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August 24, 2006

ATTORNEY CLIENT PRIVILEGED AND CONFIDENTIAL

Hon. Bradley Abelow, Treasurer
Department of Treasury
State House
PO BOX 002
Trenton, NJ 08625-0002

Re: Limitations on the Ability of the Legislature to Reduce Retirement Benefits Provided to Public Employees Under Certain Pension Systems

Dear Treasurer Abelow:

You have asked whether the Legislature may reduce the retirement benefits that have been provided by law for public employees in several state retirement systems.[1] This question arises in the context of the ongoing deliberations of the Joint Legislative Committee on Public Employee Benefits Reform. For the reasons set forth below you are advised that N.J.S.A. 43:3C-9.5 created legally enforceable rights in vested members of the

[1] This opinion addresses the pension systems referred to in N.J.S.A. 43:3C-9.5, namely the Teachers' Pension and Annuity Fund, the Judicial Retirement System, the Prison Officers' Pension Fund, the Public Employees' Retirement System, the Consolidated Police and Firemen's Retirement System, the Police and Firemen's Retirement System and the State Police Retirement System. These systems shall be referred to, hereafter, as the "state pension systems."

state pension systems to the benefits programs of those systems. The extent of those rights is described in more detail herein. Under the State and Federal Constitutions, the Legislature may not enact laws which substantially impair those rights, except in the narrow circumstances recognized by state and federal courts. You are further advised that even where the federal and State constitutions do not bar changes to the pension systems, there may be federal tax consequences to any legislative action.

The Contract Clauses of State and Federal Constitutions

The federal Constitution limits the authority of a state to impair the obligations of contract. It provides that "No State shall...pass any...law impairing the obligation of contracts." U.S. Const. art. I, §10, cl.1. Our State Constitution has long contained a similar prohibition. N.J. Const. art. IV, §7, ¶3 provides:[2]

> The Legislature shall not pass any...law impairing the obligation of contracts, or depriving a party of any remedy for enforcing a contract which existed when the contract was made.

Although the language of these provisions (hereafter "the Contract Clauses") is not identical, our Supreme Court has found that "the provisions of the federal and state constitutions provide parallel guarantees." Fidelity Union Trust Co. v. New Jersey Highway Authority, 85 N.J. 277, 299 (1981) (internal quotations omitted). These two provisions are applied in the same way to provide the same protection. IMO Allegations of Violations of Law and the New Jersey Administrative Code by Recycling & Salvage Corp., 246 N.J. Super. 79, 100 (App. Div. 1991).

The limitations found in the Contract Clauses are not as broad as the language would suggest and the prohibitions set forth therein are not absolute. IMO Public Service Electric and Gas Company's Rate Unbundling, Stranded Costs and Restructuring

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[2] The 1844 Constitution contained a similar prohibition. See N.J. Const. (1844) art. IV, §7, ¶3.

Filings, 330 N.J. Super. 65, 93 (App. Div. 2000) aff'd. 167 N.J. 377 (2001). These clauses do not deprive the States of their broad powers to adopt general regulatory measures. United States Trust Co. v. New Jersey, 431 U.S. 1, 22, 97 S. Ct. 1505, 1517, 52 L. Ed. 2d 92 (1977). Instead, the courts have recognized that the Contract Clauses accommodate "the inherent police power of the State to safeguard the vital interests of its people." Energy Reserves Group, Inc. v. Kansas Power and Light Co., 459 U.S. 400, 410, 103 S. Ct. 697, 704, 74 L. Ed. 2d 569 (1983) (citing Home Bldg. & Loan Ass'n v. Blaisdell, 290 U.S. 398, 434, 54 S. Ct. 231, 239, 78 L. Ed. 413 (1934)); In re PSE&G, supra, 330 N.J. Super. at 93.

The United States Supreme Court has fashioned, and our Supreme Court has adopted and applied, a three part test for determining whether legislation impermissibly impairs a contract. They ask

> (1) has it substantially impaired a contract? (2) if so, does it have a significant and legitimate public purpose? and (3) is it based on reasonable conditions and reasonably related to appropriate governmental objections?
> [In re PSE&G, supra, 330 N.J. Super. at 92 citing State Farm Mutual Automobile Ins. Co. v. State, 124 N.J. 32, 64 (1991).]

