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Public Schools, Public Service

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RETIREMENT BOARD

To: Members, State Administration and Veterans Affairs Committee
Members, Legislative Finance Committee

From: Eric Feaver, President, MEA-MFT
Date: July 24, 2012
Re: Contract Clause Issues and Employee Contribution Rates to TRS

As you know MEA-MFT supports Governor Brian Schweitzer's proposal to address unfunded liabilities in TRS and PERS.

To date, critics of his proposal have in part focused on the question of whether or not his proposal to increase active employee contributions would violate employee contract rights.

We believe there is a way to answer this question proactively and secure the constitutional promise and obligation this state has made to actuarially fund public employee retirement. And to do so in fairly short order.

So, enclosed is a legal analysis attorney Karl Englund has prepared for your consideration. Consider it a beginning. We refuse to believe "nothing can be done."

Thank you.

Cc Governor Brian Schweitzer
David Senn
Roxanne Minnehan
Denise Juneau
Clayton Christian
Lance Melton
Kirk Miller
Denise Ulberg
Tom Schneider
Timm Twardoski
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1232 East Sixth Ave., Helena, MT 59601 ■ TEL 406/442-4250 or 800/398-0826 FAX 406/443-5081 www.mea-mft.org

KARL J. ENGLUND

Karl J. Englund, P.C.

401 North Washington Street

P.O. Box 8358

Missoula, Montana 59807

Telephone: 406.721.2729

Facsimile: 406.721.2729

E-Mail: KarlJEnglund@aol.com

MEMORANDUM

To: Eric Feaver

From: Karl J. Englund

Re: Contract Clause Issues and Employee Contribution Rates to TRS

Date: July 24, 2012

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Like public pension plans throughout the country, some of Montana's public employee defined-benefit pension systems are experiencing financial difficulties. Specifically, the actuaries for the two largest Montana systems estimate that the liabilities for system members' accrued benefits cannot be paid off in 30 years, as required by Montana's Constitution and statute.[1] While the situation is not immediately crucial in that the pension systems are sufficiently solvent to pay current retiree benefits, the long term problems will likely get worse if they are not addressed during the next legislative session.

[1] Article VIII, Section 15 requires that pension funds "shall be funded on an actuarially sound basis." Section 19-2-409, MCA defines "actuarially sound basis" to mean "that contributions to each retirement plan must be sufficient to pay the full actuarial cost of the plan. For a defined benefit plan, the full actuarial cost includes both the normal cost of providing benefits as they accrue in the future and the cost of amortizing unfunded liabilities over a scheduled period of no more than 30 years."

Governor Schweitzer has proposed to increase funding into the two largest pension funds by a combination of increased contributions from the state, from public employers and from the employees (in the form of an additional 1% increase). The increase in the employees' contribution raises the issue of whether the state may constitutionally require current employees to contribute more of their salary to their pension funds. This memo addresses that issue as it relates only to the members of the Teachers' Retirement System. It addresses the Teachers Retirement System only because the TRS has done a great deal of work analyzing how to achieve actuarial soundness, the TRS Board has indicated its general support for the Governor's proposal, and, while the general legal principles apply to both plans, TRS and PERS statutes are not exactly the same[2] and analyzing this issue as it relates to PERS' very diverse membership adds complexity to the consideration of potential solutions.

1) Public Employee Pensions and the Federal and State Contract Clauses:

Montana treats its public employee pensions as contracts.[3] Section 19-20-501(6), MCA states specifically, "Benefits and refunds to eligible recipients are payable pursuant to a contract

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[2] As will be discussed below, a significant aspect of this analysis depends on the exact wording of the statutes.

