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DEFINED (YET UNCERTAIN) BENEFIT PENSION PLANS IN AMERICA

TRAVIS BAYER*

INTRODUCTION

In recent years Congress has requested numerous studies from the Government Accountability Office (GAO) regarding the status of both private and public—state and local—pension systems, perhaps because it fears that under-funded pension plans, private and public alike, might come with hat in hand to the federal government someday.1 Congress is not alone in worrying, as Governors,2 state legislators,3 special state investiga-

* J.D. candidate, Chicago-Kent College of Law, May 2012. I thank William Birdthistle and David Franklin for their helpful comments and insights, as well as Clarence and Frieda Bayer for sharing their actuarial and accounting knowledge of pension plans.

1. See, e.g., Testimony before the Subcommittee on Oversight, Committee on Ways and Means, House of Representatives, BARBARA D. BOVBJERG ET AL., U.S. GOV'T ACCOUNTABILITY OFFICE, PENSION BENEFIT GUARANTY CORPORATION: IMPROVEMENTS NEEDED TO ADDRESS FINANCIAL AND MANAGEMENT CHALLENGES at Highlights, 19 (2008), available at http://www.gao.gov/new.items/d081162t.pdf [hereinafter PBGC IMPROVEMENTS] (noting that as of 2008, the GAO had conducted ten reviews of the PBGC since 2003 and that PBGC officials had testified twenty times before various congressional committees since 2002); testimony before the Special Committee on Aging, U.S. Senate, BARBARA D. BOVBJERG ET AL., U.S. GOV'T ACCOUNTABILITY OFFICE, PENSION BENEFIT GUARANTY CORPORATION: FINANCIAL CHALLENGES HIGHLIGHT NEED FOR IMPROVED GOVERNANCE AND MANAGEMENT at Highlights (2009), available at http://www.gao.gov/new.items/d09702t.pdf [hereinafter PBGC FINANCIAL]; testimony before Senator Charles E. Grassley, BARBARA D. BOVBJERG ET AL., U.S. GOV'T ACCOUNTABILITY OFFICE, STATE AND LOCAL GOVERNMENT PENSION PLANS; GOVERNANCE PRACTICES AND LONG-TERM INVESTMENT STRATEGIES HAVE EVOLVED GRADUALLY AS PLANS TAKE ON INCREASED INVESTMENT RISK at Highlights (2010), available at http://www.gao.gov/new.items/d10754.pdf [hereinafter GOVERNANCE PRACTICES] (discussing the state of public defined benefit plans). In fact, in one study, the Government Accountability Office looked at a sample of about seventy public retirement systems at the request of Senators Max Baucus, Democrat of Montana, and Charles E. Grassley, Republican of Iowa, the chairman and ranking Republican member of the Finance Committee at that time, respectively. Mary Williams Walsh, Report to Senators Says Many States Are Lax in Funding Their Pension Plans, N.Y. TIMES, Feb. 29, 2008, http://www.nytimes.com/2008/02/29/business/29pension.html. The two senators wanted to increase monitoring of public pension plans because they did not "want a fund collapsing and looking to the federal government for a bailout." Id. (quoting Senator Baucus and noting that the request was somewhat unusual, because Congress has little authority over the way states handle their pension funds).


tors, non-governmental organizations, businesses, academics, and the media have spoken out about the looming pension problems in the United States. Pension under-funding even reached the national election stage in 2010, with candidates across the country offering a variety of proposals to strengthen pension financing.

This concern certainly seems warranted given the fact that the SEC recently sued New Jersey, the first time the agency has ever sued a state for securities fraud, because of the way New Jersey has been funding its pension system. From 2001 to 2007, New Jersey allegedly "misrepresented and failed to disclose material information" about the under-funding of its pension plans while issuing $26 billion in bonds. The state used those bonds to raise pension benefits 9 percent for state and local government employees. Someday, New Jersey’s liabilities will reach a tipping point where the state will have to choose between repaying the bonds it has issued or honoring its pension obligations; it will not be able to do both.


