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NewsFlash!

**THE MISSOURI SUPREME COURT'S DECISION IN NESKE
APPEARS TO HAVE CONFIRMED THAT PUBLIC EMPLOYEES
HAVE CONTRACTUAL RIGHTS TO THEIR PENSIONS, AND THAT
GOVERNMENTAL UNITS MUST FUND PENSIONS TO
CONFORM WITH PRINCIPALS OF ACTUARIAL SOUNDNESS**

By: Daniel G. Tobben

Introduction

Following the victory in the Missouri Supreme Court, in March, 2007, the Firemen's Retirement System of St. Louis ("FRS") and its Board of Trustees recently received \$49.4 Million from the City of St. Louis ("City"). This payment related to the underfunding of FRS by the City of St. Louis for Fiscal Years 2004, 2005, 2006 and 2007.

The History of the Case

Prior to the disputed fiscal years, the City of St. Louis had fully paid the amount certified by the Trustees, based upon the calculations of the Pension Plan's actuary. Relying upon various legal authorities and reacting to an alleged budget crisis, the City underfunded the Pension Plans, and provided funding based upon a percentage of payroll unrelated to the actuary's calculations (i.e., 401(k)-like contributions were made for this defined benefit plan).

The City advanced a number of arguments in the course of this litigation. One was an argument concerning the structure of the State of Missouri's enabling legislation and the corresponding St. Louis City Ordinances and whether the contribution amounts were mandatory or discretionary. Though there were interesting twists on the arguments advanced by the City,

eventually the trial court, the Missouri Court of Appeals and the Supreme Court of Missouri rejected all of those arguments and essentially ruled that "shall" means "shall" and the contribution is mandatory. The Courts also held that the Trustees' interpretation of the Plan language harmonized the numerous City ordinances pertaining to FRS, whereas the City was trying to argue that part of one section of one City ordinance trumped remaining ordinance provisions.

The trial court also noted that the City's proposed construction contravened actuarial soundness, an issue which became important in the Supreme Court's ultimate analysis of the case. That issue, and its implications, will be discussed more thoroughly in the second part of this article.

The City also attempted to invoke several state constitutional arguments. The trial court, in addressing those alleged constitutional issues, questioned whether the City had exhausted all administrative remedies, because the City had not challenged the amount certified by the Trustees as being incorrect or improperly calculated by the actuaries. Since the City did not argue in the litigation that the actuary's calculations were incorrect, the trial court found that no waiver had occurred, and went on to consider the constitutional issues presented.

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The City advanced a constitutional argument, based upon an alleged invalid delegation of a legislative authority. The City argued that the actuaries calculated amounts that varied from year to year and that these amounts, which had been increasing in recent years, seriously impacted the City's budget and the City's ability to fund other activities or important City functions. All Courts rejected this argument and, in the process, distinguished an important 1932 Missouri Supreme Court case entitled *Field v. Smith*, 49 S.W.2d 74 (Mo. banc 1932), which had involved the creation of the Kansas City Police Department, and in which the Supreme Court had held that unlimited delegation of discretionary spending to a non-legislative body violated the Missouri Constitution.

The City also alleged a violation of Article VI, Section 26(a) of the Missouri Constitution, which mandates balanced budgets. The City argued that if the City now had to pay the amounts certified by the Trustees, as calculated by the actuary after funds had already been committed, their budgets would be exceeded. In this regard, the City relied heavily upon the Missouri Supreme Court's decision in *Tomlinson v. Kansas City*, 391 S.W.2d 850 (Mo. 1965). In *Tomlinson*, pension plan beneficiaries attempted to argue that the ordinance which established the Firemen's Pension Fund in Kansas City "created a contractual relationship between the cities and the beneficiaries of the fund", so that they could challenge underfunding issues. This position was rejected by the Missouri Supreme Court in *Tomlinson*. Moreover, the Court indicated, probably in dicta, that the Supreme Court viewed pension benefits as "mere gratuities", rather than a form of deferred compensation, where contractual rights existed. The *Tomlinson* case had never been overruled in Missouri, so the question of "contractual rights" with respect to public pensions was an open issue. As recently as 1999, the Court of Appeals, Western District,

based a decision, in part, on the concept that public pensions were mere gratuities, not contractual rights. See, *Fraternal Order of Police Lodge 2, et al. v. City of St. Joseph, et al.*, 8 S.W.2d 257 (Mo. App. 1999). The trial court in the FRS case, however, rejected *Tomlinson's* logic and application to this case. As will be discussed in the next section of this article, concepts of actuarial soundness presuppose contractual rights, so the Supreme Court's decision in *Neske, et al. v. City of St. Louis*, 218 S.W.3d 417 (Mo. 2007) may overrule *Tomlinson* by implication on this point.

