EXHIBIT 1
DATE 1/23/09
HB Legislative Division

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(406) 444-3064
FAX (406) 444-3036

Hand out

Committee on Public Employee Retirement Systems

55th Montana Legislature

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MEMORANDUM

FOR : MS SHERI HEFFELFINGER

FROM: DAVID S. NISS

RE : LEGAL ISSUES SURROUNDING CHANGES FROM DB TO MODIFIED DB WITH DC COMPONENT RETIREMENT PLAN

DATE: FEBRUARY 27, 1998

I
INTRODUCTION

In connection with the Committee on Public Employees Retirement Systems (CPERS) study of possible changes in the Public Employees Retirement System (PERS) from a defined benefit (DB) system to a modified DB system with a defined contribution (DC) component, you have asked three related questions regarding the character or status of retirement benefits offered by the PERS and the creation of the modified DB system. Your questions are as follows:

A. To what extent are PERS retirement benefits protected from change by Art. II, sec. 31, of the Montana Constitution?

B. May PERS retirement benefits of current PERS members be transferred to a modified DB system with a DC component?

C. May future PERS members be required to join a retirement system consisting of a modified DB system with a DC component?

II
DISCUSSION

A. To what extent are PERS retirement benefits protected from change by Art. II, sec. 31, of the Montana Constitution?

Article II, sec. 31, Mont. Const. provides:

> No ex post facto law nor any law impairing the obligation of contracts, or making any irrevocable grant of special privileges, franchises, or immunities, shall be passed by the legislature.

Courts and legislatures in the United States have generally taken one of several approaches in defining the legal status of retirement benefits offered by state employee retirement systems. Some states treat those benefits as "property" that is protected by those state and federal constitutional provisions prohibiting the taking of property without due process of law. Other states treat those retirement benefits as gratuities that may be changed at the will of the state legislature. Other states treat those benefits as a right that is subject to promissory estoppel (an equitable remedy, not important to this discussion, that courts use to enforce promises by a person even though no actual contract exists). Still other states treat public retirement benefits as a matter of contract governed by the state law is of contracts.[1]

Montana is among those states that treat the right to a public pension as a contract right. The Montana Supreme Court has held in Clarke v. Ireland, 122 M 191, 199 P2d 965 (1948), Evans v. Fire Dept. Relief Ass'n 138 M 172, 355 P2d 670 (1960), Bartles v. Miles City, 145 M 116, 399 P2d 768 (1965), and Sullivan v. State, 174 M 482, 571 P2d 793 (1977), that benefits provided by public retirement systems are governed by a contract between the public employer and the employee to provide retirement benefits and that attempts to change the benefits agreed to in the contract are generally prohibited by Art. II, sec. 31, of the Montana Constitution,

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[1]60A Am. Jur. 2d Pensions and Retirement Funds sec. 1620 and 1626 through 1628; Til Death Do Us Part: Pennsylvania's "Contract" With Public Employees for Pension Benefits, Dwyer, 59 Temple L.Q. 553, 370 (1985); Public Employee Pensions in Times of Fiscal Distress, 90 Harvard L. R. 992 (1977). Most states that do not subscribe to the gratuity theory appear to treat public retirement system assets as protected by either the "property" theory or the "contract" theory. The West Virginia Supreme Court applies both theories and has held pension assets to be "contractually vested property rights". Dadisman v. Moore, 384 SE2d 816, 827 (W.Va. 1989).

prohibiting the interference with contract rights.[2] Public employee pensions are therefore protected by Art. II, sec. 31 of the Montana Constitution. The extent of that protection is the subject of the remainder of this memorandum.

B. May PERS retirement benefits of current PERS members be transferred to a modified DB system with a DC component?

1. Vesting and pension plan modifications -- the "California rule".

Because transfer of members and benefits from the current PERS plan to a new or modified retirement plan would necessarily involve a modification of the current contract with employee parties to the contract, your question must be analyzed in terms of the modifications to the contract that the courts may allow. With this in mind, it is important to note first that the "contract" to provide a pension of some sort is formed immediately upon employment. In Evans, the Supreme Court said that "the contract arises when the fireman pays into the fund" and in Sullivan the Supreme Court held that the "terms of the teachers' retirement benefit contract in Montana are determined by the controlling provisions of the teachers' retirement system statute in effect at the time the teacher becomes a member of the Montana Teachers' Retirement System." Thus, under the rationale of Evans and Sullivan, there is no point in time when transferral of an employee's benefits may be made free from consideration of principles of contract law as applied by Montana courts to a public retirement plan[3].

