STATE LEGAL ANALYSIS

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MEMORANDUM

DATE: December 22, 2016

TO: The Select Committee on Pension Policy
c/o Office of the State Actuary

FROM: Anne Hall, Senior Counsel
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SUBJECT: **Report by the Attorney General's Office on State Law Analysis of the Merger of LEOFF 1 and TRS 1 pursuant to the provisions of Senate Bill 6668**

The 2016 Legislature directed the Select Committee on Pension Policy (SCPP or Committee) to study Senate Bill 6668 (2016) and to report to the Legislature on the tax, legal, fiscal, policy, and administrative implications of that bill by January 9, 2017. Senate Bill 6668 merges the assets and liabilities of Law Enforcement Officers' and Firefighters' Retirement System Plan 1 (LEOFF Plan 1) and Teachers' Retirement System Plan 1 (TRS Plan 1), and makes a number of other changes and additions to statutes governing LEOFF Plan 1, the Department of Retirement Systems, and the actuarial funding of the state public pension systems.

The SCPP asked counsel assigned to the Committee to analyze Senate Bill 6668 and provide a report to the Committee on the legal implications of that bill. The following report discusses the *state law* implications of Senate Bill 6668 and makes recommendations to the Committee regarding modifications to the bill. In a separate report, the State Actuary's Special Assistant Attorney General, the Ice Miller law firm, analyzes the *federal tax law* implications of Senate Bill 6668.

The state law report is presented in three parts. The first part is a short summary of state pension law and pension rights of members,[1] and a discussion of whether Senate Bill 6668 affects those rights. The second part is an abbreviated legal analysis of the summary and conclusions found in the first part. The third part addresses in more detail the legal analysis governing whether LEOFF Plan 1 and TRS Plan 1 members' constitutionally protected contractual rights may be impaired if Senate Bill 6668 is enacted in its present form. A summary of Senate Bill 6668 is attached as Appendix A.

[1] The term "members" is used to refer to both public pension members and retirees unless a distinction needs to be made in the text.

This report is intended to assist the SCPP in responding to the Legislature's directive to prepare a report on the provisions of Senate Bill 6668. The report is my considered legal judgment as the Committee's assigned counsel. This report is not intended to be a formal opinion by the Attorney General. I understand that the SCPP waives the attorney-client privilege solely as to the contents of this report, and does not waive that privilege as to any underlying research or analysis generated to prepare either the state law or federal law report.

Part 1 – Short Summary of State Law Analysis

- Members of LEOFF Plan 1 and TRS Plan 1 have certain pension rights that are contractual in nature. Those rights can be found in Washington statutes and rules, and in Washington case law that interprets those statutes and rules.

- LEOFF Plan 1 and TRS Plan 1 members have a vested contractual right to a monthly service or disability retirement allowance that was guaranteed to them at the beginning of their service. This retirement benefit cannot be modified except under certain circumstances and to the advantage of the member.

- LEOFF Plan 1 and TRS Plan 1 members' monthly service or disability retirement allowance will not be reduced after a LEOFF Plan 1 and TRS Plan 1 merger under Senate Bill 6668. Therefore, Senate Bill 6668 does not deny LEOFF Plan 1 and TRS Plan 1 members' their vested contractual right to a monthly retirement allowance.

- In the absence of evidence that the merger will create an actuarially unsound pension plan, LEOFF Plan 1 and TRS Plan 1 members' vested contractual right to the systematic funding of their retirement plan to maintain its actuarial soundness is probably not violated by the merger, although this question has never been considered by Washington courts.

- Under state law, TRS Plan 1 employers cannot pay for LEOFF Plan 1 benefits from monies provided by the Legislature for basic education. However, until there is a viable scenario under which TRS Plan 1 employers are required to pay for LEOFF Plan 1 benefits out of funds designated for education, it is difficult to answer the question whether TRS Plan 1 employers will have to pay for LEOFF 1 benefits out of education funds, whatever the funds' source.

- The issue of distribution of a surplus is governed generally by federal law, however, state case law indicates that plan members are not entitled to their pension fund surplus.

- It appears unlikely that counties and cities will need to book any unfunded liability resulting from the LEOFF Plan 1/TRS Plan 1 merger in their financial reporting under GASB. In addition, it does not appear that counties and cities have a legal cause of action against the state because of the merger's impact on counties' and cities' financial requirements under GASB.

- The payment of a lump sum amount to LEOFF Plan 1 retirees, and to future LEOFF Plan 1 members when they retire, is not contrary to state law.

- It is unlikely that Washington courts will find the Alaska case of *Municipality of Anchorage v. Gallion*, 944 P.2d 436 (Alaska 1997) to be persuasive.

Part 2 – Explanation of the State Law Analysis

1. LEOFF Plan 1 and TRS Plan 1 members and retirees have certain vested contractual rights to provisions in the public pension plans.

Members of LEOFF Plan 1 and TRS Plan 1 have a contractual right to a pension that is guaranteed at the time the member begins public service. That pension right may be modified but only for limited purposes. *Lenander v. Dep't of Ret. Sys.*, 186 Wn.2d 393, 415, 377 P.3d 199 (2016). The rights of these members to a pension is defined by the Washington laws that create these rights. *Wash. Educ. Ass'n v. Dep't of Ret. Sys.*, 181 Wn.2d 233, 244-45, 332 P.3d 439 (2014).

