MEMORANDUM

State of Alaska

Department of Law

TO: Ray Matiashowksi, Commissioner
Department of Administration

DATE: April 20, 2005

OUR FILE: 663-05-0192

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SUBJECT: Retirement system amendments - constitutional issues

You have asked three questions regarding application of proposed legislative modifications of the state's public employees' (PERS) and teachers' (TRS) retirement systems to current members of the systems. Those questions are:

1. Is it allowable to increase PERS and TRS contribution rates for individuals who became members of the systems before the effective date of the rate increases?

2. Is it allowable to discontinue pre-funding the medical component or set a rate that targets less than 100 percent funding for existing members or new members?

3. Is it allowable to prospectively not pay existing members new [or additional] ad hoc post retirement pension adjustments (PRPAs)? If not, could a new statutory provision reduce the existing number of members eligible for this benefit prospectively to reduce costs to the system?

While we believe that definitive answers to these questions will only be provided by the Alaska Supreme Court, based on our review of existing case law our, short answers to these questions are:

1. PERS and TRS contribution rates may be increased for individuals who became members of the systems before the effective date of the rate increases if the increases are accompanied by comparable enhancements to benefits.

2. Pre-funding of the medical component of PERS and TRS benefits, to the extent that pre-funding would be considered an accrued benefit, may not be discontinued for members who were employed during the period that statutes required pre-funding. Funding of medical benefits may be set at less than 100% funding for new members.

3. If the financial condition of the funds does not permit payment of the PRPA, it is allowable to prospectively not pay existing members new [or additional] ad hoc PRPAs. A new statutory provision cannot reduce the existing number of members who retain a vested right to a PRPA if one is awarded, unless the new statutory provision includes comparable enhancements to benefits.

The above responses might be different if it were established that application of modification of the retirement systems to current members is necessary to allow the retirement systems to pay current benefit claims.

ALASKA CASE LAW

Each of these questions raises substantial legal issues under Alaska Constitution article XII, section 7, as interpreted by the Alaska Supreme Court. That constitutional provision provides:

> **Retirement Systems.** Membership in employee retirement systems of the State or its political subdivisions shall constitute a contractual relationship. Accrued benefits of those systems shall not be diminished or impaired.

There is a substantial body of Alaska jurisprudence interpreting article XII, section 7 of the Alaska Constitution. Since this case law guides our advice on the issues you have raised, we provide the following synopses of the most pertinent Alaska Supreme Court cases.

State ex rel. Hammond v. Allen, 625 P.2d 844 (Alaska 1981)

The Alaska Supreme Court first interpreted Alaska Constitution article XII, section 7 in the case of *State ex rel. Hammond v. Allen*, 625 P.2d 844 (Alaska 1981). That case involved the Elected Public Officers' Retirement System (EPORS), which was established by the enactment of chapter 205, SLA 1975. A referendum petition to repeal the Act was filed in September 1975, before the Act became effective on

January 1, 1976.[1] Following passage of the referendum by a substantial majority of the voters in an election on August 24, 1976 (effective October 14, 1976), the state filed an action for declaratory judgment, arguing that article XII, section 7 did not apply and that the repeal was effective as to "officials who were participating in EPORS at the time of its repeal, but who were not then entitled to benefits." 625 P. 2d at 845.

The court held that article XII, section 7 did apply, and that even "the extreme likelihood of the subsequent repeal" of EPORS did not constitute an implicit condition subsequent that would extinguish the state's contractual obligation to provide benefits under EPORS.[2] The court concluded that "[a]ll elected officials who were participating in EPORS at the time its repeal became effective will, therefore, be entitled to the benefits provided by that system upon retirement." Under this holding, the state was required to permit even those EPORS members who had not met the minimum age or service requirements for retirement to continue to participate in the repealed retirement system.

***Hammond v. Hoffbeck*, 627 P.2d 1052 (Alaska 1981)**

Later in 1981, the court issued its opinion in *Hammond v. Hoffbeck*, 627 P.2d 1052 (Alaska 1981). In that case, public safety employees challenged statutory changes enacted in 1976 regarding PERS occupational disability and death benefits. Two of the challenged statutory changes reduced the amount of benefits, and one modified the eligibility requirements for occupational disability benefits.

The court first had to address whether an employee's rights to benefits under PERS vest on employment and enrollment in the system or only at the time when the employee becomes eligible to receive those benefits. The court ruled that under the Alaska Constitution, the former applied.[3] The court stated

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[1] The repealed provisions of EPORS are set out in the editor's notes to AS 39.37.

[2] The court observed "[w]e believe that if the possibility of repeal of a law could function as an implicit condition subsequent to a contract formed under that law, the protection of contract rights afforded by article XII, section 7, would be seriously eroded."

[3] The court noted that it had "previously held that the phrase 'accrued rights' is synonymous with 'vested' rights. *Bidwell v. Scheele*, 355 P.2d 584, 586 (Alaska 1960)." *Id.* at n.4.

