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Honorable Members of the Joint Legislative Committee
on Public Employee Benefits Reform
State House Annex
PO Box 068
Trenton, New Jersey 08625

Dear Members of the Committee:

You have asked for a legal opinion as to whether the Legislature, by law, may reduce the retirement benefits that have been provided for public employees in the statutes establishing the various State-administered retirement systems.

For the reasons set forth below, it is our opinion that legislation that has the effect of detrimentally altering the retirement benefits of active members of State-administered retirement systems who have accrued at least five years of service credit, or of retired members, would be unconstitutional as violative of the federal and State constitutional proscription against impairment of the obligation of contracts.

“Pensions for public employees serve a public purpose. A primary objective in establishing them is to induce able persons to enter and remain in public employment, and to render faithful and efficient service while so employed.” Public pensions “act as an inducement to continued and faithful service.” Geller v. Dept. of the Treasury of New Jersey, 53 N.J. 591, 597 (1969) (citation omitted). “It is common knowledge that a pension is an element in encouraging qualified individuals to enter and remain in public service.” Masse v. Public Employees’ Retirem. Sys., 87 N.J. 252, 261 (1981). Similarly, “one of the ‘fundamental purposes’ underlying the pensioning of civil servants is to ‘secure good behavior and the maintenance of reasonable standards of discipline during service.’” Uricoli v. Police & Fire. Retirem. Sys., 91 N.J. 62, 70 (1982) (citation omitted).

In Uricoli, the New Jersey Supreme Court acknowledged the evolution of the

philosophy underlying public employee pensions from the early view that they were mere gratuities bestowed by a grateful sovereign to the more modern concept that a public pension is a form of deferred compensation to which an employee has a contractual right. In addressing the issue before it, specifically pension forfeiture for dishonorable service, the court found it unnecessary to embrace either view as to the nature of a public pension. Nevertheless, the court recognized the trend toward the acceptance of a contractual right to promised benefits:

This view of a pension as deferred compensation, designed to induce individuals to enter public service through its guarantee of payment for services and retirement security, has led some courts to regard pensions as a vested contractual right, with such benefits to be subject to forfeiture only where the Legislature clearly provided for that result. [Uricoli, 91 N.J. at 71]

More recently, in a case involving pension forfeiture for misconduct in office, the Appellate Division of the Superior Court stated: “Deferred compensation benefits have been earned by an employee and are no longer considered a gratuity.” Charles C. Widdis v. Retirement System, 238 N.J. Super. 70, 77 (App. Div. 1990). On this point, the Appellate Division also quoted from its prior decision in Fiola v. N.J. Treas. Dept., 193 N.J. Super. 340, 347 (App. Div. 1984):

It is virtually axiomatic that statutory pension provisions are to be liberally construed in favor of public employees and that pensions represent not merely the gratuity of a benevolent governmental employer but rather that they constitute deferred compensation earned by the employee during his years of service. [Widdis, 238 N.J. Super. at 78]

While the New Jersey courts have not had occasion to recognize a contractual right to a public pension, a majority of jurisdictions now “take the view that public employees have certain contractual rights in a public pension where a pension is part of the terms of employment.” 60A Am. Jur. 2d, Pensions, §1175 (2003). The modern trend has “been to protect pension rights on the theory that a state’s promise of pension benefits represents an offer that can be accepted by the employee’s performance.” Transport Workers v. SEPTA 145 F.3d 619, 623 (3rd Cir. 1998). However, states differ “regarding the point at which rights under public pension programs become protected from change where no right to modify is expressly reserved by the employer.” Id.

In 1997, the New Jersey Legislature addressed this issue through the enactment of N.J.S.A.43:3C-9.5 which established, for members of State-administered retirement systems,

a non-forfeitable right to receive benefits, as follows:

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.

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 Pension 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.

. . .

d. This act shall not be construed to preclude forfeiture, suspension or reduction in benefits for dishonorable service.

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.

Thus, the law provides that a member of a retirement system with five years of service on the act's effective date, June 5, 1997, has a non-forfeitable right to receive benefits under the laws governing the retirement system on that date.¹ A member accruing five years of service credit after the law's effective date has a non-forfeitable right to benefits based on the

¹ Use of the term "vested members" in N.J.S.A. 43:3C-9.5 is apparently intended to mean that a member's non-forfeitable right to receive benefits as provided by law after five years of service is contingent upon the member vesting (that is, eligible for deferred retirement) in the retirement system after ten years of service. See, for example, N.J.S.A. 18A:66-36 for Teachers' Pension and Annuity Fund (TPAF) and 43:15A-38 for Public Employees' Retirement System (PERS).

laws governing the retirement system on the date the member completes five years of service.² In either case, the non-forfeitable right to receive benefits means that the benefits program for that member “cannot be reduced.” The enactment of N.J.S.A.43:3C-9.5 also served to provide notice to persons beginning public employment after the law’s effective date that their pension rights will not become unalterable until they accrue five years of service. Although it appears that the retirement benefits for members with fewer than five years of service could be detrimentally altered, implementation of any change may have to be limited to prospective application, the rescission of any credit earned for the period prior to completing five years of service being problematic.³

“In general, 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.” United States Trust Co. v. New Jersey, 431 U.S. 1 (1977).