LEOFF Plan 1 and TRS Plan 1 have two vested contractual rights that are relevant to the provisions of Senate Bill 6668. The first is the right to a monthly retirement allowance granted to the members when they first began service. This is the right guaranteed by *Bakenhus v. City of Seattle,* 48 Wn.2d 695, 296 P.2d 536 (1956). The second is the right to the systematic funding of the members' retirement plan to maintain the plan's actuarial soundness. *Ret. Pub. Emp. Council v. Charles,* 148 Wn.2d 602, 625, 62 P.3d 470 (2003).

a) Members and retirees have the right to a monthly retirement allowance. That right not only is not impaired by Senate Bill 6668, but it is guaranteed by Senate Bill 6668.

The *Bakenhus* court held that the monthly retirement benefit promised to a public pension member when the member begins employment is a contractual right. The question here is whether, as a result of the merger, members of LEOFF Plan 1 and TRS Plan 1 will lose the monthly retirement benefit promised to them during employment, or whether their benefit will be reduced as a result of the merger. The answer is no.

Senate Bill 6668 prohibits a modification of members' retirement benefits if that modification is to the member's detriment. Senate Bill 6668 specifically provides that the merger "may not impact benefits for members of these plans." Further, the bill instructs the Department of Retirement Systems to administer the merged plans "in a way that neither reduces, nor grants additional benefits, for members of those plans." Section 3, Senate Bill 6668. *See also* Section 1. Because the merger legislation specifically provides that the benefits the members receive after the merger must be equal to the benefits the member was entitled to before the merger, the members' contractual right to the monthly retirement benefit under *Bakenhus* provided is protected.

b) Members have the right to the systematic funding of their pension plans to maintain the plans' actuarial soundness. That right is not impaired by Senate Bill 6668.

Members have a right to the systematic funding of their pension fund to maintain the fund's actuarial soundness. *Weaver v. Evans,* 80 Wn.2d 461, 495 P.2d 639 (1972), *Ret. Pub. Emp. Council v. Charles,* 148 Wn.2d 602, 62 P.3d 470 (2003). The question is whether the merger described in Senate Bill 6668 negatively impacts the systematic funding of either TRS Plan 1 or LEOFF Plan 1. The answer is probably no.

In *Charles*, the Washington Supreme Court held that in the absence of proof that a statute or an action of the Legislature impaired the actuarial soundness of a pension plan, members' right to the systematic funding of an actuarially sound system was not violated. Here, there appears to be no evidence upon which a court could find that merging the TRS Plan 1 and LEOFF Plan 1 pension funds under Senate Bill 6668 will render the funds actuarially unsound. The court in *Charles* required proof that something more than the possibility of future harm will occur before finding that legislative action caused a pension fund to become actuarially unsound. On the other hand, the *Weaver* court did not require proof of inability to pay current or future benefits. Washington courts could go either way on this issue but the better reasoning probably is found in *Charles*. If so, in the absence of proof that the merged plan would be actuarially unsound, Senate Bill 6668 cannot be said to violate members' contractual rights.

2. State law does not prohibit two different pension plans from being merged.

As explained above, the terms of members' public pension rights are defined by the language of the statutes creating those rights. After review of the TRS Plan 1 and the LEOFF Plan 1 statutes and other provisions governing public pension plans, there appears to be no state statute that addresses whether either plan may merge with another plan. Given (i) the statutory silence on merger, and (ii) the Legislature's plenary power to design the public pension plans, there is no apparent prohibition under state law to the merger of these two different pension plans.

3. It is difficult to envision a scenario in which TRS Plan 1 employers will be required to pay for LEOFF Plan 1 benefits, and such a scenario seems unlikely to happen.

Questions have arisen regarding whether it is legal under state law for TRS Plan 1 employers to use money generated solely for the purpose of paying education costs to pay for LEOFF Plan 1 benefits. It is difficult to answer this question because there appears to be no scenario under which a TRS Plan 1 employer will be required to pay for benefits of LEOFF Plan 1 members, or will be required to pay down an unfunded liability in LEOFF Plan 1, using money designated solely for education. First, actuarial analysis indicates that there are sufficient funds to pay for all future LEOFF Plan 1 benefits, and second, under a merger, TRS Plan 1 and LEOFF Plan 1 assets and liabilities will be accounted for as a combined fund. It will be impossible under the combined fund to determine what amount each plan may be underfunded. Because contribution rates will be paid to the combined fund without designating which contributions go to which plan, there is no scenario under which TRS Plan 1 employers will pay specifically for LEOFF Plan 1 liabilities.

Nevertheless, basic education funds provided under RCW 28A.150, *et. seq.*, must be used solely for the funding of public school education. If there is any scenario which requires the use of basic education funds to pay for LEOFF Plan 1 benefits, that use is probably contrary to law. The state has had a history of contributing to LEOFF Plan 1. In fact, over the history of LEOFF Plan 1, the state has paid approximately 87% of the contributions paid to LEOFF Plan 1. *See* the *2016 Participating Employer Financial Information (PEFI)* at page 114 (http://www.drs.wa.gov/administration/annual-report/pefi/PEFI-2016.pdf). There is nothing in state law that prevents the Legislature from contributing again to the merged TRS Plan 1 and LEOFF Plan 1.

4. LEOFF 1 members do not have a right to the surplus assets of their plan. Generally, distribution of the surplus of LEOFF Plan 1 is controlled by federal law.