> We are of the view that the plain meaning of Alaska Const. Art. XII, § 7, as well as the purposes underlying its adoption, compels such a conclusion. Furthermore, a review of the relevant case authority from several jurisdictions has persuaded us that this rule represents the better reasoned of the alternative approaches that have been adopted. The rule that regards members' rights in public employees' benefits systems as vested only at the time which an individual employee is eligible to receive payment of those benefits necessarily depends in some degree upon the anachronistic notion that such benefits are in the "nature of a bounty springing from the appreciation and graciousness of the sovereign." . . . . Under the rule mandated by Alaska's Constitution, on the other hand, these benefits are regarded as an element of the bargained-for consideration given in exchange for an employee's assumption and performance of his employment. This approach, in our view, more accurately reflects the realities of public employment in Alaska.

Id. at 1056-57 (citations omitted). Therefore, the court held

> that benefits under PERS are in the nature of deferred compensation and that the right to such benefits vests immediately upon an employee's enrollment in that system.

Id. at 1057.

Recognizing that "rigid adherence to labels like 'gratuity,' 'compensation,' 'contract,' and vested rights' has not allowed the courts the flexibility necessary to deal properly with legitimate legislative response to changing economic and social conditions," the court found California's "'limited vesting' approach to be instructive." *Id*. The court agreed with the California court's analysis[4] and held

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[4] *Citing Betts v. Board of Administration of the Public Employees' Retirement System*, 582 P.2d 614, 617 (1978) (1974 amendment changing "fluctuating" computation method to less beneficial "fixed" computation method included no comparable new advantages and could not constitutionally be applied to official whose employment was performed before the amendment); *Allen v. City of Long Beach*, 287 P.2d 765 (CA 1955) (invalidating city's increase in employee contribution rate, change in method of computing benefits, and change in contribution requirements upon reinstatement of employment following absence for military service).

> the fact that rights in PERS vest on employment does not preclude modifications of the system; that fact does, however, require that any changes in the system that operate to a given employee's disadvantage must be offset by comparable new advantages to that employee.

Id. The court reserved judgment on changes to the retirement system that might be needed to sustain a retirement system that could not pay all the benefits it owed. In footnote 11, the court stated:

> We are not called upon to consider the problem, which has frequently arisen in other jurisdictions, presented by a pension fund that is insufficient to satisfy all employee claims brought under its provisions. We intimate no view as to the appropriate legal analysis of any legislative alteration in employee benefits systems made in response to such circumstances.

Id.

Addressing the amendment to the method of computation of PERS occupational disability benefits, the court held that "at least as to some individuals, the new system cannot be said to offer advantages which outweigh its obvious disadvantages." *Id.* at 1058.

Regarding the change in eligibility requirements for occupational disability benefits, the court rejected the state's argument that eligibility standards were not part of the vested benefits protected by article XII, section 7. The court stated that the protected vested benefits "necessarily include not only the dollar amount of the benefits payable, but the requirements for eligibility as well." The court regarded "it as self-evident that this change will entail serious disadvantage" to certain injured public safety employees. *Id.*

The court rejected the state's argument that modification to PERS death benefits could be applied to current employees because rights to those benefits do not vest until the death of an employee. The court reasoned

> It is not the vesting of survivors' benefits that is at issue; it is rather the vesting of employee benefits. The fact that part of an employee's benefit package is, effectively, a life insurance policy, the proceeds of which will never be received by the employee, does not make that whole package any less an element of the consideration that the state contracts to tender in exchange for services rendered by the employee.

Id. at 1059.

The court concluded that the three challenged modifications to PERS "violate Alaska Const. Art. XII, § 7, as to those public safety employees who are adversely affected by them." The court noted "that a determination of whether vested rights to benefits have been diminished must be made on a case-by-case basis" and that the "choice is best made by each affected individual." *Id.* However, the court reversed the superior court's holding that the amendments were invalid as to all public safety employees. The court's interpretation rendered "the 1976 amendments . . . constitutional except as to public safety employees hired before July 1, 1976, who opt to receive benefits under the system in effect at the time they were hired." *Id.*

***Sheffield v. APEA*, 732 P.2d 1083 (Alaska 1987)**

The court next interpreted Alaska Constitution article XII, section 7 in the case of *Sheffield v. APEA*, 732 P.2d 1083 (Alaska 1987). That case involved statutes allowing employees to take early retirement, and also requiring that early retirement benefits be actuarially adjusted. "Actuarial adjustment" was statutorily defined as "equality in value of the aggregate expected payments under two different forms of pension payments, considering expected mortality and interest earnings on the basis of tables adopted from time to time by the board."

A new, more accurate table of early retirement factors adopted by the board in 1981 resulted in computation of slightly lower early retirement benefits than the 1972 table of factors previously in effect. APEA sued to prevent application of the factors in the new table to employees hired before the board adopted the new table. APEA also stipulated that the factors set out in the new table came "closer to achieving equality in value of aggregate payments as between early and normal retirement than would be possible under the old factors." *Id.* at 1084

The court quoted favorably from a case interpreting Massachusetts' law regarding contractual rights to public employee retirement benefits:

> The minimal meaning … is that the "contract" is formed when a person becomes a member by entering the employment, and he is entitled to have the level of rights and benefits then in force *preserved in substance in his favor without any modification downwards.*… When we speak of the level of rights and benefits protected by [this statute] we mean the *practical effect of the whole complex of provisions* not excluding the [employees' contributions], for an increase in the [rate thereof] is little different from a diminution of the allowance.