[3] The Court has evolved to this conclusion. In *Casey v. Brewer,* 107 Mont. 550, 88 P.2d 49(1939), the Court held that benefits provided by a pension system were "a gratuitous allowance in the continuance of which the pensioner has no vested right; and that pension is accordingly terminable at the will of the grantor." *Id.* at 88 P.2d at 53. Later, in *Clarke v. Ireland,* 122 Mont. 191, 199 P.2d 965 (1948), the Court drew a distinction between older pension systems "based on the concept of a pension as largesse donated to faithful public servants by a grateful and beneficent sovereign," *Id.* at 196, 199 P.2d at 967, and "the modern retirement systems based on annuity contracts" in which employees voluntarily elect to be members. *Id.* Because the teacher in *Clarke* voluntarily opted into the teachers' retirement system created in 1937, she had "a contractual annuity," and her rights to benefits were held to be "contractual rights." *Id.* at 199, 199 P.2d at 969. Later, in *Evans v. Fire Department Relief Assn.,* 138 Mont. 172, 178-79, 355 P.2d 670, 672 (1960), the Court said that the obligations of a pension fund are "clearly contractual" and the contract "arises when the fireman pays into the fund." The Court drew no distinction between voluntary and mandatory employee contributions. In *Bartles v. Miles City*, 145 Mont. 116, 399 P.2d 768 (1965), the Court repeated its holding in *Evans* that

as contained in statute." The amount of the employee contribution to TRS is provided for in statute. Section 19-20-602(1), MCA says, "The normal contribution of each member is 7.15% of the member's earned compensation."

Montana's Constitution provides that "[n]o . . . law impairing the obligation of contracts . . . shall be passed by the legislature." *Art. II, Sec. 31, Mont. Const.* Similarly, the United States Constitution states that "[n]o state shall . . . pass any . . . law impairing the obligation of contracts." *U.S. Const., Art. I, § 10.* The Montana Supreme Court construes these two constitutional clauses "interchangeably, relying on United States Supreme Court opinions to test the validity of Montana legislation under both contract clauses." *Neel v. First Federal Savings and Loan Assoc. of Great Falls*, 207 Mont. 376, 387, 675 P.2d 96, 103 (1984).

The Contract Clause operates as a limitation on governmental action. "At the time the Constitution was adopted, and for nearly a century thereafter, the Contract Clause was one of the few express limitations on state power." *U.S. Trust Co. of New York v. New Jersey*, 431 U.S. 1, 14-15 (1977). While a literal reading of both the Montana and federal clauses prohibits any impairment of any contract, neither Montana nor federal courts give an absolute interpretation of the Contract Clause. "Although the Contract Clause appears literally to proscribe 'any' impairment . . . the prohibition is not an absolute one and is not to be read with literal exactness like a mathematical formula." *Id.* at 20.

The Contract Clause operates in two separate legal arenas – its impact on government authority over contracts between private parties and its impact on contacts in which the government is one of the parties.

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pension rights are contractual rights in a case involving a police officer who was required to make contributions to his pension system. The Court has following this principle since then. *See, e.g. Gulbrandson v. Carey,* 272 Mont. 494, 901 P.2d 573 (1995).

Regarding the government's power to affect contracts between private parties, the Montana Supreme Court, following federal precedent, holds that "private contracts must give way before a legitimate exercise of [the state's] police power," and that business conducted in Montana is "subject to the retained power of the state to protect public welfare." *Western Energy Co. v. Genie Land Co.*, 227 Mont. 74, 82, 737 P.2d 478, 483 (1987). "An impairment may be constitutional if it is reasonable and necessary to serve an important public purpose." *City of Billings v. County Water Dist.*, 281 Mont. 219, 229, 935 P.2d 246, 252 (1997); *See also, Home Building & Loan Assn. v. Blaisdell,* 290 U.S. 398, 428 (1934)(holding that laws adjusting the rights and responsibilities of private contracting parties are permitted if they are based upon reasonable conditions and of a character appropriate to the public purpose justifying their adoption).

These same basic principles apply to contracts between the government and a private party, but both the Montana and U.S. Supreme Courts apply a heightened level of scrutiny when a governmental entity is a party to the contract. "[C]omplete deference to a legislative assessment of reasonableness and necessity is not appropriate [when] the State's self-interest is at stake." *City of Billings*, 281 Mont. at 229, 935 P.2d at 252, *quoting, U.S. Trust Co., supra,* 431 U.S. at 25-26. "A governmental entity can always find a use for extra money, especially when taxes do not have to be raised. 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." *U.S. Trust Co., supra.* at 26. Additionally, "[t]he severity of the impairment [to the contract] increases the level of scrutiny to which the legislation is subjected. " *City of Billings*, 281 Mont. at 229, 935 P.2d at 252, *quoting, Buckman v. Montana Deaconess Hosp.*, 224 Mont. 318, 325, 730 P.2d 380, 385 (1986).