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[2]This area of Montana law is not entirely free from doubt. In the case of Casey v. Brewer, 107 M 550, 88 P2d 49 (1939), the Montana Supreme Court held that retirement benefits provided by a pension system requiring mandatory membership 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 sovereign." This view, as it applies to mandatory contributions to a retirement system, was repeated in Clarke v. Ireland but was not repeated in either Evans or Bartles, both of which involved mandatory contributions to a retirement system. Nor were the Court's prior opinions in Casey v. Brewer or Clarke v. Ireland even mentioned by the Court in the Evans and Bartles opinions. The opinions of the Montana Attorney General concerning retirement issues have followed Evans and Bartles and disregarded the fact that the contributions to the retirement system were required by statute. See footnotes no. 5 and 6 and accompanying text.

[3]However, in Gulbrandson v. Carey, 272 M 494, 502, 901 P2d 573 (1995), the Montana Supreme Court ruled in a case in which a retired District Court judge attempted to take advantage of a Judges' Retirement System benefit enhancement that became law two years after the judge's retirement. Without citing either the opinions in Evans or Sullivan or any other authority, the Montana Supreme Court held that "[t]he terms of Gulbrandson's retirement benefit

However, case law from other states indicates that the prohibition against impairment of contract rights provided by Art. II, sec. 31, of the Montana Constitution and the analogous federal provision in Art. 1, sec. 10, of the U.S. Constitution should not be taken too literally. There exists in some of the judicial opinions of those states adopting the contract theory of protection an exception to the prohibition against modification of pension contracts known as the "California rule", which provides that prior to retirement, an employee is vested immediately upon employment with a "limited" contract right to a "reasonable pension", that that limited right becomes a fully "vested" right to a specific pension benefit only upon retirement of the employee, and that the initial right to a "reasonable pension" is limited because the legislature may, before the employee's retirement, make "reasonable modifications"to the retirement plan. To be a "reasonable modification", a modification 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 must be accompanied by comparable new advantages. Valdes v. Cory, 139 Cal.App.3d 773, 189 Cal.Rptr. 212 (1983).[4]

The "California rule", allowing certain modifications to an employee retirement plan, has not been specifically adopted in Montana, but in the Clarke opinion, the Montana Supreme Court stated:

> 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, increases 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 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

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contract are determined pursuant to the statutes in effect at the time of his retirement on August 31, 1989." In making this statement, I believe that the Supreme Court assumed, without stating so, that the statutes they referred to are those that apply in the first instance to the person in question.

[4]Modifications have also been allowed by some state courts and by the U.S. Supreme Court, pursuant to Art. 1, sec. 10, of the U.S. Constitution, even if the modification results in a change that does not advantage the employee, under the conditions that (1) the modification must serve to protect basic interests of society, (2)there is an emergency justification for the enactment, (3) the enactment is appropriate for the emergency, and (4) the enactment is designed as a temporary measure. Sonoma County Organization of Public Employees v. County of Sonoma, 23 Cal.3d 296, 152 Cal. Rptr 903, 591 P2d 1 (1979).

> 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.

The foregoing language from Clarke sounds like the "California rule" as discussed in the Valdes case. However, the language quoted from Clarke was not central to the Court's holding and might therefore be classified as dicta. Only litigation of specific changes made to retirement statutes will tell whether the Montana Supreme Court will permit some types of changes to the pension contract of an active member, under which the right to a specific benefit payment has not yet vested, while prohibiting other types of changes.

2. Opinions of the Montana Attorney General and cases from other states

Montana has seen few cases litigating the effectiveness of changes to its public retirement systems. However, several opinions have been issued by the Montana Attorney General which shed some light on the legality of several types of changes to pension contracts. In a 1973 opinion[5], Attorney General Woodahl gave his opinion as to whether the Game Wardens' Retirement System had to maintain the level of retirement benefits for present members of the system without raising the percentage contribution by members and, if it had to maintain those benefits, the options available to the Game Wardens' Retirement System. The Attorney General began by summarizing the Clarke v. Ireland opinion, noting that the rights of the members of the system were contractual in nature, the terms of the contract being "dependant upon statutes in force at the time the relationship was entered into". The Attorney General then summarized the Evans decision and noted, as pointed out above, that in Evans, the Supreme Court did not make its decision concerning the contractual nature of the benefit depend upon whether contribution to and membership in the retirement system was mandatory or voluntary. The Attorney General concluded that PERS had to maintain the level of benefits for current members that was then specified in statute, that to maintain that level of benefits the System had to either increase its present contribution or make up any difference at a later time, and that the employee contribution then specified in statute could not be increased "without a corresponding increase in benefits which will accrue to members at retirement." The Attorney General also pointed out that the state could always increase its contribution to the system without increasing benefits to the members of the System.