8. E.g., Balz, supra note 3 (Washington Post staff writer).


Unfortunately, New Jersey is not the only state struggling with its pension system, nor are pension problems limited to the public sector. Defined benefit retirement plans, which place the burden of providing retirement benefits on employers, are putting an enormous strain on both states and private companies alike. Only one state—Arkansas in 1934—has defaulted on its general obligation pension bonds since the 1800s, but unless action is taken, the current national and global economic situation, the poor decisions made by state and local governments concerning their retirement plans, and the imminent wave of Baby Boomer retirements threaten to push the United States' economy to the brink of insolvency.

This Note begins in Part I by examining relevant background information regarding defined benefit pension plans and demographic data of the Baby Boomer generation. Part II explores how states and private employers have created contractual obligations through defined benefit plans and examines the magnitude of the financial burden those obligations have created. Part III addresses what happens when those contractual obligations are breached, but suggests that litigation cannot provide a complete solution to pension under-funding. Finally, Part IV discusses and evaluates some of the options public and private pension systems have to combat potential disaster, while recommending linking retirement ages to average life expectancies and enforcing actuarial reductions based on early retirements as especially effective in combating the financial burden of Baby Boomer retirements. Additionally, although this Note addresses problems in both the private and public sectors, it focuses more heavily on potential solutions for public pension plans, based on the regulatory constraints that are already in place for private companies' pension plans.

I. SETTING THE STAGE: DEFINED BENEFIT PLANS AND BABY BOOMER DEMOGRAPHICS

The current strains on private and public pension systems in the United States have been influenced by both the structure of our pension plans, as well as the number of workers who rely on those plans. As explained below, the use of defined benefit plans—as opposed to defined contribution plans—poses particular problems. Compounding these problems are the demographics of the Baby Boomer generation, a large group that will soon rely on pensions for retirement funding.
A. Defined Benefit Plans

A traditional “defined benefit pension plan” is one that promises to pay an employee a benefit under a fixed formula that “takes into account factors such as final salary and years of service with the employer.” A common example of a defined benefit formula specifies that at retirement an employee will receive an annual income equal to a percentage of her average salary times the number of years she worked for her employer. Employees are thus guaranteed a specific benefit at their normal retirement age, which is usually sixty-five. Post-retirement cost of living adjustments (COLAs), which typically attempt to offset inflation, are frequently included in defined benefit plans. These plans traditionally disburse a retiree’s retirement payments on a monthly basis until the participant’s death, often with the payments continuing at a reduced level to the retiree’s surviving spouse. The employer generally makes the contributions to the plan, although employee contributions are sometimes required.

In contrast, defined contribution plans often require employers to contribute a specified amount, usually a percentage of an employee’s annual salary, to an individual account for each employee, at which point the employer’s obligation to fund the employee’s pension plan is complete. In fact, most defined contribution plans do not include COLAs. Thus, a defined contribution plan guarantees an input, while a defined benefit plan

21. Zelinsky, supra note 16, at 455. In some cases, defined contribution accounts are solely funded by the employees, while other plans can be designed to permit an employer to decide how much, if any, it will contribute to an employee’s retirement account each year. Karen Eilers Lahey & T. Leigh Anenson, Public Pension Liability: Why Reform is Necessary to Save the Retirement of State Employees, 21 NOTRE DAME J.L. ETHICS & PUB. POL’Y 307, 312 (2007).
22. BOVBJERG ET AL., supra note 18, at 4.
guarantees an output. As will be shown below, there are great difficulties in guaranteeing a defined benefit’s future output in changing economic and political conditions.

Notable disparities exist between public and private sector retirement plans. While an increasing number of private employers offer defined contribution plans for their employees, public employees are overwhelmingly members of defined benefit plans. In fact, as of 2007, forty-six states required that new employees participate in defined benefit plans. Among full-time employees, 98 percent of state and local government employees participate in retirement or savings plan participation, with 91 percent of them participating in defined benefit plans. As of 2005, however, only 60 percent of private sector full-time employees participated in retirement or savings plans, with only 20 percent of those participating in defined benefit plans.