These principles are applied in a three-part test that Montana and some federal courts employ when analyzing a Contracts Clause challenge:

> (1) Is the state law a substantial impairment to the contractual relationship;
> (2) Does the state have a significant and legitimate purpose for the law; and,
> (3) Does the law impose reasonable conditions which are reasonably related to achieving the legitimate and public purpose?

Seven Up Pete Venture v. State, 2005 MT 146, ¶ 41, 327 Mont. 306, 114 P.3d 1009, *citing*, *Carmichael v. Workers' Comp. Court*, 234 Mont. 410, 414, 763 P.2d 1122, 1125 (1988).

This three-part test will be applied by the courts if the legislature decides to increase the amount of employee contributions to the teachers' retirement fund. A heightened level of scrutiny will be applied because the government is a party to the pension contract at issue.

2) Reasonableness and Necessity:

It makes sense to analyze this three-part test out of order because there is case law holding that the second and the third prongs of this test are very difficult to satisfy. In other words, if there is a substantial impairment of contract under the first prong of this test, meeting the remaining two parts of the test is difficult, particularly under federal case law precedent.

But we begin with Montana law. *Seven Up Pete Venture* is a Montana Supreme Court case involving a claim that Initiative 137, which banned cyanide heap leach open pit gold and silver mining, unconstitutionally interfered with pre-existing state mining leases. The Court analyzed the Contract Clause claim using the three part test as outlined above. The Court first looked closely at the language of the leases themselves and then held that I-137 substantially impaired those contracts. *Id.* at ¶ 44. It then held that the State had a significant and legitimate purpose for I-137 (based, in large part, on the constitutional guarantee of a clean and healthful environment), *Id.* at ¶ 46, that the factual record showed that the State could legitimately determine that this method of mining required strict regulation, *Id.* at ¶ 50, and that I–137 was

reasonably related to that legitimate purpose. *Id.* Importantly, the Court did not apply a heightened level of scrutiny to I-137 because it found that I-137 "did not act to benefit the State's self-interest" in that it "caused the State to forego the opportunity to receive royalty payments" estimated at $60 million. *Id.* at 47. "Thus, though the State was a party to the contract, its interests as a contracting entity were actually diminished by I–137's passage." *Id.*

If an increase in employee pension contribution rates is challenged in state court, and if the Court applies the second and third part of the Contract Clause test as it did in *Seven Up Pete*, then arguments can be made that increases in employee, employer and State's contributions to TRS to make TRS actuarially sound have a significant and legitimate purpose based in the constitutional requirement of actuarial soundness, and that such a law, because it involves shared sacrifices and because it imposes increased financial costs on not just the employees, but on the state and employers as well, contains reasonable conditions which are reasonably related to achieving that legitimate public purpose.

However, the second and third parts of the Contract Clause test have been summarized by the federal courts as requiring a government to prove both reasonableness and necessity. *University of Hawaii Professional Assembly v. Cayetano*, 183 F.3d 1096, 1106 (9th Cir. 1999); *Southern California Gas Co. v. City of Santa Anna*, 336 F.3d 885, 894 (9th Cir. 2003).

In considering reasonableness, the federal courts consider "the extent of the impairment as well as the public purpose to be served." *Cayetano, supra,* 183 F.3d at 1107. An "impairment is not a reasonable one if the problem sought to be resolved by an impairment of the contract existed at the time the contractual obligation was incurred." *Id.* "Changed circumstances and important government goals do not make an impairment reasonable if the changed circumstances are 'of degree and not kind.'" *City of Santa Anna, supra,* 336 F.3d at 895, *quoting, U.S. Trust,*

supra, 431 U.S. at 32. Thus, if an employee contribution increase is challenged in federal court, Montana would seem to have to prove that at the time the legislature set the amount of the employees' contribution, it never anticipated that the pensions could run short of money or that they could be actuarially unsound. This might be possible given that the primary reason for the funds' problems today is investment losses caused by the extraordinary 2008 recession and the unusually long and slow recovery thereafter, but that argument must be based on the development of some important facts that are beyond the scope of this analysis.

