An Aging Workforce:

States and Municipalities Respond

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Introduction

No one likes talking about America's public pension crisis.

Not even those who, like me, are paid to do so.

The stakes are simply too high; the potential consequences of inaction too awful to contemplate. Any honest discussion of the unfunded liabilities attendant to such plans sends public officials (and their lawyers) to the drawer where they keep their secret stash of antacids.

Once upon a time, an *ad hoc* strategy of avoidance and denial bore fruit. Money was sometimes found for one-time" cash infusions." Investment returns temporarily "came back." Such short-term "fixes" often allowed us to weather the next election or bond rating agency presentation.

Those days are over.

New GASB standards require that public pension fund liabilities be reported "above the line" – that is, as true debt. Even healthcare trust liabilities must be so reported effective FY 2018.

And while markets continue to modestly rebound, the international instability typified by the "Brexit" movement (and, perhaps more significantly, China's recent economic slowdown) makes any long-term market solution uncertain at best. Bond rating agencies – and increasingly educated and skeptical electorates – will no longer buy the fiction that plans can somehow "earn their way out" of giant unfunded liabilities.

Worse, some actuaries now argue that public funds should be evaluated based upon the market value of their assets – thus eliminating the current "dynamic" evaluations that include discount rates/assumed rates of return. If this idea catches on, *every* fund in the country will be "underwater."

These new challenges aside, the demographic and economic pressures that have long harried public plans continue apace. Aging workforces, skyrocketing medical costs, increased standards of living, enhanced life expectancies – all of these forces inexorably conspire to force many state and municipal plans ever closer to insolvency.

Given this grim landscape, wholesale recalibration of benefits, contributions and investment strategies are inarguably in order. Yet a web of union contracts, political conflicts and competing budgetary concerns often make systemic change a political (and thus practical) impossibility.

Increasingly, states and cities have turned to both state and federal courts in search of relief – not only from their mounting obligations, but also from the prospect of outside political control by other government entities.

This paper is intended to serve as a high-level overview of recent efforts to modify retirement benefits and active employee contributions in our nation's courts. But it is also intended to create a dialogue regarding the frequent futility of this approach, and to posit collaborative strategies as a vehicle for moving public pensions into the 21st Century.

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Let us start with a controversial – but, in my view, axiomatic – proposition:

State and local entities have no business managing their own pension plans.

It bears repeating:

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Legislative bodies – whether state general assemblies or city councils – are by nature slow to act. Consensus is required. Multiple interests are considered, evaluated and given their proper respective weight(s). Individual elected officials are often forced to react to media coverage and constituent concerns (or, in many cases, media coverage of constituent concerns). And public records laws ensure than even a theoretical discussion of retiree benefits will be front page news.

Ask any plan manager at Fidelity or Great American and they'll tell you – this is simply no way to run a retirement system in 2016.

The hallmark of successful private plans can be summed up in one word: *Nimbleness*. Benefits and contribution levels are adjusted at least annually. Contribution levels are routinely revisited. Medicare and Medicaid changes are incorporated into the overall plan design in a timely manner.

City councils and state legislatures, by their very nature, cannot act in this manner. And even if they could take the "best practices" outlined above into account, they could not do so in a timely manner. Some legislatures, like that in the Commonwealth of Kentucky, only convene every other year.

Again: Municipal entities have no business running a pension plan.

The only problem is – they have no choice. A battery of state constitutional and statutory provisions obligate them to do so. And millions of state and local employees have paid into these plans, expecting them to be managed such that benefits will be available upon their retirement.

These state-specific requirements often not only force states and cities to maintain the plans, but also constrain even the most modest efforts to modify or “right-size” public benefits which typically far out-strip those available to private sector employees.

For instance, the constitutions of Michigan and Illinois contain express provisions which appear to guarantee retiree benefits once conferred. Similarly, the Revised Code of Kentucky explicitly refers to an “inviolable contract” between the Comonwealth and its workers in regards to retirement benefits. These are the sorts of terms which resist even the most artful of pleadings.