There are no Washington statutes that describe the ownership of surplus assets in any of the pension systems. In a defined benefit plan such LEOFF Plan 1, statutory benefits are not proportional to the contributions that employees pay into the plan. *Wash. Fed'n of State Emp. v. State*, 107 Wn. App. 241, 245, 26 P.3d 1003 (2001). The risk for any shortfall falls on the employer. As a result members are entitled to their retirement allowance, but they have no share in the plan's surplus. *Hughes Aircraft Co. v. Jacobson,* 525 U.S. 432, 440-41 (1999).[2]

LEOFF Plan 1 has been determined to be a tax qualified plan under the federal Internal Revenue Code. Because it is a tax qualified plan under federal law, LEOFF Plan 1 must be administered consistent with federal law requirements. Washington rule provides that benefits paid from

[2] *Hughes Aircraft* analyzed claims under the Employee Retirement Income Security Act of 1974 (ERISA), a federal law that is inapplicable to state public pension systems. Nevertheless, ERISA interpretation is sometimes used as guidance for the interpretation or analysis of general pension concepts.

pension plans administered by the Department of Retirement Systems must comply with IRS distribution rules. WAC 415-02-750. IRS distribution rules provide for the distribution of surplus assets to the employers and sponsors of the plan. It is appropriate, then, to defer to Ice Miller's analysis regarding the federal rules on distribution of the LEOFF Plan 1 surplus.

5. LEOFF Plan 1 and TRS Plan 1 members are statutorily entitled to a refund of their contributions but they do not own their contributions and probably do not have a contractual right to the same.

Members question whether they own the contributions they paid into their pension fund over the course of their employment. While the LEOFF Plan 1 and TRS Plan 1 statutes do not address "ownership" of contributions, each plan provides a right to receive an amount equivalent to the member's employee contributions if the member leaves LEOFF Plan 1-covered membership or TRS Plan 1-covered membership. These contributions are paid only if the member has not retired for service or disability and only upon the application of the member. Members will receive their contributions with interest, but will not receive the investment earnings on those contributions. If a member elects to receive the member's contributions, in most instances the member will no longer be eligible for a retirement benefit. *See* RCW 41.26.170 and RCW 41.32.510. There is no statute that provides that LEOFF members are entitled to receive their contributions even though they have retired. Under *Johnson v. City of Tacoma*, No. 74848-3-I, 2016 WL 3190548, *3 (Wash. Ct. App. June 6, 2016) (unpublished)[3] a member has a claim only to a monthly retirement allowance, not to the contributions made during employment. The *Johnson* court notes that a member of the city of Tacoma retirement system no longer "had an ownership interest in his retirement contributions," and could not therefore devise the contributions through his will. *Id.*

The provisions for payment of accumulated contributions, however, poses a different question than the question of who is entitled to, or "owns," a pension fund's surplus assets.

6. Counties and cities have no apparent legal challenge to Senate Bill 6668, if enacted, based on GASB requirements.

In June 2012, the Governmental Accounting Standards Board (GASB) issued new standards for pension accounting and reporting. The new GASB standards require employers to recognize the employers' proportionate share of any unfunded pension liability or surplus in their financial statements. These standards went into effect for fiscal years beginning after June 15, 2014. Public employers who employ or employed LEOFF Plan 1 members have been able to account for, or "book," their proportionate share of the surplus in LEOFF Plan 1. Senate Bill 6668 indicates that the Legislature intends to improve the actuarial soundness of TRS Plan 1 through

[3] *Johnson v. City of Tacoma* is an unpublished case but may be cited as nonbinding authority. GR 14.1. The case analyzed rights under the city of Tacoma public pension plan.

the merger. As a result of this merger there will no longer be a surplus for which LEOFF Plan 1 employers may book their proportionate share of the assets. On the other hand, TRS Plan 1 employers will book a lower amount in liability. It is understood that the reporting by employers under GASB has no direct, and perhaps no indirect, impact on public employers. Nothing in state statute indicates that counties and cities have a legal right to the continued booking of their share of the LEOFF Plan 1 assets, nor is there evidence upon which the counties and cities may claim damages as a result of the merger. Therefore, cities and counties have no apparent claim against the state should Senate Bill 6668 be enacted in its present form.

7. It is permissible under state law to distribute a lump sum payment to LEOFF Plan 1 members and retirees and survivors that is taken from the LEOFF Plan 1 pension fund.

Section 6 of Senate Bill 6668 authorizes a one-time payment of $5000 to each LEOFF Plan 1 "active member, term-vested member, retiree, and survivors" eligible for benefits under LEOFF 1, to be paid out of LEOFF Plan 1 assets. The question has arisen whether it is permissible to distribute a lump sum payment from the pension fund. Article II, section 25 of the Washington Constitution prohibits what is termed a gift of public funds. However this provision does not "prevent increases in pensions after such pensions shall have been granted." Based on this constitutional provision, and case law in support of this provision, there appears to be no prohibition to the distribution of the $5000 lump-sum payment to LEOFF Plan 1 members, retirees, and their survivors.

8. It is unlikely that a Washington court will find the Alaska case of *Municipality of Anchorage v. Gallion*, 944 P.2d 436 (Alaska 1997), to be persuasive.

The SCPP asked whether the case of *Municipality of Anchorage v. Gallion*, 944 P.2d 436 (Alaska 1997) affects how to analyze the issues related to the LEOFF Plan 1/TRS Plan 1 merger. *Gallion* involved an Anchorage police and firefighter retirement system consisting of three tiers of membership (Plan I, II, and III) much like Washington's PERS and TRS. The case did not involve a plan merger. The three tiers had different contribution rates and benefits but the tiers' assets were merged for investment purposes. Anchorage suspended employer and employee contributions to all three tiers because two out of the three funds were overfunded and assets for the three tiers were sufficient to cover liabilities for all three tiers. The *Gallion* court held that the suspension of the contributions reduced the funding status of the plans, which impaired "the inherent integrity" of the two overfunded plans, and that members had a constitutionally protected contractual right to have their plans evaluated separately for actuarial soundness.