Defined benefit plans traditionally require larger cash injections from employers, with one Bureau of Labor Statistics reporting that defined benefit plans cost private companies $2.21 per hour on average, compared to $0.27 for defined contribution plans. The perception that government

24. See infra notes 71–133 and accompanying text.
26. Drummonds, supra note 25, at 282; see also BOVBJERG ET AL., supra note 18, at 2–3 (as of 2007, forty-six states had defined benefit plans as their primary pension plans for general state workers, two had defined contribution plans, and two had plans which combined both defined benefit and defined contribution components); id. at 10 ("[E]ach of the [fifty] states has also established a defined contribution plan as a supplementary, voluntary option for tax-deferred retirement savings for their general state employees.").
27. BOVBJERG ET AL., supra note 18, at 9 fig.1.
32. ALISON T. TOUHEY, FDIC OUTLOOK: THE SHIFT AWAY FROM DEFINED BENEFIT PLANS n.38 (2006), available at http://www.fdic.gov/bank/analytical/regional/ro20061q1a/2006_spring02.html; see also Marion Crain, Managing Identity: Buying into the Brand at Work, 95 IOWA L. REV. 1179, 1193–95 (2010) (noting that defined benefit plans, as opposed to defined contribution plans, require employer contributions even after an employee has ceased employment).
employees have a better retirement system than private sector employees because of the disparity in their salaries is somewhat at odds with recent data showing that state and local government employees have higher salaries than those with comparable private sector jobs. Thus, in some areas, public sector employees earn more money during their actual employment than private sector workers and then have a more secure, employer-backed, defined benefit pension plan waiting for them when they retire. According to 2007 U.S. Labor Department data, state and local governments paid $3.04 per hour towards each employee’s retirement while private employers paid $0.92 per hour. The expense of defined benefit pension plans will become even more apparent once the Baby Boomer generation begins to retire.

B. Demographics of Baby Boomers

The seventy-eight million “Baby Boomers,” comprising those born between 1946 and 1964, form one of the largest generations in U.S. history—a generation equal to roughly 26 percent of the total U.S. population. These Baby Boomers are about to play a central part in one of the largest problems the public and private pension funds in the United States have ever seen. According to a study by the Urban Institute—a non-partisan non-governmental organization—approximately 33 percent of all Baby Boomers will be eligible to receive defined benefit pension plan benefits upon retirement, which equates to roughly twenty-six million eligible retirees.

33. Laing, supra note 14 (noting that state and local employees earn an average $26.11 per hour, versus $19.41 per hour for comparable private sector employees).


The leading edge of the aging Baby Boomer generation recently hit retirement age; the oldest turned sixty-two in 2008 and will be turning sixty-five in 2011. Due to the aging of this large generation, the average ratio of active workers to beneficiaries in the United States will decrease from 3.3:1 in 2002 to 2.2:1 by 2030, with most of that change occurring after 2010. These numbers are even worse when focused specifically on state retirees, with a ratio of 2.02:1 in 2008 compared to 2.45:1 in 2001. Although 12.97 percent of the population is over the age of sixty-five, that number is projected to grow by roughly one and a half percentage points every five years until 2035 when it will stabilize at around 20 percent.

In light of these figures, it is probably not too surprising that life expectancy has increased dramatically in recent history. Indeed, James W. Vaupel—director of the program on population, policy, and aging at Duke University—has said that life expectancy in leading countries has increased by three months every year for the past 160 years and believes that it will continue to do so. Because defined benefit plans continue paying benefits to each retiree and his or her spouse until their deaths, a large influx of retirees living longer than ever before will create a large strain on pension plans' coffers.

Past economic recessions have come and gone, and although it is possible that the current global economic situation will improve sometime soon, the United States cannot escape its aging population. In fact, some economists even predict that the stock and bond markets will decline once Baby Boomers start to withdraw money from their retirement accounts.

39. Laing, supra note 14 (reporting data from the National Association of State Retirement Administrators).
Although there may not be an *en masse* sale of all assets,\textsuperscript{44} the Baby Boomers will shift from saving and investing to reducing their net assets as they slowly withdraw and no longer add to their retirement accounts.\textsuperscript{45} If this prediction becomes reality, it will become increasingly harder for plan managers to use investment gains to grow out of pension fund deficits.

II. **Legal Obligations and the Resulting Financial Burdens of Defined Benefit Plans**

As noted above, defined benefit pension plans exist in both the public and private sectors. However, the legal obligations that defined benefit plans impose vary in different settings. The following sections examine the different legal obligations in the two sectors and explore the magnitude of the financial burdens that defined benefit plans are placing on employers. Additionally, the following sections explore how and why pension plan managers have failed to properly fund these large financial burdens.