FRS relied upon Article VI, Section 25, of the Missouri Constitution. This constitutional provision allowed pension plans to be created as an exception to the general rule that counties or other political subdivisions could not issue a grant of public monies to private individuals under most circumstances. As cost of living adjustments (COLA) became more common in pension plans, Article VI, Section 25, was amended, so that political subdivisions "may provide for the payment of period cost of living increases in pension and retirement benefits paid under this section to its retired officers and employees and spouses of deceased officers and employees, provided such pension and retirement systems will remain actuarially sound".

The City also advocated the position that the claims asserted by the FRS were unconstitutional because they violated the Hancock Amendment. The Hancock Amendment contains many provisions which relate to limits on taxation and government spending. The portion of the Hancock Amendment invoked by the City basically provides that the State could not mandate "increased activity" resulting in increased payments by a governmental subdivision without the State providing the revenue to fund those increased expenses or activities. With respect to the FRS, the Hancock Amendment was not applicable because FRS is ultimately a creation of

City ordinance, though the City ordinance must conform to the enabling legislation enacted by the State. It was difficult for the City to effectively argue that ordinances voluntarily enacted by the City were mandated by the State.

The Hancock issue was more directly raised in a companion case, filed by the Police Retirement System (“PRS”), because PRS is purely a creature of Missouri statute, rather than an ordinance-based system with enabling legislation, as with FRS. The funding of both retirement plans, however, rests with the City. Both the trial court and the Missouri Court of Appeals held that the City did not properly raise the Hancock issue, holding the City had no standing because a taxpayer was not joined as a party to assert the claim or defense. As will be discussed later, the Missouri Supreme Court did allow the Hancock issue to be raised. The Supreme Court consolidated the FRS and PRS cases and issued an opinion applicable to both cases. *See Neske, et al. v. City of St. Louis*, 218 S.W.3d 417 (Mo. 2007).

The Honorable David L. Dowd, Circuit Judge, authored a scholarly, 130-page Opinion, ruling for FRS. It can be obtained upon written request from this author. That decision was affirmed, on appeal, by the Missouri Court of Appeals, but transferred to the Supreme Court because of questions of state-wide interest and importance. Therefore, the Court of Appeals’ opinion is not precedent, but may be interesting and valuable reading for trustees of, or attorneys representing, public pension plans facing similar underfunding problems.

The Supreme Court Decision and What It May Mean for the Future

The Supreme Court unanimously affirmed the trial court’s Judgment in *Neske*. That meant the trial judge, three appellate court judges and seven Supreme Court judges all concluded that the City had acted improperly in failing to properly fund FRS and PRS.

The initial part of the Missouri Supreme Court’s decision focused upon procedural aspects of the Hancock Amendment. In Missouri, that aspect of the Opinion has received substantial attention because it made clear that the Hancock Amendment could be asserted as a defense, not just as the basis for a cause of action. The Supreme Court also clarified the proposition that a Hancock claim can be asserted, even if a taxpayer is not named as a party in the litigation. Those procedural holdings are important, but may be unique to Missouri, and are not the focus of this article. The other aspect of the Supreme Court’s decision regarding the Hancock Amendment is significant to the issue of mandatory funding of public pensions.

Governmental entities aim for predictability in their budgeting process from year to year. Benefit increases, unusually high or low market returns, rates of inflation, numbers of persons retiring and other matters extraneous to the governing statutes or ordinances, may significantly affect the amount of the annual contribution to the pension plan, as calculated by an actuary. However, the Missouri Supreme Court in *Neske* clearly held that these fluctuations do not violate the tax, spending or unfunded mandate aspects of the Hancock Amendment. This holding in *Neske* will certainly be important in future pension cases in the State of Missouri and, if adopted by other courts as a well-reasoned position, could have much broader implications on the severe underfunding problem that now exists with many public pension plans.

The Courts’ construction of the statutes and ordinances presented in this case was key to the decisions, but again, since plan language and the ordinances or statutes upon which the plans are based, will vary from city to city or jurisdiction to jurisdiction, this article will not focus on the precise funding language, nor upon the exact reasons why the Missouri Supreme Court found it to be mandatory. The most significant aspect of this case

may be in the Supreme Court's adoption of a standard of actuarial soundness as a basis for its decision.