In 1982, the Montana Attorney General gave his opinion concerning the right of members of the former firefighters' retirement system who had transferred to the new

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[5]35 A.G. Op. 4 (1973).

Firefighters' Unified Retirement System (FURS) their benefits accrued under the old system[6]. After the opinion noted that the legislation creating FURS had failed to address whether a certain class of firefighters was entitled to a certain "adjustment allowance" (guaranteeing a certain minimum retirement payment) as they had been under the old system, the Attorney General pointed out that section 19-13-107, MCA, stated legislative intent that members of the old system transferring to FURS were to retain "all rights and benefits accrued under a prior plan" and that this section actually codified the contractual rights protected by Art. II, sec. 31, of the Montana Constitution. The Attorney General held:

> A firefighter's pension constitutes an element of compensation, and a vested contractual right to pension benefits, which are stated in the retirement plan during the firefighter's employment, accrues when he begins paying into the retirement fund. * * * It is clear that those firemen who have transferred to the new retirement system cannot lose any retirement benefits accrued to them under the old system.

No reported Montana cases have litigated the right of PERS members to actuarial funding of their retirement benefits or the application of that right in the context of the creation of a new or modified retirement plan. Cases from other states may therefore help clarify the rights of PERS members who transfer to a modified DB pension plan and the rights of those members who do not.

In Board of Administration of the Public Employees' Retirement System v. Wilson, 52 Cal. App.4th 1109, 61 Cal. Rptr. 207 (1997), administrators of the California PERS brought suit to invalidate two legislative appropriation measures. In the two appropriation bills, the legislature sought to change the "level contribution" form of funding the PERS, in which employee contributions were made as liability was incurred for future pension obligations, to an "in arrears" funding method, by which the employer contributions were made in the fiscal year following that in which employee services were rendered. The Court of Appeals reviewed the history and legislative intent of previous legislative funding schemes for the California PERS and concluded that "[a]ctuarial soundness of the system is necessarily implied in the total contractual commitment, because a contrary conclusion would lead to express impairment of employees' pension rights." The Court of Appeals held the two appropriation measures as not being the kind of modifications allowed to the pension plan under the "California rule" and held that the appropriation bills were unconstitutional under the provision of the California constitution prohibiting impairment of contract rights.

In Association of State Prosecutors v. Milwaukee County, 544 NW2d 888 (Wisc. Sup. Ct, 1996), a group of county prosecutors, newly designated as state employees pursuant to a reorganization of prosecution services, brought a mandamus action to compel the transfer of

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[6]39 A.G. Op. 51 (1982).

their contributions from a county administered retirement system to a separate state-administered retirement system. Milwaukee County refused to transfer money to the state system, contending that the transfer would be a misappropriation of money held in trust for the benefit of vested employees and retirees. The Wisconsin Supreme Court held two statutes pursuant to which nonvested prosecutors could transfer employer contributions, and interest, made on their behalf from the county to the state fund and receive a service credit for county employment depending upon the amount transferred to constitute a "taking" of property without due process of law and prohibited by the 5th Amendment to the U.S. Constitution. In its opinion, the Wisconsin Supreme Court discussed the distinction that the Association tried to make between some previous Wisconsin judicial opinions and the current case on the basis that the former opinions involved defined contribution systems, whereas the case before the Court involved a defined benefit plan. The Supreme Court noted that "[a]ny pension plan's ability to meet its obligations can be jeopardized when funds are taken from it, since every dime is arguably part of a management strategy dependent upon spreading the fund's monies as broadly as possible."

As previously noted[7], Montana is not one of the states that subscribes to the "property" theory of protection of public pension money but rather one of the group of states that applies the "contract" theory of protection of those funds. For this reason it's likely that the Association of State Prosecutors opinion would not be applied per se by Montana courts. Nevertheless, the opinion is helpful in that Montana courts could, by application of the contract theory of protection of actuarial funding as expressed in Board of Administration of the Public Employees' Retirement System v. Wilson, reach the same conclusion that the value of all contributions to a retirement system, when actuarial funding is required, is so great that members transferring to another retirement plan may not physically take all of those contributions and their earnings with them upon transfer to the new plan.