A. **Legal Obligations of Public Pension Plans**

Public pension plans are legally protected by state constitution, state statute, or contract.\textsuperscript{46} The majority of states have some form of constitutional protection for their pensions. According to data compiled in 2000, thirty-one states have a combined total of ninety-three constitutional provisions protecting their pensions, and the other nineteen states have pension protections either in their statutes or under common law.\textsuperscript{47} The strongest of the constitutional provisions, which are in nine state constitutions, guarantee participants in the retirement systems a contractual right to their benefits and prohibit reducing or eliminating an accrued benefit.\textsuperscript{48} For example, Alaska's Constitution states: "Membership in employee retirement systems of the State or its political subdivisions shall constitute a contractual relationship. Accrued benefits of these systems shall not be diminished or impaired."\textsuperscript{49}

Even though not every state has a constitutional provision promising contractual rights to pension plan participants, the majority of states view

\textsuperscript{44} BOVBJERG ET AL., supra note 36, at 16, 23 (stating that there is no big risk to market declines).

\textsuperscript{45} Powell, *supra* note 43.

\textsuperscript{46} GOVERNANCE PRACTICES, *supra* note 1, at 7.


\textsuperscript{48} BOVBJERG ET AL., *supra* note 18, at 13 tbl.1.

\textsuperscript{49} ALASKA CONST. art. XII, § 7.
public employees as having "certain contractual rights in a public pension where the pension was part of the terms of employment." As some courts have phrased it, "[a] public employee’s pension constitutes an element of compensation, and a vested contractual right to pension benefits accrues upon acceptance of employment," and "the contractual basis of a pension right is the exchange of an employee’s services for the pension right."

Another approach that some jurisdictions take is to view employees as having property rights in pension funds, and thus protection under federal and state due process provisions, instead of contractual rights with the governmental employer.

**B. Legal Obligations of Private Pension Plans: Protected by Federal Regulation**

In 1964, the wagon and automobile manufacturer Studebaker Company’s bankruptcy left its employees with only fifteen cents for each pension dollar promised. In response to that bankruptcy and an increasing amount of private pension plan abuses, Congress established the Pension Benefit Guaranty Corporation (PBGC) under the Employee Retirement Income Security Act (ERISA) in 1974 to safeguard private defined benefit pension plans. ERISA does not require private companies to create defined benefit plans, but once created the plans are regulated by ERISA and partially insured by the PBGC. Thus, while companies that have created defined benefit plans are contractually obligated to make payments to retirees, the PBGC provides an additional level of protection for employee benefits in severely under-funded plans.

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56. For example, ERISA requires that participating employers make minimum annual plan contributions. Daniel J. Morse, et al., Involuntary Terminations of Pension Plans under ERISA Are Non-core Matters, 36 AM. BANKR. INST. J. 75 (2006).

57. Crain, supra note 32, at 1193.
The PBGC is a non-profit government corporation whose mission is to protect the retirement incomes of more than forty-four million American workers in more than 27,500 private sector defined benefit plans. The PBGC receives its revenue from the following sources: insurance premiums paid by employers that sponsor insured pension plans, investment earnings, funds of pension plans the PBGC takes over, and recoveries of plan sponsors’ bankruptcy estates. Importantly, 29 U.S.C. § 1302(g)(2) states that the United States is “not liable for any obligation or liability incurred by the corporation.”

Under current law, the PBGC guarantees workers who retire at or above age sixty-five up to $4500 per month. The vast majority—about 90 percent—of the participants in PBGC-trusted plans receive all of the benefits their plan promised. The PBGC’s latest figures indicate that it pays the monthly retirement benefits, up to a maximum guaranteed amount that is set by law, to almost 801,000 retirees in 4200 pension plans that have ended.