"The statutes and ordinances relating to the PRS and the FRS, when taken as a whole, support the view that actuarial soundness is the principle at the heart of the PRS and the FRS funding provisions. Actuarial soundness requires the City to make its annual contribution of the actuarially-determined amounts certified by the PRS and the FRS boards of trustees."

Neske, at 426.

When an actuary calculates the amount due, the actuary makes certain assumptions which must be reasonable, based upon available information and which must be made in accordance the standards of the actuarial profession. In Missouri, a unit of government could challenge the actuarial assumptions as being unreasonable or without basis in an administrative hearing setting, but would bear a high burden in making such challenges. The actuaries' calculations are presumed reasonable and correct and the governmental unit must show that the calculations are unreasonable or an abuse of the actuaries professional discretion. Just proving that another actuary's calculations are different, or arguably use a superior methodology, is insufficient. In the PRS and FRS cases, the City conceded that the actuarial calculations were properly made by not challenging them.

When an actuary performs these calculations, the actuary looks to the plan provisions, including retirement benefits, disability benefits and other forms of payments to retirees and their beneficiaries in order to calculate the annual funding obligation ("normal contribution") and the annual amount needed to correct underfunding problems (the "unfunded accrued actuarial liability" or "UAAL"). This actuarial approach, approved by the Supreme Court in *Neske*, would not make sense unless an underlying assumption exists that the plan provisions

confer a guaranteed, contractual right. If benefits are deemed to be gratuities (as in *Tomlinson*) or rights which are subject to divestiture and forfeiture, the Supreme Court could hardly base its decision to require funding upon grounds of actuarial soundness. Thus, the *Tomlinson* case, which labeled public pension retirement benefits to be a mere gratuity, should be interpreted as having been overruled by implication by *Neske*. Missouri seems to have joined the majority of states that, by constitutional provisions, statutes or case law decisions, have concluded that public pension benefits are vested, contractual rights which must be paid. Protestations of budgetary or financial difficulties are not, and should not be, a basis for failing to fund these pensions properly, since public pensions are legal obligations of the governmental entity.

These issues are important throughout the United States because of the underfunding problems that exist in many states, counties and municipalities. San Diego has perhaps become the poster child for such problems, but they affect many jurisdictions. In Missouri, the Joint Committee of the Missouri Senate and House of Representatives has been investigating these issues and has concluded that numerous local pension plans are significantly underfunded. In our sister state of Illinois, significant underfunding of public pensions exists at both the state and local levels. The New York Times has reported extensively concerning the problems facing New Jersey and the tremendous unfunded liabilities that are present in pension plans in that state. Perhaps because of economic difficulties relating to manufacturing, especially the auto industry, Michigan, which is typically viewed as a pro-union, pro-labor state, is also faced with significant problems in terms of the funding of its pensions.

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Conclusion

The Missouri Supreme Court's decision in *Neske*, binding in the State of Missouri, should also be seen, in a broader context, as an affirmation of the contractual rights of public employees to their pension benefits. Such contractual rights have little meaning if the plans are not reasonably and properly funded. Though it does not overtly address the issue of a contractual right to funding of benefits, the Missouri Supreme Court has found that there is a requirement of actuarial soundness present, and has found actuarial soundness to be at the heart of the funding obligation. It is the author's belief that this actuarial requirement is based on the Missouri Constitution, Article VI, § 25, and not merely on the language of the FRS and PRS plans. As noted previously, *Tomlinson* seems to have been overruled by im-

plication. Missouri appears to have joined the majority of states which hold public pension benefits are enforceable contractual rights.

This article has not addressed what would occur, or should occur, in the event that a governmental entity is in such great financial distress that it declares bankruptcy. As noted by the Missouri Supreme Court, however, the fact that a governmental unit may have to make different budgeting choices, perhaps choices that are difficult because of alleged financial constraints, is not a valid reason for the governmental unit to allocate money to other budget preferences, at the expense of its legal obligation to fund public pensions.

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Daniel G. Tobben's representation frequently involves public pensions, especially regarding underfunding issues, and other intra-governmental litigation. The Firemen's Retirement System of St. Louis (FRS) received \$49.4 million in September 2007, as a result of his victory in the Missouri Supreme Court.