And it gets worse.

Colorable federal constitutional claims exist in regards to benefits previously received or guaranteed. These arguments range from property rights to due process – often paired with non-constitutional-but-complimentary claims like detrimental reliance, estoppel and *in quantum meruit*. While some courts have begun to reject free-standing claims of this nature, they continue to be filed, and are particularly potent when coupled with claims grounded in state law.

The end result: More than a third of the country lives in a city or state where unfunded public pension liabilities pose a threat to the delivery of basic services.

The nationwide tab in terms of unfunded public pension liabilities? Per the Brookings Institute’s 2013 estimate -- *$2.7 trillion*. And there is reason to believe that’s a conservative number.

And, as we will show below, efforts to address this problem through litigation sometimes makes matters more complicated.

Recent Trends In Public Pension Litigation: The Good, The Bad And The Extremely Ugly

As noted above, employees and retirees have myriad legal theories at their disposal – contractual, quasi-contractual, equity-based and constitutional.

While there is a clear trend against more general constitutional claims, there is also a clear trend of state courts giving full force to state constitutional language that appears to guarantee certain benefits.

For the purposes of this discussion, I will only focus on four state court decisions – rulings which, even when favorable, illustrate the pitfalls of a litigation-based approach to unfunded liabilities.

Illinois/Chicago

During the last two years, the Illinois Supreme Court has struck down two comprehensive public pension reform packages – one adopted by the State of Illinois and one adopted by the City of Chicago.

While the court's 2015 rejection of the state package produced the most staggering fiscal impact – the fund is $111 *billion* underwater – it was the sweeping language of the 2016 City of Chicago ruling that was the most troubling from a reform-minded standpoint.

This is not to say that the Illinois Supreme Court, as a matter of law, was incorrect. The state's constitution contains a broad "pension protection clause" which would appear resistant to even the most artful pleading:

> *Membership in any pension or retirement system of the State, or any unit of local government or school district, or any agency or instrumentality thereof, shall be an enforceable contractual relationship, the benefits of which shall not be diminished or impaired.*

Illin. Const., 1970, Article XIII, § 5.

Given this language, the Illinois Supreme Court understandably held that an employee forms a contract with the City of Chicago when it begins to pay into its retirement system. Even the relatively modest modifications at issue – the abolishment of a compound cost of living adjustment; gradually increasing the employee contribution rate from 8.5 percent to 11 percent – would result in a net "diminishment" of retiree annuity benefits, and thus violate the Illinois constitution.

This rationale mirrored the court's reasoning in its 2015 decision striking down state-level pension reforms. In both rulings, the Illinois State Supreme Court took a view of Article XIII that was as reductive as it was inarguably logical – that is, the provision was clearly designed to create an obligation that the state's legislative bodies would have no choice but to fund. If the state legislature and Chicago City Council had failed to meet these funding obligations – well, that was their problem. They can explain it to the unions, bond rating agencies, and, ultimately, their constituents.

Lower courts interpreted these decisions as creating an "absolute prohibition" on any measures which would serve to diminish retiree benefits. A Chicago area labor official praised the decision as one which would allow municipal retirees to retire with "grace and dignity" – despite the fact that the decision left two of the city's funds facing insolvency.

What is most troubling about this decision, however, is that the Illinois Supreme Court was overturning a *negotiated* set of reforms. Granted, these reforms were ultimately embodied in a piece of legislation, but they were the result of a collaborative process. In the end, fewer than two dozen active employees and retirees invalidated these packages via declaratory judgment.

This introduces one of the central questions we faced in the Cincinnati reform process – namely, how to bind the thousands of individual "rogue" retirees who indisputably possessed standing to challenge any negotiated settlement? (Hint: The answer involved Rule 23 of the Federal Rules of Civil Procedure.)