Id. at 1087, *quoting Opinion of the Justices*, 303 N.E.2d 320, 327 (Mass. 1973) (emphasis added by court). Adhering to its case-by-case diminishment analysis in *Hoffbeck*, the court held that employees had a vested right to application of the more-favorable factors in effect during their employment. The court noted that

If the PERS board repeatedly revises the tables during the course of an employee's employment, we think the employee should be permitted to elect which of those tables will apply to the computation of his or her PERS early retirement benefits. *Cf. Hoffbeck*, 627 P.2d at 1059 n. 13 ("Upon remand the state is to give requisite notice to and a reasonable time for all those public safety employees affected to exercise their right to choose which system they desire to come under.").

Id. at 1089 n.13. The court explained

To hold that employees have a right only to early retirement benefits which are subject to actuarial changes until retirement would vitiate Alaska's constitutional protection of accrued benefits for those employees who anticipate early retirement: they could not count on any particular amount of pension but only that they will receive one. We therefore hold that the plain meaning of Alaska Const. Art. XII, § 7 should be interpreted to cover the diminution in early retirement benefits at issue, without regard to the fact that the diminution is accomplished through regulations (the actuarial factors) contemplated by the PERS statutes.

Id. at 1089.

***Flisock v. State, Div. of Retirement and Benefits*, 818 P.2d 640 (Alaska 1991)**

In 1991, the court again interpreted Alaska Constitution article XII, section 7 in the case of *Flisock v. State, Div. of Retirement and Benefits*, 818 P.2d 640 (Alaska 1991). That case involved a claim by a TRS member that the determination of the "base salary" to be used in the computation of his benefit should include a lump sum payment he received for unused leave he accrued during a six year period of employment with one of his employers.

The court stated the first issue in the case as being whether the Alaska Constitution required "that Flisock's retirement benefits be calculated in accordance with the law and practice in 1969, the year in which he first entered" TRS. *Id.* at 643. Citing the *Hoffbeck* and *Sheffield* cases, the court held that "Flisock is entitled to have his benefits calculated according to 1969 law." *Id.* The court interpreted the law in effect in 1969 as allowing Flisock to include in his base salary the portion of the lump sum that represented compensation for unused leave accrued during the three years used for computation of his benefit. *Id.* at 644.

***Municipality of Anchorage v. Gallion*, 944 P.2d 436 (Alaska 1997)**

In 1997, the Alaska Supreme Court issued its opinion in the case of *Municipality of Anchorage v. Gallion*, 944 P.2d 436 (Alaska 1997). That case involved a challenge to a Municipality of Anchorage (MOA) ordinance that affected the funding of the Anchorage Police and Fire Retirement System (APFRS). APFRS consisted of three plans with different levels of benefits and eligibility requirements, and with membership based primarily on date of hire. In 1994, Plans I and II were more than 100 percent funded, and Plan III was 89 percent funded. Although MOA had historically funded the plans separately under its ordinances, in 1994 MOA enacted an ordinance providing that contributions were not required if "the Board's actuary determines that the funds necessary to pay the actuarial liability for the benefits for system members contained herein are available from the total assets of the system." *Id.* at 439. MOA had already suspended contributions to Plans I and II. Based on the new ordinance, and the fact that the system considered as a whole was funded at over 100 percent of projected liabilities, MOA discontinued contributions to Plan III.

Anchorage Police and Fire Retirement System members sued on behalf of Plans I and II, contending that MOA's diversion of funds from those plans violated Alaska Constitution article XII, section 7. In discussing the constitutional standard to be applied, the court pointed out that, in the *Sheffield* case, it had adopted the reasoning of the Massachusetts Supreme Court when

> we made it clear that the benefits in force at the time of enrollment in the system will be protected, stating:
> [A member] is entitled to have the level of rights and benefits then in force *preserved in substance in his favor without any modification downwards.* ... When we speak of the level of rights and benefits protected by [this statute] we mean the *practical effect of the whole complex of provisions....*
> *Id.* at 1087 (quoting *Opinion of the Justices,* 364 Mass. 847, 303 N.E.2d 320, 327 (1973) (emphasis added)).

Id. at 441. Dispelling any notion that rights protected by the constitution are limited to the amount of and eligibility requirements for benefits,[5] the court held that MOA's ordinance impaired

> the vested right of members of Plans I and II to have the actuarial soundness of those plans evaluated and maintained separately without being affected by the soundness of other plans. That failure impairs the ability of Plans I and II to withstand future contingencies, such as increases in plan obligations, declines in investment revenue, and inability by MOA to fund any shortfall. It is therefore unconstitutional.

Id. at 444. The court declined to adopt the reasoning of case law from other jurisdictions that upheld allocations of fund earnings or surpluses to supplemental benefits because those allocations did not diminish or impair payment of full benefits[6] or to an underfunded plan because the system remained actuarially sound.[7] Instead, the court was persuaded by *Valdes v. Cory*, 139 Cal. App.3d 773, 189 Cal. Rptr. 212 (1983). In *Valdes*, the Court of Appeal for the Third District of California held that provisions of emergency

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[5] In the 1988 case of *Rice v. Rice*, 757 P.2d 60 (Alaska 1988), the court mentioned that "[t]he modifications to PERS which we have found to operate to disadvantage an employee are those changes which reduce the dollar amount of the benefits payable or the requirements for eligibility." 757 P.2d at 62 (citations omitted).

