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MEMORANDUM

DATE: November 9, 2016

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

FROM: Anne Hall, Senior Counsel
Staff Counsel to the SCPP

SUBJECT: **Draft Report on State Law Analysis of the Merger of LEOFF 1 and TRS 1 pursuant to the provisions of SB 6668**

The 2006 Legislature directed the Select Committee on Pension Policy (SCPP) 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 LEOFF 1 and TRS 1, and makes a number of other changes and additions to the statutes governing LEOFF 1 and to statutes governing the actuarial funding of the state pension systems.

The SCPP asked me, as staff counsel to the Committee, to analyze SB 6668 and provide a report to the Committee on the legal implications of that bill. Pursuant to the SCPP's request, this report, in draft form, is provided to the Committee for discussion at the Committee's meeting on November 15, 2016. This 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.

This state law report is presented in three parts. The first part is a short summary of my analysis of the state law implications of Senate Bill 6668. The second part provides an explanation of the short summary in Part 1. The third part, which will be provided in the final report to the Committee in December, provides a detailed legal analysis that may be of some assistance to the Committee when providing its final report to the Legislature.

This report is intended to assist the SCPP in responding to the Legislature's directive and 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 this report.

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Part 1 – Short Summary of State Law Analysis

- Members¹ 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 granted to them at the beginning of their service.
- In the absence of an actuarial opinion 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 not violated by the merger.
- Under state law, TRS Plan 1 employers cannot pay for LEOFF Plan 1 benefits from monies provided to educational institutions by the Legislature for basic education. However, until there is a viable scenario under which TRS Plan 1 employers could be required to pay for LEOFF Plan 1 benefits out of funds designated for education, the merger cannot be deemed to violate state law.
- There is no provision in state statute that requires a LEOFF Plan 1 surplus to be paid to LEOFF Plan 1 members, retirees, and beneficiaries. The issue of distribution of a surplus is governed by federal law.
- 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.

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

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- 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 (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.*, 337 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).

Washington courts have held that members of a public pension system have a vested contractual right to a pension consistent with what was promised by the employer at the time of employment, the 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 systematic funding of a pension plan to maintain its actuarial soundness. *RPEC v. Charles*, 148 Wn.2d 602, 624-25, 62 P.3d 470 (2003).

Of these rights listed immediately above, members of 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. *RPEC v. Charles*, 148 Wn.2d at 625.²

- 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.**

² The other vested contractual rights listed in the *Charles* case do not appear to be addressed by Senate Bill 6668.

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The *Bakenhus* court held that the monthly retirement benefit promised to a public pension member when the member began 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 as a result of the merger, or whether their benefit will be reduced as a result of the merger. The answer is no.

Both LEOFF Plan 1 and TRS Plan 1 are designed to provide an actuarial reserve system for the payment of death, disability, and retirement benefits to LEOFF Plan 1 and TRS Plan 1 retirees. RCW 41.26.020, RCW 41.32. Members have a vested contractual right to a monthly retirement benefit under *Bakenhus*. Senate Bill 6668 recognizes this right and 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' *Bakenhus* contractual right to the monthly retirement benefit provided for at the time they were employed 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), *RPEC 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 no.

In *RPEC v. 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 *RPEC v. Charles* required proof that something more than the possibility of future harm will occur before finding that legislative action has caused a pension fund to become actuarially unsound. In the absence of that proof, Senate Bill 6668 cannot be said to create an actuarially unsound TRS Plan 1 and LEOFF Plan 1 combined pension plan.

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

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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 type of 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 (called the Prior Acts). However, unlike Senate Bill 6668, the transfer of Prior Act employees into LEOFF did not require that the provisions of 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.

As mentioned 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, I see no prohibition under state law against the merger of these two different pension plans.

3. It does not appear that TRS Plan 1 employers will be required to pay for LEOFF Plan 1 benefits.

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, or to shore up an unfunded liability in LEOFF Plan 1. 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 paying down an unfunded liability in LEOFF Plan 1, using money designated solely for education. I reach this conclusion because, 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 merged plans to determine what amount each plan may be underfunded once it becomes a combined plan. Because contribution rates will be paid to the combined fund to reach funded status 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. I note that 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*

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(<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. The distribution of the surplus of LEOFF Plan 1 is controlled by federal law.