However, even if the State can prove reasonableness, it faces a "heavy burden" of proving necessity. *City of Santa Anna, supra,* 336 F.3d at 896. "An impairment may not be considered necessary if there is an evident and more moderate course of action" that would serve the State's purpose "equally well" because the Contract Clause "limits the ability of a state, or subdivision of a state to abridge its contractual obligations without first pursuing other alternatives." *Cayetano, supra,* 183 F.3d at 1107. "When a state or city impairs its own agreements by imposing additional financial burdens on a private party, obvious more moderate alternatives include raising revenues through higher taxes or preserving funds through budget restrictions. In the last thirty-five years, no Ninth Circuit or Supreme Court case has found a statute or ordinance necessary when the law in question altered a financial term of an agreement to which a state entity was a party." *City of Santa Anna, supra*, 336 F.3d at 897. Given Montana's overall sound financial condition and large surplus (and talk of property tax rebates and business equipment tax cuts), necessity will be hard to prove.

In other words, proving both reasonableness and necessity will be difficult – maybe possible, but certainly difficult. Therefore, it makes sense to examine the first prong of the

Contract Clause analysis and determine whether such an increase substantially impairs the pension contract.

3) Substantial Impairment:

When analyzing whether there has been a substantial impairment to a contractual relationship, the first determination is whether there is a contractual relationship, and if so, the second question is whether the law substantially impairs the contractual relationship. *Seven Up Pete Venture, supra*, at ¶ 41; *General Motors Corp. v. Romein*, 503 U.S. 181, 186 (1992).

As mentioned, the law seems well settled that the Montana courts will treat pensions as contracts.

The issue of whether there has been a substantial impairment of that contract necessarily depends upon the terms of the contract and the nature of the rights created by the contract. Specifically, the issues here are: whether the employee contribution rate of 7.15% is or is not a specific term of the contract; whether TRS members have a contractual right to pay no more than 7.15%; and, whether a 1% increase in employee contributions is a "substantial" impairment.

The Montana courts have never ruled on the issue of whether an employee pension rate increase is a substantial impairment of the pension contract. There are cases from other jurisdictions holding that when the amount of employee contribution is set in statute, it cannot thereafter be increased substantially without providing offsetting benefits. *See, e.g., Opinion of Justices,* 364 Mass. 847, 864, 303 N.E.2d 320, 329 (1973)("Legislation which would materially increase present members' contributions without any increase of the allowances finally payable to those members or any other adjustments carrying advantages to them, appears to be presumptively invalid."); *Oregon State Police Officers' Association v. State,* 323 Or. 356, 375, 918 P.2d 765, 776 (1996)[invalidating a ballot measure which provided, in part, that Oregon

public employers could no longer "pick up," assume or pay up to 6% percent of employees' salary to the retirement system and holding that the "statutory pension system and the relationship between the state and its employees clearly established a contractual obligation to provide an undiminished level of benefits at a fixed cost" and "because plaintiffs must pay (6% of their salary) more (for their pensions), the value of their PERS pension contract has been diminished unilaterally."]; *Association of Pennsylvania State College and University Faculty v. State System of Higher Education,* 505 Pa. 369, 376, 479 A.2d 962, 965 (1984)[holding that a 1.25% increase in the employee contribution (from 5% to 6.25%) "reduces the value of members' retirement benefits" and thus "is unquestionably a unilateral modification in the system adverse to its members"]; *Allen v. City of Long Beach*, 45 Cal.2d 128, 131, 287 P.2d 765,767 (1955)(invaliding an increase in employees' contribution from 2% to 10%, without affording the employee any new advantages over the existing pension scheme. "To be sustained as reasonable, alterations of employees' pension rights must bear some material relation to the theory of a pension system and its successful operation, and changes in a pension plan which result in disadvantage to employees should be accompanied by comparable new advantages"); *Marvel v. Dannemann,* 490 F.Supp. 170 (D.C.Del., 1980)(applying Delaware contract law and holding that it is a substantial impairment of contract to increase judges' contribution rates from 1.1% to 4.3%); *Singer v. City of Topeka,* 227 Kan. 356, 607 P.2d 467 (1980)(substantial impairment of contract to increase employee contribution rate from 3% to 7% without increasing benefits).