[6] *Poggi v. City of New York*, 109 A.D.2d 265, 491 N.Y.S.2d 331 (1985), *aff'd*, 67 N.Y.2d 794, 501 N.Y.S.2d 397 (1986); *Halstead v. City of Flint*, 127 Mich. App. 148, 338 N.W.2d 903 (1983).

[7] *State ex rel. Dadisman v. Caperton*, 413 S.E.2d 684 (W. Va. 1991).

legislation passed by the California legislature suspending employer contributions to the state's retirement systems for three months during a budget crisis interfered "with vested contractual rights of PERS members." 189 Cal. Rptr. at 223. The Alaska Supreme Court explained that, although the California legislature's action

> had not reduced employee benefits under the system, the [California] court determined that the state could not suspend its statutorily defined contributions absent actuarial input to insure that the system would remain actuarially sound. *Id.* at 223. The court stated that although an employee may not suffer out of pocket expenses, "the interest of the employee at issue here is the security and integrity of the funds available to pay future benefits." *Id.* at 222.

944 P.2d at 445.

***Duncan v. Retired Public Employees of Alaska*, 71 P.3d 882 (Alaska 2003)**

The Alaska Supreme Court's most recent case interpreting Alaska Constitution article XII, section 7 is *Duncan v. Retired Public Employees of Alaska*, 71 P.3d 882 (Alaska 2003). In that case, Retired Public Employees of Alaska and other plaintiffs challenged modifications to the retiree health plan made by the state in 1999 and 2000. Some of the modifications "provided greater benefits; others were disadvantageous to retirees." *Id.* at 885. In its overview of article XII, section 7, the court quoted from its *Hoffbeck* analysis of the vesting of an employee's right to benefits upon employment and enrollment in the system, and explained that "[t]his means that system benefits offered to retirees when an employee is first employed and as improved during the employee's tenure may not be 'diminished or impaired.'" *Id.* at 886-87. The court reiterated that vested benefits are subject to reasonable modification, "[b]ut to be sustained as reasonable, changes that result in disadvantages to employees should be accompanied by comparable new advantages." *Id.*

The court rejected the state's argument that health insurance benefits, which were not provided by territorial retirement systems when the Alaska Constitution was ratified, were not intended to constitute "accrued benefits." The court observed that its "case law suggests that 'accrued benefits' should be defined broadly." *Id.* at 887. The court concluded

> that the term "accrued benefits" is not limited to just the benefits that were provided to public employees at the time of ratification of the constitution. Instead, the term includes all retirement benefits that make up the retirement benefit package that becomes part of the contract of employment when the public employee is hired, including health insurance benefits.

Id. at 888. The court acknowledged "that medical costs are rapidly rising, making health insurance increasingly difficult to provide. But we do not believe that this fact is of sufficient weight to change the meaning of the plain language of article XII, section 7." *Id.*

The court also rejected the state's argument that the "accrued benefit" was not the level of coverage provided, but was the highest amount of the monthly premium for retiree health coverage in effect during an employee's employment. The court stated

> The natural and ordinary meaning of "benefits" in a health insurance context refers to the coverage provided rather than the cost of the insurance. Further, the various employee publications promise coverage, not merely payment of a particular premium.

Id. at 888-89. The court acknowledged that "[t]he state's argument that the pension system may at some point be threatened by increasing costs of health care is a serious one. Again however, we do not believe that this argument is sufficient to change the meaning of the constitutional language in question." *Id.*

The court agreed with the state's third argument, concluding that the determination of whether detrimental changes in retiree health coverage are offset by comparable new beneficial changes must be made from a group standpoint rather than on an individualized basis. The court reasoned that

> Changes to fixed streams of income such as occupational disability and pension payments can be much more readily evaluated on an individual basis to determine whether they result in a net benefit than can changes to health insurance. Pension and occupational disability payments are, for the most part, predictable and fixed, while health insurance benefits change according to the unpredictable, changing medical needs of each individual.

Id. at 891. The court cautioned that

> equivalent value must be proven by reliable evidence. Just as with an individual comparative analysis, offsetting advantages should be established under the group approach by solid, statistical data drawn from actual experience--including accepted actuarial sources--rather than by unsupported hypothetical projections.

Id. at 892. The court indicated that some individuals could suffer serious hardship from changes in medical coverage that are constitutionally acceptable from a group standpoint. Contrasting the serious hardship established in *Hoffbeck* with the examples of detriments offered in the *Duncan* case, which amounted to "at most several hundred dollars a year, without consideration of [offsetting] benefits," the court stated that individuals who showed serious hardship caused by substantial detriments that are not offset by comparable advantages "should be allowed to retain existing coverage." *Id.*

RESPONSE TO QUESTIONS

1. PERS and TRS contribution rates may be increased for individuals who became members of the systems before the effective date of the rate increases if the increases are accompanied by comparable enhancements to benefits.

Alaska Supreme Court case law summarized above is clear in establishing the date of enrollment in a public retirement system as the date upon which an employee's rights are "vested" or "accrued" under the retirement system. [8] That case law also establishes that "accrued benefits" protected by article XII, section 7 broadly include not just the amount of and eligibility requirements for benefits, but also "the practical effect of the whole complex of provisions" of the systems. *Gallion*, 944 P.2d at 441; *Sheffield*, 732 P.2d at 1087 (both quoting *Opinion of the Justices*, 303 N.E.2d 320, 327 (Mass. 1973)).