A note of caution should, however, be raised at this point about the conclusions reached by the court in the Association of State Prosecutors opinion. For whatever reason, the Wisconsin Supreme Court failed to address a significant issue in its opinion. The issue it failed to address is the fact that when a member leaves a retirement system and removes both employee and vested employer contributions from that system, the former member of the system takes with him or her not only pension system assets but system liabilities as well, those system liabilities being the duty of the system to pay the retirement benefit in the amount and at the time specified in the "contract". Whether a pension system therefore needs "every dime", as the Wisconsin Supreme Court suggested, to make the system left by the former member actuarially sound depends upon how the assets removed, the assets left behind, and the remaining liabilities of the system are valued. If, for example, the remaining liabilities are no greater than the remaining assets, it is difficult to see how the contract of remaining members would be impaired. For these reasons, valuation of assets and liabilities is critical.

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[7]See footnote no.1 and accompanying text.

C. May future PERS members be required to join a retirement system consisting of a modified DB system with a DC component?

Article VIII, section 15 of the Montana Constitution provides :

> (1) Public retirement systems shall be funded on an actuarially sound basis. Public retirement system assets, including income and actuarially required contributions, shall not be encumbered, diverted, reduced, or terminated and shall be held in trust to provide benefits to participants and their beneficiaries and to defray administrative expenses.
>
> (2) The governing boards of public retirement systems shall administer the system, including actuarial determinations, as fiduciaries of system participants and their beneficiaries.

This section of the Montana Constitution was adopted as constitutional amendment number 25 as the result of a 1994 ballot measure. Because of its recent adoption, the meaning of the text of the amendment has not been the subject of any attorney general opinions or reported judicial opinions. The first sentence in (1) essentially incorporates the holding of Board of Administration. The language of the second sentence of (1) essentially means that the state may not use either employer or employee contributions and the income they generate as the basis for a loan, use those contributions and income for any purpose other than payment of retirement benefits, and may not curtail or end altogether the rate of contributions established in statute. These prohibitions seem to apply to both contributions to the current PERS retirement plan and to contributions to any new or modified plan created in the future.

All of the prohibitions contained in Art. VIII, sec. 15 are compatible with the "contract" theory of protection of pension plans adopted by the Montana Supreme Court. However, the breadth of language used in section 15 raises two further questions. These questions are: (1) whether the requirement for actuarial funding applies to all types of future retirement plans and therefore prohibits the creation of a DC plan; and (2) whether the requirements that plan assets be held "in trust" and not be "diverted" or "reduced" prohibit the transfer of an employee's assets from the current DB hybrid plan to a modified DB plan with DC components, even though the DB plan would continue to be actuarially funded or even though the creation of the DB plan with DC components and transfer of employee assets to that system constituted a "California rule" modification. As noted, no case history has developed on section 15 because it was only recently adopted. As to the first question, there is no indication in the legislative or ballot measure history of section 15 that the section was intended to prevent the creation of a DB plan with DC components. That issue was simply not addressed in the history of the section. However, taken literally, the language of section 15 would seem to prevent the creation of such a plan. The situation is the same concerning the second question; there is no indication in the section's legislative or ballot measure history that it was intended to prevent transfer of assets with a member's consent from the current hybrid DB plan to a modified DB plan with DC

components. However, taken literally, the language of section 15 would seem to prevent such a transfer. This seems especially true because of the potential for the adverse effect of the valuation of transferred assets in times of a falling stock market if there is no protection applied to the value of those transferred assets.

III
CONCLUSIONS

The application of Montana Supreme Court opinions, 35 A.G.Op. 4, 39 A.G.Op. 51, the Board of Administration and Association of State Prosecutors opinions, and Article VIII, sec. 15, of the Montana Constitution to the PERS means that:

1. Members of the PERS have a contractual right to retirement benefits. The terms of the contract are probably governed by the laws applicable that were in effect when they became members. However, members of the PERS must await actual retirement before the right to a specific retirement benefit payment becomes fully "vested".[8]

2. The Legislature may not, without consent of the members of the PERS, make changes to the contractual rights of PERS members to a retirement benefit unless the modification is necessary to make sure that the members have the benefits they contracted for or the amendments are otherwise necessary to strengthen the retirement system.

3. Contributions by or for current members of the PERS retirement plan and any new or modified plan cannot be used for any other purpose than retirement benefits and cannot be used as the basis of a loan or be decreased or terminated for current or future members once established by the employment contract.

4. Members of the current PERS retirement plan who voluntarily transfer from the DB plan to a new or modified plan must, through a system of credits, cash payments, or otherwise, be given credit for benefits earned under the current hybrid DB retirement plan.

5. Members of the current PERS retirement plan and members of a new or modified retirement plan are entitled, both before and after any current members are transferred to that new or modified plan, to have their retirement benefit funded on an actuarially sound basis.