See also Energy Reserves Group, supra, 103 S. Ct. at 704-705.

In determining whether the impairment of contractual rights is substantial the courts have considered several factors such as whether a particular industry has been regulated in the past and whether one of the parties reasonably relied on the contractual terms and whether the legislative action constitutes an unexpected modification of those terms. Energy Reserve Group, supra, 459 U.S. at 416, 103 S. Ct. at 707, In re PSE&G, supra, 330 N.J. Super. at 93. The more substantial the impairment, the greater the level of scrutiny to which the law will be subjected. Energy Reserve Group, supra, 459 U.S. at 411, 103 S. Ct. at 704.

The court next looks at whether the impairment is reasonable and necessary to serve an important public purpose.

Fidelity Union Trust Co., supra, 85 N.J. at 288. In determining reasonableness, the foreseeability of the circumstances giving rise to and the extent of the impairment are important considerations. Ibid. As for necessity, a court will look to whether the legislative objectives could have been achieved by a less drastic alternative, including one that does not impair contractual rights. Ibid.[3]

As to the second and third prongs, courts generally defer to the legislative judgment as to the reasonableness and legitimacy of the law. Energy Reserve at 413, PSE&G at 94. However, where a State is itself a party to the contract, the courts will not simply allow the State to walk away from its financial obligations. Instead, the courts have applied a "stricter standard" and said that "complete deference to a legislative assessment of reasonableness and necessity is not appropriate because the State's self-interest is at stake." Energy Reserves, supra, citing United States Trust Co., supra, 431 U.S. at 26, 97 S. Ct. at 1519; In re PSE&G, supra, 330 N.J. Super. at 94.

The Legislature Created Contractual Rights in Chapter 113

To determine whether the Contract Clauses limit legislative action, we must first determine whether L. 1997, c. 113 created contractual rights.[4] Fidelity Union Trust Co.,

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[3] Chief Justice Burger in a concurring opinion in United States Trust emphasized that the State must demonstrate that the impairment was essential to the achievement of an important state purpose and that the state would have to show it was unaware of the state interest at the time the agreement was made. Ibid.

[4] The constitutions of five states, Alaska, Hawaii, Illinois, Michigan and New York confer contractual status on public pension membership. The proposed constitution of 1942 would have accorded contractual status to the benefits payable by virtue of membership in any State pension or retirement system. It said "benefits payable by virtue of membership in any State pension system shall constitute a contractual relationship and shall not be diminished or impaired." Proposed Constitution (1942) art. VI, §1, ¶6. Reported in Record of

supra, 85 N.J. at 287. We recognize that as a general matter statutes do not create private contractual or vested rights, absent "clear statutory language indicating that the Legislature intended to bind itself contractually...." New Jersey Ass'n of Health Plans v. Farmer, 342 N.J. Super. 536, 575 (Chan. Div. 2001). Indeed, many early cases said clearly that the incidents of the pension funds did not constitute a contractual right with the employees. Rather, the employees had no rights except those based on the pertinent statute. See McFeely v. Pension Com'n of Hoboken, 8 N.J. Super. 575, 577 (Law Div. 1950); Sganga v. Police and Firemen's Pension Fund Com'n of Teaneck, 2 N.J. Super. 575, 579 (Law Div. 1949); Laden v. Daly, 132 N.J.L. 440, 443 (Sup. Ct. 1945) aff'd o.b. 133 N.J.L. 314 (E. & A. 1945); cf. Spina v. Consolidated Police and Firemen's Pension Fund Com'n, 41 N.J. 391, 400 (1964) (1920 pension statute did not create contractual rights). Here, however, we must look to the provisions of N.J.S.A. 43:3C-9.5 to determine whether the Legislature intended to and did create private contractual rights in enacting this law. See Spina, supra, (in deciding whether statute creates a contract or merely declares state policy it is of first importance to examine language of act).