There are three reasons a Washington court would not find *Gallion* persuasive to issues relating to the LEOFF Plan 1/TRS Plan 1 merger. First, the *Gallion* court found that maintaining a separation among the plans, rather than merging them, enhanced the integrity of the plans. The court also found that the funding status of the merged plans would be 102% or 99%. The court

did not find that the merged plan would *not* be able to pay benefits after the merger. In fact, at a 102% or 99% funded status, it would appear that the plans' liabilities were fully funded. In contrast to *Gallion,* the Washington Supreme Court, in *Ret. Pub. Emp. Council v. Charles,* 148 Wn.2d 602, 62 P.3d 470 (2003), held that even though the Legislature reduced employer contributions to PERS and TRS, the plaintiffs' general allegations that the lowered contribution rates might reduce earnings on pension assets, or that the lowered rates might reduce benefits, or might curtail the opportunity for future benefit improvements, were insufficient to establish an impairment of a contractually vested right to an actuarially sound system. Unlike *Gallion,* the *Charles* court rejected plaintiff's argument that they need not show a likelihood of harm. Instead, the *Charles* court required proof that the legislative change to the retirement plan would render the plan actuarially unsound. This holding is contrary to *Gallion*, where there was no proof that members' benefits would be affected and there was every indication that the plans were actuarially sound after the suspension of contributions.

Second, the legal analysis used by *Gallion* has not been recognized or used by Washington courts in public pension cases. *Gallion* rested its decision, in part, on *Sheffield v. Alaska Pub. Emp. Ass'n, Inc.*, 732 P.2d 1081 (Alaska 1987), a case involving contractual public pension benefits for Alaskan state public employees. The Washington Supreme Court, when asked to adopt the analysis of *Sheffield,* rejected the invitation and found that the *Sheffield* analysis is "incompatible with our binding precedent." *Lenander v. Dep't of Ret. Sys.,* 186 Wn.2d 393, 417 n 9, 377 P.3d 199 (2016). Just as telling, the Alaska court in *Sheffield* rejected the Washington Supreme Court's analysis of public pension law in *King Cty. Emp. Ass'n v. State Emp. Ret. Bd.,* 54 Wn.2d 1, 336 P.2d 387 (1959), finding that the Washington analysis was not "sufficiently compelling" to overcome Alaska binding precedent. *Sheffield*, 732 P.2d at 1086. Based on the state courts' mutual unwillingness to adopt each other's analysis in public pension cases involving contractual rights, it seems unlikely that Washington courts will find the *Gallion* analysis to be persuasive.

Finally, Washington courts, which have a rich and robust body of public pension case law, generally appear to prefer to rely on Washington courts' own case law rather than the case law from other states.

Part 3 –Analysis of LEOFF 1 and TRS 1 Members' Contractual Rights Under Senate Bill 6668

The Legislature has plenary authority to establish the terms of the public pension systems. The Legislature's power to enact laws "is unrestrained except when expressly or impliedly limited." *Luders v. City of Spokane,* 57 Wn.2d 162, 164, 356 P.2d 331 (1960). The courts have repeatedly said that they will not substitute their judgment for the Legislature's with respect to the structure

of public retirement plans. *Wash. Fed'n of State Emp. v. State,* 107 Wn. App. 241, 247, 26 P.3d 1003 (2001), *State Pub. Emp. Bd. v. Cook,* 88 Wn.2d 200, 206, 559 P.2d 991 (1977).

The principal restriction on the Legislature's authority to change retirement benefits is the impairment of contracts clause in article I, section 23 of the Washington Constitution.[4] Members of the Washington state public pension systems, who have met vesting requirements, have certain rights in their pension plan that are contractual in nature. This contractual right was first recognized in the case of *Bakenhus v. City of Seattle,* 48 Wn.2d 695, 296 P.2d 536 (1956), where the Court held that under a contractual analysis, a member of a public pension plan is entitled to the monthly retirement allowance promised to the member when first employed.

In subsequent cases, Washington courts have expanded the list of pension rights that are protected by a contract. In addition to the protection of a promised retirement benefit allowance found in *Bakenhus*, members of a public pension plan have a vested contractual right to a mandatory retirement age that is not reduced during the course of employment, the right to include leave cashouts at the end of employment in the calculation of retirement benefits, the right to a refund of retirement contributions, and the right to the systematic funding of a pension plan to maintain its actuarial soundness. *Ret. Pub. Emp. Council v. Charles,* 148 Wn.2d 602, 624-25, 62 P.3d 470 (2003).

Members' rights are located in the statutes of the public pension plans, related statutes, rules governing the plans, and cases interpreting the statutes and rules. Courts will review those statutes and rules in order to determine the contours of members' benefits. State pension statutes may create contractual rights. *Wash. Educ. Ass'n v. Dep't of Ret. Sys.,* 181 Wn.2d 233, 242, 332 P.3d 439 (2014) (WEA I). In order to determine what pension rights are contractual, courts will look to the language of the statutes creating the claimed rights. *Id.* 244-45.

Over the last 15 years, the Washington Supreme Court has clarified how courts should analyze pension statutes when determining pension contractual rights. The court will address three questions:

1. Does a contractual relationship exist between the parties?
2. Does the legislation substantially impair that contractual relationship?
3. If there is a substantial impairment, was that impairment reasonable and necessary to serve a legitimate public purpose?