These cases have created the impression that in "jurisdictions that follow a contractual view of public pensions. . . . legislative enactments that increase the level of public employee

contributions . . . violate either the state or federal contract clauses." *Oregon State Police Officers' Assn., supra,* at n. 18. But that impression may be incorrect.

A) Actuarial Soundness:

To understand why it may be incorrect, one must begin with the rule that the terms of the pension contract are determined by controlling provisions of Montana law at the time the employee becomes a member of the retirement system. *State ex rel. Sullivan v. Teachers' Retirement Board,* 174 Mont. 482, 485, 571 P.2d 793, 795 (1977); *Clarke v. Ireland,* 122 Mont. 191, 199, 199 P.2d 965, 970 (1948). Thus, cases from other states may or may not be useful in analyzing a case in Montana depending on the differences between the laws of those states and the applicable Montana law that is the basis of the pension contract.

In Montana, that law begins fundamentally with the constitutional requirement that pensions be funded "on an actuarially sound basis," *Art. VIII, Sec. 15, Mont. Const.*, and the definition of "actuarially sound basis" which requires "that contributions to each retirement plan must be sufficient to pay the full actuarial cost of the plan. For a defined benefit plan, the full actuarial cost includes both the normal cost of providing benefits as they accrue in the future and the cost of amortizing unfunded liabilities over a scheduled period of no more than 30 years." *Section 19-2-409, MCA.*

The constitutional requirement for, and the statutory definition of, actuarial soundness make clear that TRS' current financial situation is illegal and untenable, even though there are sufficient funds to pay current benefits. Thus, unlike the situation in *Allen v. City of Long Beach, supra,* 45 Cal.2d at 133, 287 P.2d at 768, where the contribution rate for one group of employees was increased not because of any financial exigency but rather "to ameliorate 'personal problems' assertedly created by differences in pension costs and benefits to the two

[different] groups of employees and to 'somewhat equalize the compensation provided for employees who perform like services,'" here the present situation is not in compliance with the law (and the pension contract) and something must be done to address that situation. *See, also, Opinion of Justices,* 364 Mass. 847, 864, 303 N.E.2d 320, 329 (1973)(an advisory opinion issued in response to a question by the Massachusetts legislature in which the Court very carefully did not reach the question of whether the pension system was in a "situation of stress" sufficient to justify an increase in employee contributions).

However it must be noted that actuarial soundness as the sole justification for an employee contribution increase has been rejected. For example, in *Singer v. City of Topeka, supra,* employee contribution rates were increased from 3% to 7% with no increase in benefits.[4] The City argued that increased employee contributions would achieve statutorily-required actuarial soundness and actuarial soundness was a benefit to the members. *Id.* at 360, 607 P.2d at 471. The Court disagreed that actuarial soundness was a benefit because "there is no evidence that the City will not be able to meet its obligations in the future, no evidence that plaintiffs' pensions are in jeopardy, no evidence that plaintiffs would receive any benefit from an actuarially sound system which plaintiffs would not otherwise receive." *Id.* at 367-68, 607 P.2d at 476.

Accordingly, while the requirement for actuarial soundness creates a very solid constitutionally-based foundation for the concept that the pension contract includes some flexibility as to the amount of the employee contribution, it cannot be relied upon as the sole justification for increasing the employee contribution rate.

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[4] The decision does not say whether employer rates were also increased.

B) Employees' "Normal Contribution" Rate:

The statue setting the amount of the employee contribution to TRS says, "The normal contribution of each member is 7.15% of the member's earned compensation." *Section 19-20-602(1), MCA* (emphasis added). The critical phrase "normal contribution" is not defined.

Statutes are construed as written. *Ravalli County v. Erickson,* 2004 MT 35, ¶ 11, 320 Mont. 31, 85 P.3d 772. There are at least a couple of rules of statutory construction that, if employed, could lead to the conclusion that "normal contribution" is properly defined in such a manner that a 1% increase in employee contributions is consistent with the statute.

