their choice knowingly, cognizant of the consequences of their participation.") (second alteration in original) (quoting Pennhurst State Sch. & Hosp. v. Halderman, 451 U.S. 1, 17 (1981)).

221. New York v. United States, 505 U.S. 144, 167 (1992) (citing *Dole*, 483 U.S. at 207–08).

222. *See supra* Part IV.C.3 (discussing potential alternative solutions to solving the state pension crisis).

condition states' abilities to issue tax-exempt bonds for the purpose of funding public employee pensions on states' agreeing to adopt the proposed minimum funding requirement.

VI. CONCLUSION

The current pension shortfalls are a serious problem facing many state and local governments today. The town of Prichard, Alabama, presents an extreme example. For years, experts warned the city that its budget was unsustainable and predicted the funds would dry up.[223] In 2009, that prediction came true. The city ran out of money and could no longer write pension checks to its retired employees.[224] Many retirees had retired prior to becoming eligible for Social Security benefits in reliance on the pension income that they were promised.[225] Now, with the city unable to fulfill its promise, many struggle to make ends meet. Some filed for bankruptcy. Others, like the retired fire marshal found dead in a home without electricity or running water, have fared much worse.[226]

While repetition of the situation in Prichard in other communities must be avoided, the Colorado, Minnesota, and South Dakota reforms are not the solution. Those reforms unfairly burden retired public employees, who dedicated their careers to public service, often for less money than they would have made in the private sector, and who are now being forced to shoulder a disproportionate share of the burden of the states' years of pension fund mismanagement.

If history is any guide, relying on the states to solve this problem may not prove to be a reliable solution. Years of poor practices by state government officials led to this crisis in the first place, and it is not yet clear whether states are committed to a workable solution.[227] Moreover, as the recent Colorado and Minnesota decisions clearly indicate, state courts cannot be trusted to protect public employees from these unfair laws. Because state courts are the final arbiters of the content of a public employee's contract or property right to pension benefits, even the U.S. Constitution may not be able to protect public employees. This Note therefore urges Congress to encourage states to adopt minimum funding requirements for public

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223. Michael Cooper & Mary Williams Walsh, *In Town That Stopped Checks, A Warning on Public Pensions*, N.Y. TIMES, Dec. 23, 2010, at A1.

224. *Id.*

225. *Id.*

226. *Id.*

227. *See supra* Part II.

employee pensions that mirror those found in ERISA by authorizing states that adopt such requirements to issue tax-exempt bonds to raise money to fund public employee pensions, provided that states do not decrease the annual cost-of-living adjustment for currently retired employees. This approach will make it easier for states to raise money to fund public employee pensions while at the same time requiring states to contribute enough money to fully fund all promised benefits. By ensuring their public employee pension plans are funded to the extent of their actuarially calculated liability, states that choose to take advantage of this program will avert a future crisis without unfairly burdening retired public employees who faithfully served the very government that is now asking them to shoulder a disproportionate burden.

*Gavin Reinke**

* Candidate for Doctor of Jurisprudence, May 2012, Vanderbilt University Law School. I would like to thank Professor Mark Brandon for his helpful suggestions. I am also grateful to the editors and staff of the VANDERBILT LAW REVIEW for their comments and feedback. Finally, I thank my family and friends for their never-ending inspiration and support.

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