Although a majority of the Alaska Supreme Court has not addressed the specific issue of the circumstances under which the state's retirement systems may be amended to raise employee contribution levels, cases that the court has cited, and on which the court has relied, do address the issue.

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[8] Following the Alaska Supreme Court's issuance of its opinion in *Hoffbeck*, this office advised the commissioner of administration that the state could not, by statute, raise the employee contribution rate for teachers employed before the rate increase. 1983 Inf. Op. Att'y. Gen. (366-329-83; February 14).

The Alaska Supreme Court cited the 1955 case of *Allen v. City of Long Beach*, 287 P.2d 765 (CA 1955), in *Hoffbeck*, adopting the California Supreme Court's "limited vesting" and "comparable advantage" approach. *Hoffbeck*, 627 P.2d at 1057. In the *City of Long Beach* case, the California court specifically considered the 1951 modification of a pension plan by the city, increasing the contribution rate of employees hired before March 29, 1945, from 2 percent to 10 percent. The court stated that the change to the city's charter:

> substantially decreases plaintiffs' pension rights without offering any commensurate advantages, and there is no evidence or claim that the changes enacted bear any material relation to the integrity or successful operation of the pension system established by section 187 of the charter.
>
> The provision raising the rate of an employee's contribution to the city pension fund from 2 percent of his salary to 10 percent obviously constitutes a substantial increase in the cost of pension protection to the employee without any corresponding increase in the amount of the benefit payments he will be entitled to receive upon his retirement.

287 P.2d at 767. The court invalidated the city charter provision increasing the contribution rate.[9]

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[9] Other California contribution rate cases include *Wisley v. City of San Diego*, 188 Cal.App.2d 482, 10 Cal. Rptr. 765 (1961) (successive amendments gradually increasing employee contribution rates from one percent to eight percent were obviously detrimental and there was no showing of commensurate benefit or that increases were necessary to the integrity or successful operation of the pension program; holding that the contribution rate increases could not be sustained as reasonable as applied to the plaintiffs); and *City of Downey v. Board of Administration, Public Employees Retirement System*, 47 Cal. App.3d 621, 121 Cal. Rptr. 295 (1975) (detrimental change in contribution rate from individual actuarial computation of portion of benefits employee would receive to flat seven percent of salary was outweighed by increase in retirement allowance, reduction in mandatory retirement age, and option of benefit for spouse).

The Massachusetts case *Opinion of the Justices*, 303 N.E.2d 320 (Mass. 1973), on which the court relied in adopting the interpretation that "accrued benefits" include "the practical effect of the whole complex of provisions" of the retirement systems (*Gallion*, 944 P.2d at 441; *Sheffield*, 732 P.2d at 1087) also involved proposed legislation to raise the employee contribution rate.[10] The Massachusetts court explained that a proposed increase in the employee contribution rate from five percent to seven percent

> would mean a forty percent increase of the member contributions providing the annuity share of the yearly allowance, and a comparable decrease in the pension share provided by the government, for the pension share represents roughly the difference between what the member has created in the way of an annuity and the fixed yearly retirement to which he is entitled. The member would pay more without any enlargement of the benefits.

303 N.E.2d at 324. The Massachusetts court stated

> Legislation which would materially increase present members' contributions without any increase of the allowances finally payable to those members or any other adjustments carrying advantages to them, appears to be presumptively invalid--invalid, that is to say, unless saved by the reserved police powers. . . . That the maintenance of a retirement plan is heavily burdening a governmental unit has not itself been permitted to serve as justification for a scaling down of benefits figuring in the 'contract,' although no case presenting proof of a catastrophic condition of the public finances has been put.

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[10] Massachusetts does not have a constitutional provision comparable to Alaska Constitution article XII, section 7. The court applied Massachusetts statute section 25(5) of G.L. c. 32, which provided that the retirement system statutes "shall be deemed to establish . . . membership in the retirement system as a contractual relationship under which members who are or may be retired for superannuation are entitled to contractual rights and benefits, and no amendments or alterations shall be made that will deprive any such member or any group of such members of their pension rights or benefits provided for thereunder, if such member or members have paid the stipulated contributions . . . ." 303 N.E.2d at 322-23.

Id. at 329-30 (citations omitted). The Massachusetts court concluded that the proposed increase in contribution rate of members of the retirement system was presumptively invalid. *Id.* at 331. The court also concluded that the contribution rate could be applied to employees hired after enactment of the new rate. *Id.*

In addition to these cases from other jurisdictions on which the Alaska Supreme Court has relied, the case of *Hudson v. Johnstone*, 660 P.2d 1180 (Alaska 1983), provides insight as to the probable outcome of a challenge to application of increased contribution rates to current employees. In *Johnstone*, the Alaska Supreme Court considered amendments to the Judicial Retirement System (JRS). Before July 1, 1978, judges were not required to make contributions to JRS. Amendments enacted in 1978 kept JRS non-contributory for judges appointed before July 1, 1978, and made JRS contributory for judges hired after that date. AS 22.25.011. The court upheld the amendments, without citing Alaska Constitution article XII, section 7. Justice Rabinowitz wrote a concurring opinion analyzing that constitutional provision, and opined:

> . . . . under the provisions of article XII, section 7, justices and judges appointed on or before July 1, 1978, are constitutionally entitled to receive benefits under the non-contribution retirement system established prior to the enactment of AS 22.25.011. Thus the legislature is precluded from requiring such judges to contribute toward their retirement benefits even when they commence new "terms of office."

