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STATE ADMINISTRATION/VETERANS' AFFAIRS
October 20, 2011
Exhibit 12

TO: Senator Dave Lewis

FROM: David S. Niss, Staff Attorney

RE: Constitutionality of Potential Legislation Modifying the GABA for Both Current and Retired Montana State Employees

DATE: August 14, 2009

I
INTRODUCTION

You have asked whether there could be any circumstances that would allow the Montana Legislature to amend the statutes requiring the payment of a guaranteed annual benefit adjustment (GABA), for both current and retired state employees, to tie the amount of the GABA to the investment performance of funds from which the GABA is paid. This memorandum responds to your inquiry.[1]

II
DISCUSSION

A. Background

In 1998, the Committee on Public Employee Retirement Systems (CPERS) studied the creation of a defined contribution retirement system and recommended legislation, which was later enacted, creating that system. As part of that study, the CPERS staff examined a number of legal issues, including the extent to which existing retirement pension plans are protected by language in Article II, section 31, of the

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[1]This memorandum does not deal with Article VIII, section 15, of the Montana Constitution, concerning the protection of public retirement system assets because it seems clear that an obligation in statute or contract to pay a GABA cannot be considered an "asset" of a retirement system. However, any income and contributions necessary to fund the GABA could be considered "income" or a "contribution" under this article and section that may not be "reduced" and must be "held in trust to provide benefits to participants". There are no reported judicial opinions in Montana by which to gage whether this constitutional language, in effect, prevents reduction of the GABA or any other "benefit".

Montana Constitution prohibiting interference with contracts.[2] That language has a federal counterpart in Article I, section 10, of the U.S. Constitution,[3] usually referred to as the "contract clause", which will be used in this memorandum to refer to both the federal and state provisions because the Montana Supreme Court treats those provisions as interchangeable (see below). As part of that study of the contract clauses, the CPERS staff prepared a memorandum, dated February 27, 1998 (1998 Memorandum), explaining the contract clause case law from Montana and other states. The 1998 Memorandum has been previously furnished to you, and the conclusions reached in that Memorandum will not be repeated but will be referred to in this memorandum.

The 1998 Memorandum noted that the opinions of the Montana Supreme Court treat the state retirement laws as a contract between the employee or retiree and the state or other entity administering that law.[4] These opinions are germane to your issue of tying the amount of the GABA to investment earnings because the GABA was originally enacted in 1997 and still exists as a percentage of a retiree's benefit payment without reference to investment earnings. A change to those statutes would unquestionably have to be made and would therefore involve a change to the terms of the statutory retirement pension contract. However, because of a dearth of case law on the subject from the Montana Supreme Court and other Montana courts, lack of clarity in existing opinions, and conflicts between those opinions, the precise effect of Article II, section 31, upon a particular provision in a statutory public retirement pension contract cannot be readily predicted.[5]

Since the 1998 Memorandum was written, there have been no Montana Supreme Court opinions issued concerning the application of Article II, section 31, to changes in the retirement pension contract found by the Montana Supreme Court to exist and certainly no opinions explaining the effect of that constitutional provision upon changes to the GABA, which was not enacted until 1997. Therefore, in order to answer your question, decisions of lower Montana courts, opinions from the Montana Supreme

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[2] Article II, section 31, of the Montana Constitution provides in pertinent part that no law impairing the obligations of contracts shall be passed by the legislature.

[3] Article I, section 10, of the U.S. Constitution provides in pertinent part that no state shall, without the consent of Congress, pass any law impairing the obligation of contracts ."

[4] 1998 Memorandum, page 2.

[5] The statutes providing for the GABA in state retirement systems administered by the Public Employees' Retirement Board are listed in section 19-2-908(3)(b), MCA. The GABA for the Teachers' Retirement System is provided for in section 19-20-719, MCA.

Court not dealing directly with statutory public retirement pension contracts but with other types of contracts, and decisions from courts of other jurisdictions that have attempted to limit GABA-like statutory provisions will have to be considered.