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[8] It is believed that the only way that the Montana Supreme Court's opinions in the Evans and Sullivan cases can be reconciled with the Court's opinion in Gulbrandson is to say, like the California Court of Appeals in Valdes, that upon commencement of employment a member of the PERS is vested with a nonspecific right to payment of a retirement benefit under the statutes that apply to that member but that the member must await actual retirement for the right to a specific payment to become "vested".

Whether this requirement as a practical matter prohibits the transfer of a specific PERS member to a new or modified plan depends upon how the assets of the current PERS that are intended to be moved, the assets of remaining members, and the liabilities that remain behind are valued.

6. The employee contribution required to be made by current members of the PERS retirement plan cannot be increased, whether or not those employees elect to transfer to a new or modified retirement plan, without a corresponding increase in their retirement benefits.

7. No assurance can be given that the language of Art. VIII, sec. 15, of the Montana Constitution would not be construed by a court to prevent the creation of a modified DB plan with a DC component. Likewise, no assurance can be given that the language of the same section requiring retirement system assets to be held "in trust" and prohibiting them from being "diverted" or "reduced", would not be construed to prohibit transfer of a PERS member and the member's retirement trust fund assets from the current DB hybrid plan to a modified DB plan with a DC component.

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Average Faculty Salaries Regional Comparison, All Ranks by Institution Type
2006-7 Salaries

Institution Type	Nevada	Arizona	Colorado	Utah	New Mexico	Wyoming	Montana	N. Dakota	S. Dakota	Idaho
Public Doctoral Institutions	$80,293	$78,802	$72,767	$70,560	$69,279	$68,282	$59,833	$58,899	$58,575	$57,434
Public Master's Institutions	$59,057	$65,007	$53,113	$54,667	$52,760	n/a	$51,084	$46,641	$57,363	$55,965
Other Public 4-yr Institutions	$60,163	$66,957	$51,469	$54,399	$40,650	n/a	$45,134	$43,397	$40,023	$42,519
Public 2-yr Institutuions	$61,097	$63,628	$44,582	$45,802	$44,999	$47,891	$39,438	$40,469	$41,264	$49,217

Note: Figures cover full-time members of the instructional staff on nine-month contracts. Figures do not include medical-school faculty. The average for all faculty members includes the categories of instructors, lecturers, and faculty members without rank.

Source: The Chronicle of Higher Education, Alamanac Issue 2008-9, August 29, 2008.

Average Annual Salary by Academic Rank, 2007-08

source: Chronicle of Higher Education, AAUP Faculty Salary Survey

Doctoral Institutions in Western Region - ranked by professor salary

States	Institutions	2007-08 Salaries (in thousands)			
		Professor	Assoc Prof	Asst Prof	Instructor
AZ	Arizona State U, Tempe	118.4	80.2	72.3	36.7
CO	Colorado School of Mines	118.1	80.8	72.9	-
CO	U of Colorado at Boulder	116.4	84.9	72.3	48.0
WA	U of Washington	116.4	83.4	73.9	41.8
NV	U of Nevada at Reno	116.0	85.9	67.6	51.1
NV	U of Nevada at Las Vegas	114.5	85.5	66.2	57.2
AZ	U of Arizona	113.1	79.0	69.7	-
UT	U of Utah	109.5	77.7	68.7	62.5
CO	Colorado State U	102.3	76.4	65.6	-
NM	U of New Mexico	99.0	72.2	63.6	58.7
WA	Washington State U	96.1	71.4	64.3	43.0
OR	U of Oregon	94.8	67.5	61.9	43.2
WY	U of Wyoming	94.5	71.2	62.8	55.3
OR	Oregon State U	88.7	68.7	64.1	42.8
AZ	Northern Arizona U	87.0	64.6	53.4	41.8
ID	U of Idaho	86.5	67.4	57.6	47.0
UT	Utah State U	84.7	65.6	61.6	46.0
ND	North Dakota State U	84.2	64.9	59.2	56.6
SD	U of South Dakota	83.8	61.3	53.1	40.8
OR	Portland State U	83.6	65.1	52.7	38.0
AK	U of Alaska, Fairbanks	83.2	67.3	55.4	43.5
ND	U of North Dakota	80.3	66.3	56.5	46.1
MT	Montana State U at Bozeman	78.9	62.3	53.9	42.4
CO	U of Northern Colorado	76.3	59.5	49.5	48.2
NM	New Mexico State U	76.2	66.3	56.0	40.9
MT	U of Montana, Missoula	75.9	60.6	54.5	43.5

note: Idaho State University, University of Hawaii at Manao, and South Dakota State data not available