The first of those rules is that words not defined in statute are given their common dictionary meaning. *Id.* at ¶ 13; *Montanans for Justice v. State ex rel. McGrath*, 2005 MT 277, ¶ 53, 334 Mont. 237, 146 P.3d 759. The *American Heritage Dictionary of the English Language* defines "normal" as "conforming with, adhering to, or constituting a norm, standard, pattern, level, or type,"[5] and "norm" as "a pattern that is regarded as typical of something."[6] Thus, under the dictionary meaning of "normal," Section 19-20-602(1), MCA can be interpreted to mean that the typical or usual or standard employee contribution to TRS is 7.15%. That leaves room to argue that the statute envisions there might be times when an atypical or unusual or extraordinary additional employee contribution is also allowed.

If the 1% increase is structured in the legislation to be an extraordinary or uncommon or special contribution or assessment and the record is made that an extraordinary additional contribution is necessary to offset the extraordinary investment losses caused by the 2008 recession and the slow recovery from that recession, an argument can be made that such an

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[5] *See, http://ahdictionary.com/word/search.html?q=normal*

[6] *See, http://ahdictionary.com/word/search.html?q=norm*

increase is allowed by the statute (and the contract). This argument would depend upon legislative findings based in solid facts that the current TRS financial situation is due in large part to unanticipated investment losses (and thereafter, gains less than the assumed rate of return), and a provision in the legislation that the additional employee contribution would cease once the fund is actuarially sound.[7]

Another rule of statutory construction is that terms used in the statute should not be isolated from the context in which they were used by the legislature. *State v. Nye,* 283 Mont. 505, 510, 943 P.2d 96, 99(1997). The context in which words are used must be considered. *Blythe v. Radiometer America, Inc.*, 262 Mont. 464, 475, 866 P.2d 218, 225 (1993). The term "normal contribution" is used in only one other statute – involving the purchase of years of military service for police officers. *Section 19-19-406(1), MCA.* However, in the retirement codes, the word "normal" is commonly used to distinguish between something that is the usual or regular from something else that is allowed, but is the exception to the rule. *See, e.g., Section 19-20-702, MCA* (providing for the "normal" form of retirement allowance and allowing for additional optional allowances). Even the statute defining actuarial soundness distinguishes between "the normal cost of providing benefits as they accrue in the future and the cost of amortizing unfunded liabilities over a scheduled period of no more than 30 years." *Section 19-2-409, MCA.*

[7] If the legislature enacts any legislation which results in any challenge based on Federal or state contract clauses, it must have a well-developed record showing the basis for its decision. *See, e.g. University of Hawaii Professional Assembly v. Cayetano,* 183 F.3d 1096 (1999)(striking down a pay lag as an unconstitutional impairment of contract in part because the defendants did not produce a record explaining why "it is reasonable and necessary that the brunt of Hawaii's budgetary problems be borne by its employees.")

C) The Structure of Montana's Contribution Rates:

If one looks at the employee contribution rate number only and if one concludes that that number and only that number sets the terms of the contract regarding the employee contribution rate, it would be difficult to argue that a 1% increase (which, of course, is a 1% decrease in take-home pay) of TRS members would not substantially impair their contracts. *See, e.g. Baltimore Teachers Union, American Federation of Teachers Local 340, AFL-CIO v. Mayor*, 6 F.3d 1012, n.8 (4th Cir. 1993) ("we reject the City's contention that an annual salary reduction of .95% is insubstantial."); *Pennsylvania Federation of Teachers v. School Dist. of Philadelphia*. 506 Pa. 196, 484 A.2d 751 (1984)(a 1% increase in employee contribution to retirement fund deemed a substantial impairment of contract).

However, it may be possible to get a court to look beyond the bare numbers and to look to the overall structure of pension plans, and if that can be done, an argument can be made that because the Governor's proposal increases employee and employer and state contributions to the pension funds, it does not change the basic structure of the pension contract.

That argument would be based in the rule of contract interpretation that the contract is read as a whole. *Milltown Addition Homeowner's Assn. v. Geery*, 303 Mont. 195, ¶11, 15 P.3d 458 (2000);. RESTATEMENT (SECOND) OF CONTRACTS, §202(2) ("A writing is interpreted as a whole, and all writings that are part of the same transaction are interpreted together."). Contracts are to be interpreted in light of the circumstance in which they are made. *Id.* at § 202(1) ("Words and other conduct are interpreted in the light of all the circumstances, and if the principal purpose of the parties is ascertainable it is given great weight."). Contractual provisions are read in a manner that effectuates the contract's spirit and purpose, considered as a whole and

interpreted so as to harmonize and give meaning to all of its provisions. *Arizona v. United States,* 575 F.2d 855, 863 (Ct.Cl.1978).