The primary goal when interpreting statutes is to ascertain the Legislature's intent. Higgins v. Pascack Valley Hospital, 158 N.J. 404, 418 (1999). In that regard we are counseled to look first to the language employed as the surest indicator of the legislative design. McCann v. Clerk of the City of Jersey City, 167 N.J. 311, 320 (2001). Where that language is clear, the sole task is to enforce the statute in accordance with its terms. New Jersey Dep't of Law and Public Safety v. Bigham, 119 N.J. 646, 651 (1990). In ascertaining the

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Proceedings before the Joint Committee of the New Jersey Legislature Constituted under SCR No. 19 at 1032. A similar proposal was debated in a Committee of the 1947 Constitutional Convention, see 3 Proceedings of the Constitutional Convention of 1947 at 192. While not ultimately enshrined in the Constitution, it is evident that the framers in 1947 intended to leave to the Legislature the determination whether to accord contractual status to state pension rights. See 1 Proceedings at 475, 501 (regarding judicial pensions). See also Spina, supra, 41 N.J. at 400 n3. (discussing legislative attempts to accord contractual status).

legislative plan we may consider as well pertinent legislative history as a valuable aid in determining the legislative intent. State v. McQuaid, 147 N.J. 464, 480 (1997); Chasin v. Montclair State University, 159 N.J. 418, 427 (1999).

N.J.S.A. 43:3C-9.5 speaks of a "non-forfeitable right to receive benefits." The term "non-forfeitable" means "not subject to forfeiture." Black's Law Dictionary, 1076 (7th ed. 1999). See also Columbian National Life Ins. Co. v. Griffith, 73 F.2d 244, 246 (8th Cir. 1934). It implies that the right is legally enforceable, one which can be protected by resort to legal means.[5] The legislative history supports this understanding that the Legislature intended to create a legally enforceable right under this act. Because Chapter 113 creates a contractual right for certain members of the pension system, any subsequent amendment or repeal of Chapter 113 would not extinguish the rights conferred on those members.

N.J.S.A. 43:3C-9.5 traces its origin to L. 1997, c. 113. That section provides:

> a. For purposes of this section, a "non-forfeitable right to receive benefits" means that the benefits program, for any employee for whom the right has attached, cannot be reduced. The provisions of this section shall not apply to post-retirement medical benefits which are provided pursuant to law.

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[5] The scope of the right to a private pension protected under ERISA is more circumscribed than the rights accorded under c. 113. Federal case law has determined that the "non-forfeitable" provisions of ERISA assure that an employee's claim to the protected benefit is legally enforceable but not the particular amount or method of calculating the benefit. Bonovich v. Knights of Columbus, 963 F. Supp. 143, 146 (D. Conn. 1997) aff'd 146 F. 3d 57 (2d Cir. 1998). This ruling was rendered on March 21, 1997 at a time when the Legislature was actively considered c. 113 (Committee amendments adding the "non-forfeitable" language were added on April 17, 1997). Chapter 113, in contrast, specifies that the "benefits program" cannot be reduced and they have a right to receive those benefits.

> b. Vested members of the Teachers' Pension and Annuity Fund, the Judicial Retirement System, the Prison Officers' Pension Fund, the Public Employees' Retirement System, the Consolidated Police and Firemen's Pensions Fund, the Police and Firemen's Retirement System, and the State Police Retirement System, upon the attainment of five years of service credit in the retirement system or fund or on the date of enactment of this bill, whichever is later, shall have a non-forfeitable right to receive benefits as provided under the laws governing the retirement system or fund upon the attainment of five years of service credit in the retirement system or fund or on the effective date of this act, whichever is later.
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> d. This act shall not be construed to preclude forfeiture, suspension or reduction in benefits for dishonorable service.
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> e. Except as expressly provided herein and only to the extent so expressly provided, nothing in this act shall be deemed to (1) limit the right of the State to alter, modify or amend such retirement systems and funds, or (2) create in any member a right in the corpus or management of a retirement system or pension fund.

This section was added to the bill by the Senate Budget and Appropriations Committee. The purpose was to

> provide[] that a vested member of a retirement system or fund listed in the bill will have non-forfeitable right [sic] to receive benefits as provided under the laws governing the retirement system or fund upon the attainment of five years of service credit in the system or fund or on the date

> of the enactment of the bill, whichever is later. However, this provision of the bill will not apply to post-retirement medical benefits which are provided pursuant to law. [Senate Budget and Appropriations Committee Statement to S1119, April 17, 1997]

The bill made clear that the granting of a non-forfeitable right did not limit suspension or reduction of benefits for dishonorable service nor did it limit the State's right to alter, modify or amend the retirement system. However, it made no such reservations with respect to those employees who have obtained non-forfeitable rights, Thus, it clearly recognized that the effect of the bill was to circumscribe the State's ability to reduce the benefits package for members who have accrued rights under the non-forfeiture provision.