Lenander v. Dep't of Ret. Sys., 186 Wn.2d 393, 414, 377 P.3d 199 (2016)(citing *WEA I,* 181 Wn.2d at 243). This is the traditional test used by Washington courts to determine other, non-pension related contractual rights. This traditional test is also applicable to determine contractual

[4] Art. I, § 23 reads: "No bill of attainder, ex post facto law, or law impairing the obligations of contract shall ever be passed."

claims involving pensions. However, in the pension context, the traditional test is also guided by the principles in *Bakenhus,* which require that any changes to a pension benefit must maintain the flexibility and integrity of the pension system, and that comparable new advantages be provided to members.[5] *WEA I*, 181 Wn.2d at 244.

If Senate Bill 6668 is enacted and then legally challenged, Washington courts will undoubtedly use the legal framework described above to determine whether the legislation violates LEOFF Plan 1 members' or TRS Plan 1 members' constitutionally protected contractual rights to their pension benefits. With that understanding, this section of the merger report will discuss the pension benefits that stakeholders suggest will be impaired by Senate Bill 6668, if it is enacted, and provide analysis, under the legal framework used by Washington courts, regarding whether provisions of Senate Bill 6668 may violate specific pension rights of the members under state law.

But, first, two preliminary matters should be addressed. Members' pension rights are found in statute. *WEA I*, 181 Wn.2d at 244-45 ("The respondents contract rights are defined by the language of the statute creating those rights."). Therefore, if members have contractual pension rights, those rights must be found in the language of the statutes.[6] An analysis of Senate Bill 6668 must be done in the context of LEOFF Plan 1 and TRS Plan 1 statutes. This report assumes, therefore, that Senate Bill 6668 does not modify any provisions in either plan other than what is specifically provided for in the bill draft. In other words, it is understood that RCW 41.26 continues to provide the pension terms applicable to LEOFF Plan 1 members post-merger, and that RCW 41.32 continues to provide the pension terms applicable to members of TRS Plan 1 post-merger.

Second, in public pension analysis, courts generally have found that the first element of the traditional contract analysis, listed above, has been met. That element, whether there is an existing contract in which one party has contractual rights and the other has contractual obligations, will be assumed to have been met here without further analysis. Therefore, the analysis begins with the second element: whether any provision in Senate Bill 6668 substantially impairs LEOFF Plan 1 and TRS Plan 1 members' contractual rights.

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[5] *Bakenhus* described its holding as follows: "[T]he employee who accepts a job to which a pension plan is applicable contracts for a substantial pension and is entitled to receive the same when he has fulfilled the prescribed conditions." The employee's "pension rights may be modified prior to retirement, but only for the purpose of keeping the pension system flexible and maintaining its integrity." Any changes that cause a disadvantage to an employee should be accompanied by comparable new advantages. *Bakenhus,* 48 Wn.2d at 701-02.

[6] An exception to the statutory language requirement is found in *Bowles v. Dep't of Ret. Sys.*, 121 Wn.2d 52, 68, 847 P.2d 440 (1993), where the court found that an administrative practice may create a vested right in the future continuation of that practice.

1. Members have a contractual right to the retirement allowance provided for under RCW 41.26 and RCW 41.32, and that right is not impaired by the merger.

Of the pension benefits to which a member has a contractual right, the right to a retirement allowance provided for under statute is a clearly protected pension right. This is the right at issue in the *Bakenhus* case. *Bakenhus* involved the City of Seattle pension fund for police officers. At the beginning of the officers' employment, city ordinances provided future retirement allowances based on the salary attached to the officers' positions. During Bakenhus' employment as a police officer, the city enacted an ordinance that reduced police officers' retirement allowance by approximately one-third. Bakenhus claimed that the reduction of his benefit constituted an impairment of contract under the contracts clause of the Washington Constitution (art. I, section 23). The Washington Supreme Court agreed and found that an employee who accepts a job to which a pension plan is attached has contracted for a retirement allowance based on what was promised at the beginning of the employee's membership, and that the employee is entitled to receive that retirement allowance once the employee vests and retires. *Bakenhus,* 48 Wn.2d at 701.

Section 3 of Senate Bill 6668 provides that the merger of these two plans "may not impact benefits for members of these plans. Specifically, each member of each of these plans is entitled to receive benefits immediately after the merger . . . that are equal to the benefits the member would have been entitled to receive immediately before the merger in accordance with plan terms." The Department of Retirement Systems is to administer the merger to ensure that members' benefits are not reduced. *Id.* The intent section of the bill confirms this intent. Section 1, Senate Bill 6668.

The legislation does not define the term "benefits," however, based on *Bakenhus* and subsequent cases, and given the requirements of federal law as described by Ice Miller, it is reasonable to interpret Senate Bill 6668 to intend that members receive the retirement allowance that they were promised pursuant to the statutes in effect for each plan. Because of this language, it is a reasonable interpretation that Senate Bill 6668 protects the retirement allowances of the members of each plan, and that, post-merger, each member has a contractual right to the retirement allowance provided by the members' plan pre-merger.

2. LEOFF Plan 1 members have a contractual right to the disability benefit provided for under RCW 41.26.020, and that right is not impaired by the merger.