The "contract as a whole" for TRS members includes:

1) That public employee retirement systems are constitutionally recognized. *See, e.g., Art. VIII, Sec. 13 & 15 Mont. Const.*

2) The constitutional requirement for funding on an "actuarially sound basis." *Art. VIII, Sec. 15, Mont. Const.*

3) The statutory definition of "actuarially sound basis" that includes the requirement that the retirement funds "includes both the normal cost of providing benefits as they accrue . . . and the cost of amortizing unfunded liabilities" over a 30-year period. *Section 19-2-409, MCA*

4) TRS is and has been funded through employee contributions, employer contributions and contributions from the State, plus income from investments.

5) TRS is currently funded by the following contributions:
Employee: 7.15%
Employer: 7.47%
State: 2.49% (total of 9.96%)

6) These percentages have been set by the legislature and, at various times throughout the history of the system, they have been changed by the legislature. For example, according to TRS staff, the employee contribution rate was 5% from 1937 to 1973, then raised to 5.125%, then raised to 6.125% in 1975, then raised to 6.187% in 1977, then raised to 7.044% in 1983 and last raised to 7.15% in 1999. According to TRS staff, when employee contribution rates have increased, so have employer contribution rates. Increases in contribution rates have generally occurred when benefits were increased so as to keep TRS funded on an actuarially sound basis. Importantly, the relationship between employee and employer contributions appears to have remained roughly the same in that the employees' contributions have been matched and exceeded by the contributions from the employers and the State.

7) Importantly, Montana law has never provided that the employees pay a certain percentage of their income and the employer and/or the State pay whatever else is needed to keep the retirement system financially sound.

Under the Governor's proposal, these attributes of the contract remain unchanged and in fact, the situation is more compliant with this view of the contract that TRS will benefit from

increased revenue and will be moving toward actuarial soundness. It is also important to note that under the Governor's proposal, benefits and eligibility criteria will not change and the employer's contributions will not decrease; in fact, both the state and the employers will pay more than they paid previously.

These attributes of the TRS contract coupled with the proposed shared sacrifice to increase the amount of money contributed into that system point to some important distinctions from some of the cases cited for the proposition that any increase in employee contributions violates the Contract Clause. For example, in *Oregon State Police Officers' Assn., supra,* the statute at issue required the employees to pay all of a 6% contribution previously paid for by the State. Nothing like that is proposed here. In *Association of Pennsylvania State College and University Faculty, supra,* 505 Pa. at 372, 470 A.2d at 963, the Pennsylvania law which formed the basis of the pension contract provided for a 5% employee contribution and it also specifically provided that state and local employers were "required to make such contributions . . . as may be necessary to maintain actuarial soundness." When this formula was changed to increase employee contribution and decrease the state's obligation, the court held that the "only effects" of increasing employee contribution rates were to "increase the contribution required of members and to save the Commonwealth 1% of its budgeted payroll." *Id.* at 374, 479 A.2d at 964. The proposal here does not merely shift the cost of the retirement system from the employer and state to the employees. *See, also, Marvel v. Dannemann, supra,* 490 F.Supp. at 177 (noting that the state judge's retirement plan "from the beginning has had a provision calling for contributions from the State general fund in any amounts necessary to enable the Pension Plan to meet its commitments" and that the effect of increasing the amount of the judges' contribution "is not to increase the fiscal integrity of the Fund, but rather to provide that public funds will bear

substantially less of the costs of judicial pensions and that the judges will pay a correspondingly greater proportion of that cost.")

D. The California/West Virginia Model:

The "California rule" on the government's ability to alter a pension contract is that upon hiring, employees have "limited" contract rights to reasonable pensions. Prior to retirement, government may make "reasonable" modifications to an employee's retirement plan. To be considered "reasonable," a modification must have some material relation to the theory of the pension system and its successful operation and changes in a plan which result in disadvantages to employees must be accompanied by comparable new advantages. *See, e.g. Valdes v. Cory,* 139 Cal.App.3d 773. 189 Cal.Rptr. 212 (1983).