> The bill will not preclude the forfeiture, suspension or reduction of benefits for dishonorable service. In addition, the right to receive benefits will not be deemed to: (1) limit the right of the State to alter, modify or amend the retirement systems, other than the above-mentioned benefits for members who have attained 10 years of service, or (2) create in any member a right in the corpus or management of a retirement system. [Ibid.]

Finally, the Legislature fully anticipated that the non-forfeiture provision would have fiscal consequences for the State, particularly if further changes in pension benefits were made by future Legislatures. The Fiscal Note presented to the Committee and considered by the Legislature observed:

> The fiscal impact of [the non-forfeiture] provision, if any, cannot be calculated because any impact would only occur as the result of future statutory changes in pension benefits.... [Ibid.]

While not totally free from doubt, the Legislature may also reasonably be taken to have intended that future increases in the benefits accorded to state employees covered by the state pension systems would increase the scope of the non-forfeitable benefits accorded to covered employees and would, thus, similarly constrain the ability of the Legislature to circumscribe those benefits in the future.

Because the length of service varies for each employee covered by a state pension system, this act has had the effect of creating different categories of employees. Chapter 113 granted non-forfeitable rights to all vested members of the state pension systems. However, vesting occurs, for most of the state pension systems, upon obtaining 10 years of creditable service. The extent of the non-forfeitable benefits for individual employees is determined not at the time of vesting but with reference to the benefits provided by law for that pension system when the employee accrued 5 years of service credit. In the case of employees vested on the effective date of c. 113, the pertinent benefits were those existing by law as of that date. Employees who currently have at least 5 years of service credit, but have not yet vested, are not completely without rights under the act. A court may well find that Chapter 113, by setting the benchmark of protected rights at five years, has created an inchoate right in these employees, one which, upon vesting, matures into a fully protected, non-forfeitable right. Those employees with less than 5 years of service have neither vested nor attained the benchmark that fixes their protected benefits. It would appear, therefore, that the Legislature may, without offending the Contract Clauses, make substantial revisions to the benefits for these employees. However, as noted below, any change for these employees, and indeed all other employees, must be considered in light of the federal tax consequences of such a change.

We have not been provided with a description of the particular measures being considered by the Joint Committee, the rationale supporting those reforms or the groups of employees to which those acts would apply. We can, therefore, provide only general guidance. In weighing such measures under the Contract Clauses, a court will look at whether the changes are minimal or significant, the extent of any financial burden, what broad societal purpose the changes serve, whether the measures are temporary or permanent, whether the State was aware of its

interest at the time the contract was made and the availability of alternative measures that do not impair contractual rights.

In certain instances, courts in other jurisdictions have upheld modifications to the contractual pension rights of public employees against contracts clause challenges where comparable benefits were substituted for each employee. A leading California case held:

> An employee's vested contractual pension rights may be modified prior to retirement for the purpose of keeping a pension system flexible to permit adjustments in accord with changing conditions and at the same time maintain the integrity of the system. Such modifications must be reasonable, and it is for the courts to determine on the facts of each case what constitutes a permissible change. To be sustained as reasonable, alterations of employees' pension rights must bear some material relation to the theory of a pension system and its successful operation, and changes in a pension plan which result in disadvantage to employees should be accompanied by comparable new advantages.

City of Downey v. Board of Administration, 47 Cal. App. 3d 621, 631-32 (Cal. Court of Appeal 1975) (emphasis added) (upholding an increase in the employee contribution rate, because it was matched by an increase in the retirement allowance).