Id. at 1187. Justice Rabinowitz reviewed the 1981 cases of *State v. Allen* and *Hammond v. Hoffbeck*, and stated his view that those cases "preclude the legislature from requiring the members of the judiciary appointed on or before July 1, 1978, from contributing toward their retirement benefits, absent some offsetting comparable new advantage." *Id.* at 1188.

In your request for advice, you mention a memorandum dated January 29, 2005, from the Legislative Affairs Agency's Division of Legal and Research Services ("LAA memorandum") to Representative Mike Kelly regarding "[a]ccrued benefits of public employment retirements systems and legislative changes to the employee contribution rate." That memorandum acknowledges that, under *Hoffbeck*, a challenge may be raised to an increase in employee contribution rates, but states that

> [a] strong counter argument could be made that the employee contribution rates are not part of the 'accrued benefit' to which members are entitled. The accrued benefits are the rights to receive the retirement and medical plan offered upon employment; the rights accrue as they are earned. A person's contribution rate cannot be changed retroactively for benefits that have already accrued, however, it can be argued that the employee contribution rate can change prospectively to pay for vested benefits.

These statements and the analysis that follows them in the LAA memorandum are not consistent with the Alaska Supreme Court's repeated rulings that an employee's rights under the retirement systems vest – i.e., are "accrued" – at the time the employee first enrolls in the system, and that those accrued rights include not only the amount of and eligibility requirements for benefits, but also "the practical effect of the whole complex of provisions" of the systems.[11] In the one case cited by the LAA memorandum in which an increase in the contribution rate of a group of teachers was approved, the Michigan Supreme Court relied on Michigan constitutional history indicating that the framers intended to protect retirees from diminishment of rights "after the service has been performed." *Request for Advisory Opinion, In re Enrolled Senate Bill 1269*, 389 Mich. 659, 209 N.W.2d 200, 202 (Mich. 1973). There is no comparable Alaska constitutional history, and this is contrary to Alaska case law regarding accrual of benefits under the Alaska Constitution.[12]

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[11] The LAA opinion discusses the *Hoffbeck* case, then states that "the next discussion of Article XII, sec. 7 by the Alaska Supreme Court occurred in 2003" citing the *Duncan* case. The LAA memorandum does not address the earlier *Hammond v. Allen* case, or the intervening *Sheffield v. APEA*, *Flisock v. State*, and *MOA v. Gallion* cases.

[12] The case cited in the LAA memorandum in support of the proposition that public employees could choose to resign instead of paying increased contributions did not construe a retirement statute. In *Cook v. City of Binghamton*, 398 N.E.2d 525 (N.Y. 1979), the court upheld changes to a general law that provided for continued payment of salary and medical benefits to certain firemen who were disabled by injuries while performing their duties.

The LAA memorandum correctly points out that increases in contribution rates have been applied to current employees in the past – specifically in 1986 for PERS members and in 1990 for TRS members – without creating a new tier and without drawing legal challenges.[13] However, the 1986 and 1990 legislation that raised the contribution rates included provisions intended to enhance benefits to offset the rate increases. For example, in addition to increasing the PERS contribution rate, the 1986 legislation added the automatic actuarially funded PRPA, increased some of the multipliers for computation of benefits, and made contributions pre-tax. Ch. 82, SLA 1986.

The bill review that the attorney general's office provided to the Governor in 1986 described the increase in the contribution rates for PERS members, and explained that because of the pre-tax treatment, little if any change in the take-home pay of employees would result.[14] The bill review also explained that the bill provided "additional benefits to . . . offset any diminution in benefits resulting from the increase in the contribution rate. The most significant and valuable of these additional benefits is the automatic, actuarially funded (PRPA) . . . ." Other provisions of the 1986 legislation that would constitute diminishments of benefits, such as the increase in early and normal retirement ages, the requirements that retirees under the age of 60 pay full premiums and retirees between the ages of 60 and 65 pay half premiums for medical coverage, and limits on inclusion of geographic cost of living differentials in computation of benefits, were made applicable only to employees hired after July 1, 1986 (this created PERS Tier II).

Similarly, Ch. 97, SLA 1990 raised the TRS contribution rates, and also made offsetting changes making the contributions pre-tax, increasing a multiplier, and adding the automatic actuarially funded PRPA. Again, the increase in the early and normal retirement ages for teachers with less than 20 years of service and the medical coverage premium requirement applied only to teachers hired after June 31, 1990 (this created TRS Tier II).

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[13] Footnote 3 of the LAA memorandum mentions that the contribution rate was "last increased in 1999" for PERS school district employees. However, the 1999 contribution rate increase was not imposed on school district PERS employees. Under the 1999 legislation, noncertificated PERS employees of school districts who worked during the school year, and therefore did not accrue a whole year of service credit under PERS each year, were allowed to elect to pay a higher contribution rate in exchange for accrual of a full year of service credit. Ch. 22, SLA 1999.