B. Opinions by Lower Montana Courts on the Effect of Article II, section 31, on the Retirement Pension Contract

The only opinion by a lower Montana court dealing with the effect of the Montana contract clause upon changes to a pension retirement contract, as found by the Montana Supreme Court, that's been located is Baumgardner v. Public Employees Retirement Board, First Judicial Dist., Lewis and Clark Co., Cause No. ADV-2002-450, 2007 Mont. Dist. LEXIS 133 (2007). In that case, the court quite properly found that before it could determine the effect of the contract clause upon a statutory pension retirement contract, the court must find that a contract existed. The court found that there was no contract as to the specific method used by the Board to calculate the optional payout scheme at issue in the case. In its opinion, the District Court wrote that the Supreme Court's opinion in Clarke v. Ireland, 122 M 191, 199 P.2d 965 (1948), didn't apply because, among other reasons: (1) membership in the teachers' retirement system involved in Ireland was then voluntary; (2) two other opinions by the Montana Supreme Court, Evans v. Fire Dept. Relief Ass'n, 138 M. 172, 355 P.2d 670 (1960), and Bartels v. Miles City, 145 M 116, 399 P.2d 768 (1965), did not deal with the PERS but with other retirement systems; and (3) the statutes in question requiring membership in the PERS used the present tense, with the court stating "[t]he relevant provisions of the Public Employee Retirement Act are stated in the present tense. There is no indication that the Act provides anything other than the current policy with regard to calculation of retirement benefits".[6] However, the District Court's analysis in Baumgardner, leading to the conclusion that there was no contract as to the optional payout scheme, missed at least two very important points regarding these three reasons for holding that no contract existed: first, that the Evans and Bartels cases, which the District Court barely considered because "these cases did not involve PERS", did concern mandatory participation retirement systems created by state statutes (see 11-1825 and 11-1911, R.C.M., 1947), just like the PERS statute at issue in Baumgardner; and second, that under another statute governing statutory construction not considered by the court, section 1-2-105(1), MCA, "present tense includes the future as well as the present". For these two reasons at least, the opinion by the District Court in Baumgardner is suspect and, in any event, is not binding upon the Montana Supreme Court or even other Montana District Courts.

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[6]The District Court also found that there was no other indication in the language used in several statutory sections of a legislative intent to create a contract. Other state appellate courts have, however, found just such an intent based upon no clearer language, when read in conjunction with section 1-2-105(1), MCA. See, e.g., Strunk v. Public Employees Retirement Board, 338 Ore. 145, 108 P.3d 1058 (2005).

C. Opinions of the Montana Supreme Court Regarding the Contract Clause and Other Types of Contracts

Most recently, in Seven Up Pete Venture v. State, 2005 MT 146, 327 M 306, 114 P3d 1009 (2005), the Montana Supreme Court applied a legal doctrine that allowed the state to interfere in a contractual relationship. In that case, the Court held that a prohibition against cyanide heap leach mining enacted by a voter-approved initiated measure did not unconstitutionally interfere with any contract rights of a joint venture mining company to mine gold and silver from land on which it held mineral leases predating the voters' approval of the initiative. One of the bases for the Court's ruling was a legal doctrine that other courts have described as the "retained power" or "reserved power" of a state to interfere with a contract.[7] Under this doctrine, a state may substantially interfere with a contract if the state has a significant and legitimate purpose for doing so and the "interfering" law imposes reasonable conditions that are reasonably related to achieving the legitimate and public purpose.[8]

Without reference to "reserved" or "retained" power, the Montana Supreme Court has applied the substance of this doctrine of contract interference in cases involving other types of contracts that are not statutory public retirement pension contracts. In Neel v. First Fed. S & L Ass'n, 207 M 376, 675 P.2d 96 (1984), the Court applied a homestead exemption statute retroactively to interfere with a mortgage contract providing for forfeiture of property and held that the exemption applied notwithstanding the contract clauses in both the federal and state constitutions. In Carmichael v. Workers' Comp. Court, 234 M 410, 763 P.2d 1122 (1988), the Montana Supreme Court, relying as it did in Neel upon case law interpreting the federal contract clause, noted that a three-step analysis is necessary to determine whether a statute violates the contract clause of the Montana Constitution. Under this analysis, a court must determine the following issues before a contract may be interfered with: (1) is the

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[7]See, e.g., Maryland State Teachers' Ass'n, Inc. v. Hughes, 594 F. Supp. 1353 (1984).

[8] While this doctrine allowing interference with contracts seems to fly directly in the face of the very language of both the Montana and federal constitutional contract clauses, the Montana Supreme Court has held that the Montana and federal contract clauses are interchangeable and that federal case law allowing interference with contracts is therefore of precedential value in Montana. See, e.g., City of Butte v. Roberts, 94 M 482, 23 P.2d 243 (1932), and Neel v. First Fed. S and L Ass'n, 207 M 376, 675 P.2d 96 (1984). In Home Building & Loan Ass'n v. Blaisdell, 290 U.S. 398 (1934), the U.S. Supreme Court held that the federal contract clause prohibition "is not an absolute one and is not to be read with literal exactness like a mathematical formula".

"interfering" law a substantial impairment of a contractual relationship; (2) does the state have a significant and legitimate purpose for the law; and (3) does the law impose reasonable conditions that are reasonably related to achieving the legitimate and public purpose? As stated, no decisions of the Montana Supreme Court have been found applying this method of analysis to statutory public retirement pension contracts. This method of analysis, when applied to statutory public pension retirement contracts, is similar to the "California Rule" allowing limited interference with those contracts, as reviewed in the 1998 Memorandum.[9] As stated, that rule allowing limited interference with contracts has not been adopted by the Montana Supreme Court for the purposes of statutory public retirement pension contracts.