New Jersey/Atlanta

Two other major public plans were able to sustain legal challenges to their legislative reforms. But even these courtroom victories speak to the limitations inherent in running a complex pension plan by means of public processes.

In June, 2016, the New Jersey Supreme Court upheld a reform package that hinged upon reductions in cost of living adjustments ("COLAs"). At issue was a 2011 New Jersey state law which effectively suspended COLAs for state retirees until the fund reached 80 percent funding. While the New Jersey constitution was silent on pension rights, a 1997 law held certain state pension benefits were "non-forfeitable."

The New Jersey Supreme Court ultimately adopted the essence of the state's argument – that the 1997 law covered, at best, monthly annuity benefits, and COLAs were not included in the original law's reach. To the 6-1 majority, the issue boiled down to legislative intent. Had the New Jersey legislature intended to render COLAs untouchable in perpetuity, it would have expressly said so.

The savings associated with the freezing of the COLAS? An estimated $70 billon (of the fund's total $140 billion unfunded lability).

The Atlanta story presents a similar scenario. In 2014, a group of active employees filed a class action lawsuit alleging, *inter alia*, that the mayor's plan to increase employee pension contributions by five percent violated their contracts (and, thus, the contracts clause in the Georgia state constitution). In their view, the employees were owed tens of millions in restitution (even though the true amount of alleged damages was apparently never liquidated).

Absent express language to the contrary, the Georgia Supreme Court ruled for the city. This decision followed a growing number of federal court holdings in which standalone constitutional claims – absent pension-specific language – were found to be an improper vehicle for stopping legislative changes to public pensions.

Despite the successful outcomes embodied in these rulings, they did not provide ultimate solutions. Long-term flexibility – the aforementioned nimbleness – was not achieved. And both cases highlighted the ability of a handful of motivated retirees to sideline reform through aggressive litigation.

Cincinnati Collaborative Settlement Agreement: Creating – And Preserving – Nimbleness

Our firm began working on the Cincinnati Retirement System ("CRS") and its $870 million unfunded liability (on less than $3 billion in assets) in 2010. While the scale of the fund is smaller than most state funds, several universal lessons can be extrapolated.

The CRS is somewhat of an oddity – at least in the Midwest, where most municipal pension funds long ago merged with state funds (in Ohio, all cities but Cincinnati had invested their assets in the Ohio Public Employees Retirement System ("OPERS"). Founded in 1931, the CRS is a pre-ERISA plan and

a pure creature of municipal statute – that is, despite a highly-unionized workforce, plan benefits have never been subject to collective bargaining.

For decades, Cincinnati's decision to remain an independent municipal fund was more than defensible – it was laudable. CRS investment returns "beat the market" for generations. By 1998, the fund was so flush with cash that it added free dental, vision and a death benefit to assist with burials. Even after the turn of the century, investment returns were such that the city was at least theoretically justified in skipping its annual actuarially-required contribution ("ARC").

Then the market crashed in 2002.

And it crashed again in 2008.

In the course of these two fiscal catastrophes, CRS assets lost more than 35 percent of their value. Workforce attrition left 1.14 active employees to every four retirees – a nearly perfect inversion of the healthy ratio for a public fund. Medical costs continued to skyrocket – and the retirees, God bless them all, continued to live longer, projection-thwarting lives.

In 2009, Cincinnati City Council had no choice but to act. After a review of the Ohio Constitution (which contains no specific pension protections) and the Cincinnati Municipal Code (which did contain some arguable "vesting" language), City Council eliminated many ancillary benefits (vision, dental and death benefits) and modified the general retiree healthcare package for the first time in decades (many retirees still did not have a co-pay for office visits).

Within weeks, the Cincinnati Municipal Retirees Association ("CMERA") and their president, Thomas Gamel, had filed suit in federal court. The suit demanded an immediate TRO to halt the changes to the healthcare plan (it was filed on December 26 to create the requisite "emergency" prior to the January 1 enforcement date).