[14] File no. 883-86-0140.

In applying Alaska Supreme Court case law interpreting Alaska Constitution article XII, section 7 to your first question, we conclude that legislation increasing the PERS and TRS contribution rates for employees who became members of the systems before the effective date of the rate increases is likely to face a serious legal challenge. Because this kind of dispute is resolved on a case-by-case basis, only a definitive opinion of the Alaska Supreme Court will provide certainty as to the outcome of the challenge. However, we can say that if the increases are accompanied by comparable enhancements to benefits, the prospects of prevailing are increased.

2. Pre-funding of the medical component of PERS and TRS benefits may not be discontinued for members who were employed during the period that the statutes required pre-funding. Funding of medical benefits may be set at less than 100 percent funding for new members.

State law requires employer contribution rates to be calculated in amounts sufficient, when combined with employee contributions, "to provide the benefits earned . . . . " AS 39.35.250; *see also* AS 14.25.070. Under PERS each employer, including the state, is required to provide in its budget for the payment of the contributions, and to remit the payments monthly. AS 39.35.260, 39.35.270, and 39.35.280. Additionally, AS 39.30.095(b), requires the commissioner of administration, after obtaining the advice of an actuary, to determine and set the rate of employer contribution and employee contribution, if any, required for payment to the group health and life benefits fund for payment of benefits including retiree health benefits.

As explained in the summary of the *Duncan* case above, the Alaska Supreme Court has held that health benefits provided by the state's retirement system statutes are part of "the retirement benefit package that becomes part of the contract of employment when the public employee is hired." 71 P.3d at 888. As such, retiree health benefits are among the benefits that must be included in the PERS and TRS employer contribution rates under AS 14.25.070, AS 39.30.095, and AS 39.35.250-39.35.290. We understand that, in accordance with these statutes, employer contribution rates have historically been set to fully fund retiree health benefits.

In a memorandum of advice dated December 2, 1992, this office addressed the question of "whether the governor is constitutionally or statutorily mandated to include in the budget, and the legislature is constitutionally mandated to appropriate, those employer contributions that are prescribed by the boards of the various retirement systems to keep the systems actuarially sound." 1992 Inf. Op. Att'y Gen. (663-92-0073; December 2). We advised that "we believe the court would hold that article XII,

section 7, requires the funding of the retirement systems . . . ." *Id.* at 3. That advice was tempered by the lack of Alaska case law directly addressing the question, and by the fact that recent case law from other jurisdictions created some uncertainty.

Since 1992, the Alaska Supreme Court decided the *Gallion* case, holding that employees' vested interest in the integrity and security of their plans could not be diminished by combining the plans with a plan that was less actuarially sound. In *Gallion*, the court was persuaded by the California Court of Appeal case relied upon in our 1992 memorandum of advice, *Valdes v. Cory*.[15] The court also declined to adopt the rationale of one of the cases that created uncertainty, *State ex rel. Dadisman v. Caperton*, *supra*, n.7.

We adhere to the advice we gave in 1992. We believe that the Alaska Supreme Court would hold that the "the practical effect of the whole complex of provisions" of the systems in which employees have accrued rights includes the statutory provisions for employer contributions and the state's practice of establishing employer contribution rates that fully fund retiree medical benefits in accordance with those statutes.

The legislature may change the employer contribution statutes to provide for less than full funding of the retiree medical benefits of employees hired after the effective date of the legislation.[16] We understand that no Governmental Generally Accepted Accounting Principle requires a public entity to fully actuarially fund retiree medical benefits. If the legislature chooses to enact such a change, in accordance with the court's holding in the *Gallion* case, past and future contributions for fully funded medical benefits for employees hired before the effective date of the legislation should be kept separate from contributions for underfunded medical benefits in the trust fund, in order to maintain the integrity and security of the fully funded benefits.

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[15] 139 Cal. App.3d 773, 189 Cal. Rptr. 212 (1983). *See also Board of Administration of the Public Employees' Retirement System v. Wilson*, 52 Cal. App.4th 1109, 61 Cal. Rptr.2d 207 (1997) (state PERS employees' contractual right to an actuarially sound system was unconstitutionally impaired by amendment to employer contribution portion of funding methodology).

[16] It is also possible that such a change could be applied to benefit recipients whose benefits are based solely on service performed before the legislature first enacted legislation providing for employer-paid retiree medical benefits in 1975. Ch. 200, SLA 1975. Those benefit recipients would not have a contractual right to pre-funded medical benefits arising from employment with the state.

3. If the financial condition of the funds does not permit payment of the PRPA, it is allowable to prospectively not pay existing members new [or additional] ad hoc PRPAs. A new statutory provision cannot reduce the existing number of members who retain a vested right to a PRPA if one is awarded, unless the new statutory provision includes comparable enhancements to benefits.

Before July 1, 1986, for PERS, and before July 1,1990, for TRS, the retirement system statutes provided for granting of post retirement pension adjustments to retirees if the administrator determined that the cost of living had increased, and that the financial condition of the funds permitted. AS 14.25.143 (TRS); AS 39.35.475 (PERS). The amount of the PRPA was based on the increase of the cost of living since retirement, with a cap of four percent of the base benefit compounded for each year of retirement. The PRPAs were not automatic, and were considered discretionary or "ad hoc." Potential future PRPAs were not included in the actuarially-determined employer contribution rates.