D. Decisions in Other States

In other states, the three questions applied in Carmichael or some version of them has been applied to statutory retirement pension contracts that include GABA-like increases in public retirement benefits, with varying results. In Maryland State Teachers Ass'n, Inc. v. Hughes, 594 F. Supp. 1353 (1984), a federal district court found that a 3% cap on a previously unlimited cost of living adjustment (COLA) was a reasonable response under Maryland's reserved powers to save a retirement system for which actuarilly sound funding was endangered. Conversely, in Strunk v. Public Employees Retirement Board, 338 Ore. 145, 108 P.3d 1058 (2005), the Supreme Court of Oregon held that the Legislature had breached its promise to provide a COLA based on the Consumer Price Index, by subsequently limiting the COLA to a maximum of 2% per year, notwithstanding an "economic necessity" defense to that breach made by the state.

E. Discussion

Upon examination of the courts' rulings in Maryland State Teachers Ass'n and Strunk and other similar opinions by courts of other jurisdictions dealing with impairment of a statutory public pension retirement contract for payment of GABA-like increases pursuant to that contract,[10] it's apparent that changes made by a legislature to the law governing a GABA-like benefit are to be treated no differently than a modification to any other provision of a statutory public retirement pension contract. Therefore, the

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[9]1998 Memorandum, pp. 3 - 5.

[10]See, e.g., Levine v. State Teachers Retirement Board, 1998 Conn. Super. LEXIS 233 (1998), Booth v. Sims, 193 W. Va. 323, 456 S.E.2d 167 (1994), United Firefighters of Los Angeles City v. City of Los Angeles, 210 Cal. App. 3d 1095, 259 Cal. Rptr. 65 (1989), Association of Blue Collar Workers v. Wills, 187 Cal. App. 3d 780, 232 Cal. Rptr. 174 (1986).

question of whether Montana courts would find unconstitutional, as a violation of the Montana and federal contracts clauses, a change in a vested right to the GABA now provided for in Montana statutes is to be answered no differently than whether Montana courts would sanction any other change to vested rights in a statutory public retirement pension contract. The issue of impairment of statutory public retirement pension contracts was examined in the 1998 Memorandum, and the conclusion there was that there was no clear indication that Montana courts were moving to adopt the "California Rule" or any other legal theory under which reasonable and necessary modifications could be made in certain situations.[11] If, therefore, changes to the GABA statutes were to be undertaken for the purpose of state retirees and employees (employed by the state at the time the legislative change became effective), certain things would have to happen: (1) the courts would have to recognize a theory of law allowing interference with statutory public retirement pension contracts; and (2) the contemplated "interfering" legislation must be written in a manner that comports with the Neel and Carmichael opinions and perhaps with the opinions in Maryland State Teachers Ass'n , Strunk, or other "California Rule" cases as well. That legislation should therefore consider and be responsive to the following types of issues:

(1) Is the contract provision to be interfered with a vested right?
(2) How substantial is the contemplated change and therefore the interference?
(3) What does the legislation hope to achieve?
(4) Does the legislation achieve that goal?
(5) Was the situation creating the need for the legislation forseeable at the time the original legislation was adopted?
(6) What will happen if the contemplated legislative change is not passed by the Legislature?
(7) Are there other alternatives to the contemplated legislation?
(8) What advantage does the legislation carry for those persons to whom it applies?

The foregoing considerations are taken from the Montana and other judicial opinions previously cited using a contract interference doctrine applicable to contracts generally or to statutory public retirement pension contract interference doctrines like the "California Rule".[12]

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[11]1998 Memorandum, pages 3 through 5.

[12]Several of these listed considerations are particularly important because the U.S. Supreme Court has held that under the federal contract clause, states are not as free to modify their own contracts as they are to modify contracts to which the state is not a party. In United States Trust Company of New York v. New Jersey, 431 U.S. 1 (1977), the Supreme Court held that complete deference to a state legislature's decision that impairment of a contract is necessary for a public purpose will not be paid when the contract is between the state and another party because the state's own self- interest is at stake.

III
CONCLUSION

Since the 1998 Memorandum was written, there have been no decisions by the Montana Supreme Court that clearly alter the Court's previous opinions finding that a contract exists between the state and its employees governing the retirement benefits payable to those employees. However, the Montana Supreme Court has issued opinions both before and after the date of that memorandum stating the conditions under which contracts not involving statutory public retirement pensions can be altered without offending the contract clauses of the Montana and U.S. Constitutions. The circumstances that must exist in order to allow the Legislature to constitutionally amend the existing GABA provisions to require that the amount of the GABA be tied to investment earnings for current state retirees and employees are: (1) the Montana Supreme Court must hold its decisions applicable to impairment of other types of contracts to be applicable to statutory public retirement pension contracts, as found in previous decisions of the Court (in effect, adopting the "California Rule", or something like it, described in the 1998 Memorandum) and (2) the legislation that would otherwise impair the retirement contracts must consider and be responsive to those issues found in such cases as Neel and Carmichael to justify contractual interference generally or (3) the Montana Supreme Court must reverse its previous decisions such as Clarke v. Ireland and hold that statutory public retirement pension provisions are not part of a contract at all but are either: (a) a gratuity that the state may change at will; or (b) entitled to some lesser form of protection under a different theory of law that would allow the contemplated change.

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