The provisions of Senate Bill 6668 do not address LEOFF Plan 1 disability benefits, although Section 2(3) of the bill affirms that all liabilities for LEOFF Plan 1 medical costs, which support disability benefits, remain the responsibility of LEOFF Plan 1 employers, and that the merger "does not impact the disability boards" established under LEOFF Plan 1.[7] Section 4, Senate Bill

[7] These boards grant and deny disability benefits to LEOFF Plan 1 members.

6668. Because the legislation provides that members' benefits will not be reduced because of the merger, and because disability benefits have the same character as a service retirement allowance, which is a *Bakenhus* right, and because federal law forbids the diminution of benefits in a merger, it is a reasonable interpretation of Senate Bill 6668 that LEOFF Plan 1 members' disability benefits are protected under the provisions of Senate Bill 6668, and will not be reduced as a result of the merger.

3. LEOFF Plan 1 and TRS Plan 1 members have a contractual right to the systematic funding of their pension plans to maintain the plans' actuarial soundness, and that right is not impaired as a result by the merger.

LEOFF Plan 1 stakeholders ask whether they have a right to an actuarially sound pension plan and, if so, whether the merger jeopardizes the actuarial soundness of the plan. They note that the LEOFF Plan 1 pension fund is overfunded, that the TRS 1 pension fund is underfunded, and that the resulting merged fund would be underfunded even with the infusion of the surplus assets provided by LEOFF Plan 1.

LEOFF Plan 1 and TRS Plan 1 members have a contractual right "to the systematic funding of the retirement system [here, their respective plans] to maintain [the plans'] actuarial soundness." *Retired Pub. Emp. Council v. Charles*, 148 Wn.2d 602, 625, 62 P.3d 470 (2003). This right has been established in both *Weaver v. Evans,* 80 Wn.2d 461, 478, 495 P.2d 639 (1972) and in *Charles.*

In *Weaver*, an appropriation was made by the Legislature to TRS for the 1969 – 1971 biennium. Toward the end of the biennium the governor sought to reserve some of the appropriation in order to balance the state's budget. There were insufficient funds in the TRS pension fund for benefit payments, therefore the governor advised TRS trustees to pay remaining benefits by transferring funds in the pension reserve account to the TRS pension fund. While it appears that the pension reserve fund had sufficient money to pay for benefits, the *Weaver* court found that by modifying the Legislature's effort to systematically fund TRS in order to make it a financially sound system, the actions of the governor impaired TRS' members contractually protected right to the systematic funding of their system to maintain its actuarial soundness.

In *Charles,* the Legislature implemented an additional contribution rate reduction for employers in both PERS and TRS during the 1999 – 2001 biennium, after reducing those rates at the beginning of the biennium. The plaintiffs challenged the second rate reduction as violating their right to the systematic funding of their plan because the lower rates, they argued, might affect the actuarial soundness of the plan. The *Charles* court found that members' contractual right to the systematic funding of their plan to maintain its actuarial soundness was not impaired where there was no indication that the lower contribution rates would render the plan actuarially unsound. *Charles*, 148 Wn.2d at 484.

Neither the *Weaver* court nor the *Charles* court was specific about whether a member's right is to the "systematic funding" of the pension plan or to the "actuarial soundness" of the plan, or both. The *Weaver* court's focus was on systematic funding as a pension right. The court appeared to view *any* modification of the existing funding system was a per se impairment. The court did not analyze whether the "actuarial soundness" of the plan had been affected. The *Charles* court, on the other hand, focused on the actuarial soundness of the plan as the contractual right belonging to members. Rather than finding a per se impairment, the court looked at the effect the reduction of the contributions would have on the actuarial soundness of the plan. Because there were no facts to demonstrate that the actuarial soundness of the plan would be affected, the court found that plaintiffs did not prove that the system was actuarially unsound.

Note that the term "actuarial soundness" was not defined by either court. Because neither the *Weaver* court nor the *Charles* court explain what is meant by this term, it is unclear whether a comparison of these decisions is comparing apples to oranges. A court, in reviewing a challenge to Senate Bill 6668, might adopt the *Weaver* reasoning and find that the merger would lead to an actuarial unsoundness in LEOFF 1 plan. However, that finding depends on complicated issues regarding whether the LEOFF Plan 1 pension fund can be deemed to be underfunded when it becomes a tier of the TRS 1 pension plan. In addition, an analysis of soundness of the merged plans may very well depend not only the current funded status of the merged plans, but also on the reasonableness of the assumptions and methodology of the funding policy for the merged plans.

On the whole, it seems more likely that a court would follow the *Charles* analysis because it represents a more modern approach to public pensions and funding policy. The State Actuary's fiscal note for Senate Bill 6668 expects the merged plans to be fully funded by 2026. There is no indication that the merged plans could not pay current and future obligations to the LEOFF 1 members and beneficiaries, or that the merger affects the successful operation of the merged plans. *Charles,* 148 Wn.2d at 628. Nevertheless, it cannot be said with legal certainty which direction a court would take in this type of challenge to Senate Bill 6668. This uncertainly represents a risk regarding the merger of these two plans.

4. LEOFF 1 members do not have a contractual right to the LEOFF 1 surplus assets.

The purpose of LEOFF is to provide for an actuarial reserve system for the payment of death, disability, and retirement benefits to law enforcement officers and firefighters and to their beneficiaries. RCW 41.26.020. LEOFF Plan 1 is a defined benefit plan. As a defined benefit plan, LEOFF Plan 1 guarantees members a fixed periodic payment for life. *Wash. Fed'n of State Emp. v. State,* 107 Wn. App. 241, 245 n.5, 26 P.3d 1003 (2001). Because it is a defined benefit plan, the "employer bears the risk of investment and guarantees the distribution of the fixed benefit even if the value of the plan's investments decline." *Johnson v. City of Tacoma*, No. 74848-3-I, 2016 WL 3190548, *3 (Wash. Ct. App. June 6, 2016) (unpublished).