The United States Constitution provides that:

No State shall...pass any...Law impairing the Obligation of Contracts... . [U.S. Const. Art.I, Sec.X, cl.1]

Similarly, the New Jersey Constitution states that:

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. [N.J. Const. Art.IV, Sec.VII, par.3]

It has been held that these two constitutional provisions provide “parallel guarantees” and are to be construed in the same way to provide the same protection. Fidelity Union Trust Co. v. N.J. Highway Auth., 85 N.J. 277, 299 (1981). In general, “Our federal and state

² When a member has served and retired, all of the conditions precedent to the receipt of a pension have been fulfilled and the member’s benefits may not be changed to his or her detriment. 60A Am. Jur. 2d, Pensions, §1175 (2003). In addition, we believe that, because N.J.S.A.43:3C-9.5 created a contractual right for the members to whom it is applicable, any subsequent amendment or repeal thereof would not extinguish the rights conferred on those members.

³ For example, this may mean that if legislation were to be enacted that changes the formula for calculating benefits to reduce the benefit payable upon retirement for employees having fewer than five years of service on the bill’s effective date, the benefit should be calculated by applying the prior formula to service accrued before that effective date and the revised formula to the service accruing thereafter.

courts apply a three-prong test to determine whether legislation has unconstitutionally impaired a contract: they ask (1) has it substantially impaired a contractual relationship? (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 objectives?" In re PSE&G Co.'s Rate Unbundling, 330 N.J. Super. 65, 93 (2000); aff'd 167 N.J. 377.

In United States Trust Co., the United States Supreme Court established the standard of review to be applied when a state impairs a contract to which it is a party. The Port Authority of New York and New Jersey had issued bonds containing a statutory covenant restricting the extent to which revenues could be applied to deficits created by mass transit operations. Both states subsequently repealed the covenants. A trustee and holder of Port Authority bonds challenged the constitutionality of New Jersey's legislation repealing the covenant. The court held that repeal of the covenant violated the Contract Clause by impairing the obligation of the State's contract with the bondholders. In reaching this conclusion, the court said that a state statute which impairs a financial obligation of the state, like laws impairing private contracts, may be constitutional if it is reasonable and necessary to serve an important public purpose. The extent of the impairment is a relevant factor in determining its reasonableness. However, because the state's self interest is at stake, complete deference to a legislative assessment of reasonableness and necessity is not appropriate. "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." United States Trust Co., 431 U.S. at 26.

The standard of review established in United States Trust Co. was applied by the New Jersey Supreme Court in Fidelity Union Trust Co. v. N.J. Highway Auth., 85 N.J. 277 (1981). Bondholders brought a challenge under the Contract Clause to an amendment to the New Jersey Highway Authority Act which provided that toll increases could not become effective without the prior approval of the Governor and the Treasurer or Comptroller of the Treasury. The court summarized the appropriate standard of review as follows:

When a state's contract is involved, the initial inquiry is whether the state had the power to create an irrevocable contract right in the first place, since a state cannot surrender "an essential attribute of its sovereignty". ...

The next step in the analysis is whether the impairment is reasonable and necessary to serve an important public purpose. Necessity is met if the objectives could not have been achieved by a less drastic alternative. Reasonableness depends upon the extent of the impairment and upon whether the circumstances giving rise to the impairment were foreseeable when the contract was made. [85 N.J. at 287, 288 (citations to United States Trust Co. omitted)]

When these standards are applied to legislation having the effect of reducing pension benefits to which, by law, non-forfeitable rights have attached, it is apparent that the State would be impermissibly impairing the obligation of a contract to which it is a party.⁴ There can be no doubt that the State has the authority to contractually obligate itself to the payment of public employee pensions as a means of attracting and retaining qualified employees and has not thereby relinquished an essential aspect of its sovereignty. In addition, public employees who rely upon an offer of deferred benefits to their detriment and to the benefit of the employer, who gains the employee's services and loyalty, have expectations which are protected by the law of contract. Thus, any impairment of these rights would not be reasonable given the expectations of the parties and the employees' detrimental reliance on the employer's representations. Nor would it appear that a reduction in benefits is necessary to prevent the financial collapse of the State. More modest means of saving or raising money are available to the State that do not affect contractual obligations. A reduction of promised benefits would effectuate an impairment of the State's responsibility under a unilateral contract that it created. In addition, the circumstance giving rise to the need for a proposed benefit reduction, that the State at a future time may wish to reduce its financial obligations, was foreseeable at the inception of the contractual relationship and the State, nevertheless, committed itself and did not reserve the right to unilaterally adopt substantial modifications of the pension program.

"In many states recognizing contractual or vested rights of a public employee in a state or local pension system, those rights are subject to a reserved legislative power to make reasonable modifications in the plan, or to modify benefits, if there is a simultaneous offsetting new benefit of equal or greater value." 60A Am Jur. 2d, Pensions, §1178 (2003). Thus, such a substitution of one benefit for another may be permissible without impairing the obligation of contract as long as the change is reasonable and any disadvantage to the members is accompanied by offsetting and counterbalancing advantages, apparently under the theory that when there is no net loss in overall benefits the contractual relationship is not substantially impaired.⁵

In conclusion, it is our opinion that a law that has the effect of detrimentally altering the retirement benefit of an active member of a State-administered retirement system who has accrued at least five years of service credit, or of a retired member, would be unconstitutional

⁴ Benefit increases do not appear to raise the same problem. P.L.2001, c.133 increased the retirement allowance of members of PERS and TPAF by changing the benefit formula for members of PERS and TPAF. It would seem that this increase represented a modification of the contract which, having been accepted by the members, cannot be detrimentally altered.

⁵ Examples of reasonable modifications in other jurisdictions include raising the retirement age but increasing benefits and reducing the pension benefit but providing death benefits and payments to a surviving spouse. 60A Am. Jur. 2d, Pensions, §1178 (2003).

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as violative of the federal and State constitutional proscription against impairment of the obligation of contracts.

Very truly yours,

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AP:K/sl