In 1986 for PERS, and in 1990 for TRS, the legislature repealed the ad hoc PRPAs, and replaced them with actuarially funded automatic PRPAs. Sec. 41, ch. 82 SLA 1986; sec.12, ch. 97 SLA 1990. The automatic PRPAs are paid to retirees age 60 or older, or who have been retired for at least five years from PERS or eight years from TRS. The amount of the PRPA for members who are at least 65 years old or who are receiving disability benefits is the lesser of 75 percent of the cost of living increase in the preceding calendar year or nine percent. For other retirees eligible for PRPAs, the amount is the lesser of 50 percent of the cost of living increase in the preceding calendar year or six percent.

Following repeal of the PERS ad hoc PRPA and enactment of the automatic PERS PRPA in 1986, this office advised the commissioner of administration that the PERS and TRS ad hoc PRPAs could be withheld "if the administrator of the systems makes appropriate, factually supported findings regarding the condition of the retirement funds." 1990 Inf. Op. Att'y Gen. (663-90-0206; January 19). In that memorandum of advice, we

acknowledged that "[b]ecause the right to receive a specific type of retirement benefit, including the PRPA, vests upon the date of employment, the ad hoc PRPA remains viable for members of PERS hired before the effective date of ch. 82, SLA 1986." *Id.* at 1.[17]

Based on the Alaska Supreme Court case law summarized above, the administrator must continue to consider annually whether the cost of living has increased and whether the financial condition of the retirement funds permits awarding of ad hoc PRPAs to retirees. It is not constitutionally allowable for legislation to reduce the existing number of members eligible to receive an ad hoc PRPA if one is awarded, unless that legislation provides comparable offsetting benefits. However, as we noted in our memorandum of advice in 1990,

> [t]o the extent possible, the division should also weigh other advantages provided by ch. 82, SLA 1986 [and ch. 97 SLA 1990] (such as the increased [PERS] "multipliers" in the benefit formula applied to service accrued after June 30, 1986 in excess of 10 and 20 years) in determining whether a retiree is actually disadvantaged by the change in the . . . PRPA.

Id. at 2.[18]

Legislation that limits the administrator's discretion – for example, legislation that allows award of an ad hoc PRPA only if a retirement fund is actuarially funded at over 100 percent and employer contribution rates are set at less than eight percent – would also be subject to challenge under the Alaska Supreme Court cases summarized above.

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[17] We also acknowledged this in pleadings filed in litigation filed by and on behalf of retirees after the TRS ad hoc PRPA was repealed. *National Education Association – Alaska v. Usera*, Case No. 3AN-91-8274 Civil. That litigation was settled in October 1996. Each year since then, the administrator has considered whether to grant an ad hoc PRPA based on the increase of the cost of living and the financial conditions of the retirement funds. The administrator denied ad hoc PRPAs for 2003 and 2004.

[18] As with medical benefits, it is possible that there are benefit recipients whose benefits are based solely on service performed before the PRPA was first enacted for TRS in 1966 (ch. 151 SLA 1966) or for PERS in 1968 (ch. 235 SLA 1968). Such a benefit recipient would not have a contractual right to the ad hoc PRPA arising from employment with the state, and would be eligible only for the automatic PRPA.

The constitutional rights of members regarding the ad hoc PRPA include the right to consideration of award of a PRPA based on the discretion existing under the repealed statutes.[19]

4. The above responses might be different if it were established that application of modification of the retirement systems to current members is necessary to allow the retirement systems to pay current benefit claims.

As explained above, the Alaska Supreme Court has not ruled on application to current members of changes to the retirement systems that might be necessary if a pension fund were "insufficient to satisfy all employee claims brought under its provisions." *Hoffbeck*, 627 P.2d at 1057 n.11. Although the Alaska Supreme Court has not established standards to be applied in such a case, analysis by the California court in the *Valdes* case may be instructive:

> On the other hand, a substantial impairment may be constitutional if it is "reasonable and necessary to serve an important public purpose." . . .
>
> Both the California and United States Supreme Courts have identified factors which may warrant legislative impairment of vested contract rights on the grounds of necessity: "(1) the enactment serves 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, during which the vested contract rights are not lost but merely deferred for a brief period, interest running during the temporary deferment."

189 Cal. Rptr. at 225-26 (citations omitted).

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[19] Using the above example of potential legislative restrictions, if the administrator historically awarded a PRPA when a retirement fund was at least 95 percent funded, employer contribution rates were set at 10 percent, and no other facts existed that would cause the administrator to determine that the condition of the fund did not permit the award of a PRPA, the legislative restrictions would diminish or impair the vested rights of retirees if those historical conditions were ever achieved again.

If the Alaska Supreme Court adopted these standards for approving impairments based on reasonableness and necessity, it would consider the facts specific to the legislative enactment. We are not in a position to express an opinion as to the adequacy under these standards of the reasons advanced by legislators in support of amendments to the retirement systems currently under consideration. We must emphasize the importance of establishing as complete a record as possible for any justifications supporting the change if we are to conduct an effective defense.

Please let us know if you need additional advice regarding these matters.

VBR:rca