> Given the employer's obligation to make up any shortfall, no [defined benefit] plan member has a claim to any particular asset that composes a part of the plan's general asset pool. Instead, members have a right to a certain defined level of benefits, known as "accrued benefits." . . . [P]lan members generally have a nonforfeitable right only to their "accrued benefits," so that a plan's actual investment experience does not affect their statutory entitlement. Since a decline in the value of a plan's assets does not alter accrued benefits, members similarly have no entitlement to share in the plan's surplus – even if it is partially attributable to the investment growth of their contributions.

Hughes Aircraft Co. v. Jacobson, 525 U.S. 432, 440-41 (1999).[8]

The LEOFF Plan 1 pension fund currently has a surplus. The State Actuary notes that if all assumptions are realized in the future, LEOFF Plan 1 will have assets remaining after all benefits have been paid. October 11, 2016 Fiscal Note by OSA for Senate Bill 6668. The LEOFF Plan 1 surplus is intended to improve the actuarial soundness of TRS Plan 1 after the merger. *See* Section 1, Senate Bill 6668.

There is no provision in LEOFF Plan 1 statutes that addresses the ownership of surplus assets of the plan. Pursuant to RCW 41.26.020, members clearly have a right to a reserve system that pays them a retirement *allowance* but there does not to appear to be any statutory provision that supports members' ownership of the surplus assets. Because members of a defined benefit plan do not share in the decrease or surplus of plan assets, under the reasoning of *Johnson v. City of Tacoma* and *Hughes Aircraft Co. v. Jacobson,* it seems unlikely that a court would find that LEOFF Plan 1 members are entitled to the surplus assets of their plan. Further, Senate Bill 6668 does not appear to intend to distribute the surplus assets but, instead, to use those assets to pay down the TRS Plan 1 unfunded liability.

5. LEOFF Plan 1 members do not have a contractual right to an independent plan, or a separate pension fund, but do have a contractual right to the LEOFF Plan 1 COLA.

LEOFF Plan 1 members ask whether they have a contractual right to LEOFF Plan 1 as an independent plan, and a right to a LEOFF Plan 1 pension fund that is separate from other pension funds. These two questions are subsumed under the broader question of whether state law permits a merger of two different pension plans. The LEOFF 1 members also ask whether they will lose their COLA because of the merger.

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[8] As explained in footnote 2, above, *Hughes Aircraft* analyzed claims under the Employee Retirement Income Security Act of 1974 (ERISA), a federal law that is inapplicable to state public pension systems. Nevertheless, ERISA interpretation is sometimes used as guidance for the interpretation or analysis of general public pension concepts. In addition, the *Wash. Fed'n of State Emp. v. State* court and the *Johnson* court relied on *Hughes Aircraft* in their analysis of state and city public pension plans provisions.

Senate Bill 6668 merges the assets and liabilities of a closed law enforcement officers' and firefighters' pension plan with a closed teachers' retirement plan. There is little precedence in Washington public pension history for the merger described in Senate Bill 6668.

In 1969, law enforcement officers and firefighters were transferred into LEOFF Plan 1 from their membership in retirement plans that were administered by local governments. *See* RCW 41.16, 41.18, and 41.20 (the "Prior Acts"). However, unlike Senate Bill 6668, the transfer of Prior Act employees into LEOFF did not require that the Prior Acts become tiers of LEOFF Plan 1, and the transfers of members to LEOFF Plan 1 did not require the merger of the assets and liabilities of the Prior Acts with LEOFF Plan 1. Therefore, the creation of LEOFF Plan 1 does not provide guidance for the merger anticipated in Senate Bill 6668.

In answering the question whether state law will allow a merger of two disparate plans we need to review two basic legal provisions applicable to Washington public pensions. The first is that members' contractual rights are defined by the language of the statute creating those rights. *WEA I*, 181 Wn.2d at 244-45. The second is that the "Legislature has plenary authority to establish the terms of the public pension systems." *Luders v. City of Spokane,* 57 Wn.2d 162, 164, 356 P.2d 331 (1960). The LEOFF Plan 1 and the TRS Plan 1 statutes do not address issues of merger - either by permitting or by prohibiting mergers. While it is always a risk that a Washington court may invalidate a LEOFF Plan 1 and TRS Plan 1 merger, it is not readily apparent upon what grounds a court would invalidate a merger under state law. This is especially true given the Supreme Court's acknowledgment that the Legislature has plenary power to alter or amend retirement plans as long as the amendment passes muster under the Constitution's contracts clause. Further, courts have indicated they will not substitute their judgment for the Legislature's with respect to the structure of public pension plans. *Wash. State Pub. Emp. Bd. v. Cook,* 88 Wn.2d 200, 206-07, 559 P.2d 991 (1977). It is unlikely they would do so here.