In *Booth v. Sims*, 193 W.Va. 323, 456 S.E.2d 167 (1995), the West Virginia Supreme Court considered a law which increased the employee (and employer) contributions rates for state troopers, prohibited troopers from using accrued but unused sick leave as credit toward years of service in determining retirement eligibility, and reduced the annual benefit CoLA from 3.75% to 2%. *Id.* at 331, 456 S.E.2d at 175. The West Virginia court essentially adopted the California rule (i.e., that detriment to employees must be offset by corresponding benefits) and held that the sick leave and CoLA provisions were unconstitutional substantial impairments of contract. However, it sustained the increase in employee contributions and in doing so, it held, "The legislature may increase a public employee's salary contribution to a pension plan if it gives a corresponding raise in salary or other benefits that offsets the employee's increased contribution to the system." *Id.* at 342, 456 S.E.2d at 186. Because the law also increased

trooper pay and made some seemingly small positive adjustments in benefits,[8] the court said that the increase in contributions had been offset by the increase in salary and benefits.

The California rule has not been adopted specifically in Montana. However, in *Clarke v. Ireland, supra,* 122 Mont. at 200, 199 P.2d at 970, our Court came very close:

> It is true that the public interest in retirement funds and retirement programs for employees and public officers alike demands that those in charge of the funds be constantly watchful of the integrity of the fund. Changes in interest rates, increase in the life span of the employees, experience in the operation of the retirement program, may require changes to insure that all the members of the system have the benefits which they have contracted for. Great latitude should be permitted the legislature in making alterations to strengthen the system. But such changes are subject to the above constitutional limitations. If the legislature is convinced of the need to safeguard and protect the fiscal base of the retirement system and plans changes to maintain the solvency of the system it must legislate within the framework of the Constitution.

Accordingly, if the Montana legislature structured the changes in the employee contribution rates in a bill where the increase in state funding was required to be used by school districts to increase employee pay (to offset the increase in employee contributions), another argument could be made that the changes in the employee contribution rates have been offset by a corresponding benefit and are, therefore, constitutional.

3) Conclusion:

The Contract Clause of both the state and federal constitutions insure that government keeps its contractual promises. Because the modern view is that pensions are contractual

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[8] The adjustment in benefits were: 1) Troopers who were fired after at least two years of service were entitled to their pension contributions plus 4% interest, whereas under previous law, troopers who were fired after two years received their accumulated contributions only; 2) Troopers who terminated after 10 years of service were allowed to withdraw their contributions (plus interest) or receive a deferred annuity at age 62, whereas previously they were allowed only to withdraw their contributions (plus interest); and, 3) All retired troopers were eligible for the annual CoLA, whereas previous law provided that some troopers were eligible for the annual CoLA only after reaching age 65. The decision does not quantify the value of these additional benefits. It does say that for certain "high ranking" troopers, the value of the wage and benefit increases was less than the cost of the increase in the contribution rate. "We think this is a *de minimus* problem that should be corrected by the legislature at its next session." *Id.* at n. 26.

promises, the Contract Clause poses some significant issues for any public employer seeking to increase funding into its pension plan by increasing employee contributions. The case law shows that this is difficult to accomplish.

However, the courts have long held that the Contract Clause does not prohibit all impairments of all contracts, even including contracts in which a government is a party. As it relates to pension contracts, the courts from other jurisdictions have made changing those contracts to the detriment of employees difficult, but not impossible. The Montana Supreme Court has not ruled on the particular issue of whether an increase in employee contribution rates violates the Contract Clause. It has made it very clear that a very important threshold issue in any Contract Clause case involves a critical analysis of the contract rights at issue – rights that in the pension context are created by Montana statutes and law. Montana has some features of its teacher's pension law that can be interpreted to mean that the contract between employees covered by the Teachers' Retirement System and the state allows for an increase in employee pension contribution when that increase is coupled with an increase in employer and state funding and when that increase is thoroughly justified by a carefully constructed factual record.