The federal district court judge declined the TRO request (which was based on federal constitutional claims) and refused to exercise supplemental jurisdiction over the claims relating to the City's municipal code and the Ohio constitution.

The matter was remanded to state court and resulted in *Gamel v. City of Cincinnati, et al,* a series of decisions which codified and memorialized a seemingly simple – but seldom-litigated – axiom of Ohio law: Contractual rights cannot be inferred from statutory provisions. Express and unambiguous language is required to bind a municipality.

Gamel was decided following a week-long trial – and buttressed by detailed findings from the trial court. In the end, the court found that retiree healthcare benefits are subject to modification or elimination absent express statutory language to the contrary; mere "vesting" is not enough to create a contractual right. The court of appeals agreed with each proposition of law, and the Ohio Supreme Court ultimately declined jurisdiction. *Gamel* remains the law of the law in the Buckeye State.

While the *Gamel* decision constituted a major win for the City – it saved the plan $300 million -- it failed to dissuade other litigation. The AFSCME labor union filed suit in short order (claiming that the City had not lived up to its statutory funding obligations), as did several coordinated groups of active unionized and non-unionized employees (claiming that subsequent changes to various retirement eligibility requirements were unconstitutional).

After four years of litigation, the end was still nowhere in sight. The City's bond rating continued to tumble. The Auditor of State formally threatened to put the City on "fiscal caution" status – the first step in obtaining a state receivership over municipal assets. At the same time, the Ohio General Assembly pondered legislation that would have imposed Draconian new funding requirements for the City – measures which would have decimated its overall fiscal position.

That said, *Gamel* did give the City powerful leverage – namely, it could eliminate retiree healthcare to offset any loss stemming from the litigation.

With this in mind, the City moved to consolidate all pending actions into federal district court. In order to effect a global settlement, the City – in what is surely one of the more novel moves in the history of municipal litigation – solicited the retirees to file a motion to intervene.

The end result: An omnibus piece of class action litigation which included as sub-classes all current employees and retirees, regardless of union or legal representation.

Next, the City requested that the Court place the matter into official "mediation status" – largely removing it from the docket. This also had the effect of binding the parties to secrecy (a position the judge encouraged with an expansive protective order). This aspect of the court's involvement was crucial – many of the concepts discussed during negotiations would have sent off a panic among the classmembers had they been made public.

Lastly – and importantly – the court insisted that the parties agree upon one actuarial expert to run projections during the talks. This eliminated the "dueling experts" problem which traditionally impedes such negotiations.

After 18 months, the parties had a deal – which was memorialized in a written agreement and processed as a traditional class action settlement. Notices were sent to classmembers; public information sessions were held; and the court conducted a fairness hearing replete with individual objectors and secondary actuarial testimony. The court approved the settlement, making lengthy findings in the process. Amazingly, no appeal was filed.

The resulting consent decree contained provisions which would have been unthinkable even two years prior – COLA suspension periods; a steady City contribution; an EGWHP for existing retiree prescription benefits; and numerous re-openers tied to general economic indicators.

Perhaps most importantly, the court retained jurisdiction over the settlement for 30 years. The parties' inevitable conflicts have since played out in the confidential confines of a judge's chambers, and not before a full city council with the cameras rolling.

All told, it would be exceptionally difficult for any participant in the system – employer, employee or retiree – to initiate new litigation over benefit levels outside of the consent decree. The City also obtained complete control over benefits for future employees not covered by the settlement.

Conclusion

In our view, the only way to approximate the "nimbleness" of a private plan in a public setting is to pursue a global settlement agreement in a class action context. The role of appellate decisions is diminished, and the management of the fund is largely removed from the political process. There will certainly still be conflicts to manage, but the oversight of a federal judge keeps the focus on the actuarial, not the political.

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