In discussions with the SCPP, LEOFF Plan 1 members said they were told that they would have an independent plan and that they would have a separate pension fund. If the Legislature considers Senate Bill 6668, it would be helpful to receive information regarding what members were promised and who made those promises. Under *Bowles v. Dep't of Ret. Sys.,* 121 Wn.2d 52, 847 P.2d 440 (1993), public pension members were entitled to include leave cashouts in the calculation of their retirement benefit based on the Department of Retirement Systems' *practice* of including those cashouts. *Id.* at 68. It is possible under *Bowles* that a court might find that LEOFF Plan 1 members are entitled to an independent plan and a separate pension fund if the court found that the state had a practice in this regard. However, it is difficult to apply *Bowles* here where there is no indication members will suffer a diminution in benefits (unlike in *Bowles)* and there appears to be no other loss to members as a result of the merger. On the other hand, courts have considered the reasonable expectations embodied in a contract. *Tyrpak v. Daniels*, 124 Wn.2d 146, 155 n.1, 874 P.2d 1374 (1994)

Finally, because LEOFF Plan 1 members are statutorily entitled to a COLA described in RCW 41.26.240, and because Senate Bill 6668 requires no diminution of benefits as a result of the merger, LEOFF Plan 1 members are entitled to their continued annual COLA.

In conclusion, the above represents the analysis of the SCPP's assigned counsel as to how Washington courts may analyze a merger described in Senate Bill 6668. While, in general, the conclusion of this report is that the merger appears to meet the requirements protecting the constitutionally protected contractual rights of the affected members, there is always a risk that Washington courts may analyze a merger according to different principles. Nevertheless, the Legislature may wish to adhere closely to the framework developed by Washington courts over the last 15 years regarding the legal analysis of public pension rights of public pension members.

The following are two recommendations regarding revision of the current draft of Senate Bill 6668.

RECOMMENDATIONS

Recommendation #1: Senate Bill 6668 amends the LEOFF Plan 1 statutory provisions to provide for the merger. It is recommended that the legislation amend the TRS Plan 1 statutory provisions to also reflect the merger.

Recommendation #2: Senate Bill 6668 is unclear regarding the Legislature's intent that the benefits provided under each merged plan do not become the benefits of the other plan. In other words, it appears that the Legislature intends, under Senate Bill 6668, that TRS Plan 1 benefits continue to be governed by the provisions of TRS under RCW 41.32, and that LEOFF Plan 1 benefits continue to be governed by the provisions of LEOFF under RCW 41.26. It is recommended that this legislative intent be made clearer.

APPENDIX A

OUTLINE of SB 6668

Section of the Bill	Content of Section
Section 1	Intent Section: • Improve actuarial soundness of TRS 1 • Continue state commitment to maintain actuarial soundness of benefits for LEOFF 1 by merging assets, liabilities, and membership • Merger not to impact benefits of TRS 1 and LEOFF 1 • Merged plan administered to be consistent with plan qualification provisions of Internal Revenue Code
Section 2	• LEOFF 1 merged into TRS 1 • TRS 1 maintains its own liabilities • LEOFF 1 liabilities now liabilities of TRS 1 • LEOFF 1 benefits paid from TRS 1 fund • LEOFF 1 administered as a separate tier of TRS 1 • LEOFF 1 employers retain liability for LEOFF 1 medical benefits • TRS 1 and LEOFF 1 assets are merged
Section 3	• Merger not impact benefits for the members • DRS to administer the merged plan to not impact benefits • DRS must seek determination letter from IRS
Section 4	Merger to not impact disability boards
Section 5	UAAL rate from 9.1.2016 to 8.31.2017 is 4.24%
Section 6	New section added to RCW 41.26: • Assets of LEOFF 1 transferred to TRS 1 and will fund LEOFF 1 lump-sum benefit • LEOFF 1 active, term vested, retired and survivors who are eligible for benefits on effective date of this section are eligible for lump-sum benefit • Lump-sum payment is $5000 payable on 1.3.2017 or member's retirement date, whichever later • Interest shall accumulate on lump-sum benefit if member active or term vested • If member dies before receiving the lump-sum benefit the member's beneficiary receives this benefit • Lump sum payment exempt from judicial process (41.26.053)

	• If sections 1-5 invalid no entitlement to the lump-sum benefit
Section 7	Definition in LEOFF 1 of 'retirement fund' means TRS 1 fund
Section 8	No contribution rate charge to LEOFF 1 employers and members beginning 9.1.2016 (except admin fee)
Section 9	Strikes the provision to fully amortize costs of LEOFF 1 not later than 6.30.2024.
Section 10	• Strikes requirement for PFC to adopt or change basic state contribution rate for LEOFF 1 • Strikes provision to require employer and state contributions to be the level percentages of pay to fully amortize costs of LEOFF 1 • PFC to adopt employer and state contribution rates to fully fund benefits for LEOFF 1 beginning 9.1.2016 • Additional provisions regarding employer contribution rate for TRS 1
Section 11	• Adds 4.24% contribution rate as part of basic employer contribution rate for TRS 1 from 9.1.201 to 8.31.2021 • Minimum contribution rate of 4.24% remains effective until assets equal 100% of actuarial accrued liability
Section 12	DRS to publish annual financial statement for LEOFF 2 (implicitly deleting requirement to publish statement for LEOFF 1)
Section 13	• LEOFF 1 retirement fund closed • LEOFF 1 retirement monies transferred to TRS 1 retirement fund • any monies payable to LEOFF 1 must be paid to TRS 1 retirement fund to finance benefits of TRS 1 and LEOFF 1 beginning 9.1.2016
Section 14	Removes LEOFF 1 retirement fund from a proportionate share of the earnings credited to the Treasury income account
Section 15	• Merger must be administered to comply with 26 USC 401(a) • If IRS determines merger in conflict with 26 USC 401(a), and conflict cannot be resolved, sections 2 and 6-14 are null and void
Section 16	Savings clause
Section 17	Effective date is 9.1.2016