In City of Frederick v. Quinn, a Maryland appeals court stated: "The contractual or vested rights of the employee in Maryland are subject to a reserved legislative power to make **reasonable modifications** in the plan, or indeed to modify benefits if there is a simultaneous offsetting new benefit or liberalized qualifying condition." 371 A. 2d 724, 726 (Md. App. 1977) (bold emphasis in original other emphasis added); see also Wisconsin Professional Police Ass'n v. Lightbourn, 627 N.W. 2d 807, 841 (Wis. 2001), cert. den. 534 U.S. 1080, 122 L. Ed. 2d 696 (2002) (upholding numerous changes to the Wisconsin Retirement System). In Quinn, the City of Frederick adopted a

non-contributory retirement plan for police officers in 1951, but later repealed the plan and substituted a private contributory plan. The trial court found for the plaintiff plan members, holding that, under the Contract Clauses, the plan could not be modified to the members' detriment. The court of appeals vacated the judgment and remanded for further fact-finding as to the overall benefits and detriments of the City's plan changes. Quinn, supra; see also 60 Am. Jur. 2d §1178.

The persuasive value of decisions such as those above, coming as they do from other jurisdictions, is difficult to gauge. The opinions must also be read with a specific caveat: none of the decisions construed a statute comparable to Chapter 113 in its identification of particular plan provisions as non-forfeitable rights.

Tax Consequences

The potential exists that legislation modifying pension benefits, even if it passes constitutional muster under the Contract Clauses, could nevertheless create adverse tax consequences under the Internal Revenue Code ("IRC" or "Code"). The state pension systems currently enjoy two important tax benefits under the Code. First, the respective pension trusts are not liable for federal income tax on the earnings of the assets on deposit. 26 U.S.C. §501(a). Second, the members of the pension plans are taxed only at the time they actually receive benefit distributions from the respective pension trusts. 26 U.S.C. 402(a). To secure these two tax benefits, the trust fund for each State pension plan must be deemed a "qualified trust" under IRC §401(a). 26 U.S.C. 401(a).

We note in particular that any bill that would reduce the retirement benefits available to employees with less than five years service credit on the effective date of the bill's enactment should be examined in light of the detailed benefit accrual requirements specified by the Code. 26 U.S.C. §401(A)(7); 26 U.S.C. §411(b)(1). Failure to meet the benefit accrual standards - or any of the other qualification requirements under IRC §401(a) - could result in large tax liabilities for the trusts and the plan members. It may be advisable, therefore, to have specific proposed legislation reviewed by special tax counsel to ensure that any proposed

legislation will not adversely affect the status of the State's pension trusts under the Code.

Conclusion

For the reasons set forth above you are advised that N.J.S.A. 43:3C-9.5 created legally enforceable rights in vested members of the State pension systems to the benefits programs of those systems. Under the State and Federal Constitutions, the Legislature may not enact laws which substantially impair those rights, except in the narrow circumstances recognized by state and federal courts. You are further advised that even where the Contract Clauses do not bar changes to the pension systems, there may be federal tax consequences to any legislative action.

Our conclusion is rooted in the language, purpose and history of c. 113. It is also consonant with the well established treatment of pension laws by New Jersey courts. Pension laws are remedial in nature, and, as such, are to be construed liberally. Smith v. Consolidated Police and Firemen's Pension Fund Commission, 149 N.J. Super. 229, 232 (App. Div. 1977). Pension acts, in particular, are to be construed most favorably to the employee's interests. Mercer County v. State, 193 N.J. Super. 229, 233 (App. Div. 1984), cf. In re Smith, 57 N.J. 368, 380 (1971) (accidental disability pension law set forth in light most favorable to public employee); Greico v. Employee's Retirement System of Newark, 173 N.J. Super. 474, 478 (App. Div. 1980). Our conclusion reflects, as well, the majority view among the states that public employees have some contractual rights in their public pensions. See Darryl B.

Simko, Of Public Pensions, State Constitutional Contract Protection, and Fiscal Constraint, 69 Temp. L. Rev. 1059, 1060 (1996), at 1061-62, 60A Am Jur. 2d Pensions §1175.[6]

Sincerely yours,

ZULIMA V. FARBER
ATTORNEY GENERAL OF NEW JERSEY

By: _____
John P. Bender
Assistant Attorney General

/smb

[6] Those states generally recognize that although these rights are vested, the Legislature may make reasonable modifications if there is a simultaneous offsetting by new benefits of equal or greater value. Id. at §1178 (and cases cited therein).