The LEOFF Plan 1 pension fund currently has a surplus. In other words, as the State Actuary notes, 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. My understanding of Senate Bill 6668 is that the surplus will be used to improve the actuarial soundness of TRS Plan 1 after the merger. *See* Section 1, Senate Bill 6668. After a review of state law, both of the LEOFF Plan 1 statutes as well as the general funding statutes for the public pension plans, I find there is no provision in statute governing the disposal of a public pension funds' surplus assets. The answer to the distribution of the surplus lies in federal law.

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 (WAC 415-02-750) describes how benefits paid from pension plans administered by the Department of Retirement Systems must comply with IRS distribution rules. IRS distribution rules provide for the distribution of surplus assets to the employers and sponsors of the plan. I 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 contribution rates.

A question has been raised regarding whether members 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 describe "ownership" of contributions, each plan provides for the refund of employee contributions to a member 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. If a member applies to receive the member's contribution, in most instances the member will no longer be eligible for retirement benefit. *See* RCW 41.26.170 and RCW 41.32.510. I note, however, that the provisions for payment of accumulated contributions poses a different question than who is entitled to, or "owns," a pension fund's surplus assets.

6. Counties and cities have no apparent legal challenge to the merger that is provided for in Senate Bill 6668 based on GASB requirements and the consequence of no longer accounting for the counties' and cities' proportionate share of the LEOFF Plan 1 assets.

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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 in their financial statements as well as their proportionate share of any surplus. 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 the merger. My understanding is that 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 my understanding is that TRS Plan 1 employers will book a lower amount in liability. I further understand that the reporting by employers under GASB has no direct, and perhaps no indirect, impact on public employers. I do not see anything in state statute that indicates that counties and cities have a legal right to the continued booking of their share of the LEOFF Plan 1 assets, nor do I see any evidence upon which the counties and cities may claim damages as a result of the merger. Therefore, my conclusion is that 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 or not 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, I see no prohibition in 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 that consisted of three tiers of membership (Plan I, II, and III). 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.

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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 all liabilities. 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 four reasons a Washington court would not find *Gallion* persuasive on issues relating to the LEOFF Plan 1/TRS Plan 1 merger. First, *Gallion* rests on the conclusion that pension members have a right to future contingencies or possibilities regarding their pension systems, where those contingencies or possibilities have not yet occurred and where there is no proof those contingencies or possibilities will occur. This conclusion appears to be contrary to the analysis found in *RPEC v. Charles*, 148 Wn.2d 602, 62 P.3d 470 (2003) and, to some extent, in *Weaver v. Evans*, 80 Wn.2d 461, 495 P.2d 639 (1972). Second, the *Gallion* court found that public pension members have a constitutional right to have the actuarial soundness of their plans evaluated and maintained separately. No Washington court has so held. Third, the *Gallion* court used a legal analysis regarding contractually protected pension rights that has not been recognized or used by Washington courts. For example, the *Gallion* court relied on an Alaska case that was recently considered, and rejected, by our Supreme Court in *Lenander v. Dep’t of Ret. Sys.*, 337 P.3d 199 (2016), as incompatible with recent Washington public pension analysis adopted by our Supreme Court. Finally, Washington courts, which have a rich and robust body of public pension case law, generally seem to prefer to rely on Washington courts’ own case law rather than the case law from other states.

Part 3 – Detailed Legal Analysis of the State Law Implications of Senate Bill 6668

This analysis will be provided to the Committee in December 2016 in the final version of the report on state law analysis of Senate Bill 6668. This detailed legal analysis will further explain the conclusions listed above.

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RECOMMENDATIONS

Recommendation #1: Senate Bill 6668 amends the LEOFF Plan 1 statutory provisions to provide for the merger. My recommendation is that the legislation amend the TRS Plan 1 statutory provisions to also reflect the merger. I believe this is required under federal tax law.

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. I recommend that this legislative intent be made clearer.