The PBGC acquires terminated pension plans by three methods: standard termination, distress termination, and involuntary termina-

58. Who We Are, PENSION BENEFIT GUARANTY CORPORATION, http://www.pbgc.gov/about/about.html (last visited Nov. 27, 2010). Statutorily, the PBGC’s Mission is: 1) to encourage the continuation and maintenance of voluntary private pension plans for the benefit of their participants, 2) to provide for the timely and uninterrupted payment of pension benefits to participants and beneficiaries under plans to which this title applies, and 3) to maintain premiums established by the corporation under [29 USCS § 1306] at the lowest level consistent with carrying out its obligations under this subchapter. 29 U.S.C. § 1302(a) (2006).

59. Cearley, supra note 54, at 189; PBGC IMPROVEMENTS, supra note 1, at 5 n.6 (noting that there is statutory authority to borrow up to $100 million from the Treasury Department, but that the PBGC has only used that “line of credit” once, when it needed to cover its startup costs, and quickly repaid the loan).


62. PBGC IMPROVEMENTS, supra note 1, at 4-5 (noting that “[b]enefits for some participants may be reduced if: 1) their benefits exceed PBGC’s maximum guarantee limit, 2) a benefit increase occurred (or became payable due to a plant shutdown) within five years of the plan’s termination, or 3) a part of their benefit is a supplemental benefit.”); Kilgour, supra note 37, at 11 (those with generous pensions above the maximum guaranteed by the PBGC will not receive their full benefits).

63. Who We Are, supra note 58.


65. Either the PBGC or a bankruptcy judge can decide that a company can terminate its plan because the company’s continuing viability would be threatened by its pension obligations. John P. Henry, A Fait Accompli for the PBGC and US Taxpayers: How the Last Hope for Redemption was Missed in the 2005 Bankruptcy Code Revisions and Subsequent Court Decisions, 71 J. AIR L. & COM. 375, 379 (2006); 29 U.S.C. § 1342(c) (2006).
A company can voluntarily terminate its defined benefit plan through a standard termination if the company has enough assets to meet its pension liabilities. A company can undergo a distress termination if the PBGC or a bankruptcy judge decides that the company’s continuing viability would be threatened by its pension obligations. Finally, the PBGC can initiate an involuntary termination for a single-employer plan if the PBGC determines that either the employer has not made its minimum required contributions to the plan, the plan will not be able to pay benefits when due, a large distribution to a corporate insider renders the plan underfunded, or the PBGC’s long-term costs can be expected to be unreasonably higher if it does not terminate the plan. Because a standard termination assumes a company has enough assets to meet its obligations, only distress and involuntary terminations are relevant for this note.

C. Financial Burdens of Public Pension Plans

“Public pension promises are huge and, in many cases, funding is woefully inadequate,” Warren Buffett wrote in his 2007 letter to shareholders. “Because the fuse on this time bomb is long, politicians flinch from inflicting tax pain, given that the problems will only become apparent long after these officials have departed.”

1. The Current Financial State of Public Pension Plans

Nearly twenty million employees and over seven million retirees and their survivors are covered by state and local government pension plans. Typical asset allocation of public pension funds puts 60 percent of pension plan assets in stocks, 30 percent in fixed income, 5 percent in real estate, and the remaining in riskier investments, such as hedge funds or commodities, although allocations change with time and vary amongst different pension funds. In the early 2000s, the funded ratio of 114 state and local government pension plans was 73%.
local government pension plans was nearly 100 percent. However, one recent study by Novy-Marx & Rauh looking at data from June 2009 estimates that 116 major public pension plans sponsored by the fifty states have about $1.89 trillion of assets to pay pension promises of between $3.62 trillion and $5.28 trillion, leaving a gap of between $1.73 trillion and $3.39 trillion. The staggering implications of those pension liabilities are highlighted when they are compared to the total state non-pension debt, which was a much smaller $1.00 trillion as of 2008. The Novy-Marx & Rauh study indicates that increasing the retirement age by one year would only reduce pension liabilities by 2–4 percent, lowering COLAs by one percentage point would reduce the liabilities by 9–11 percent, and implementing actuarially fair early retirement would reduce them by 2–5 percent. Even taking extreme action, such implementing Social Security retirement age parameters or eliminating COLAs would still leave a deficit of over $1.5 trillion. Yet making these adjustments might seem pointless given the fact that about half of the states are setting aside less than their yearly contribution amounts, essentially forcing future generations to pay for the government services being performed today.
How did the states get into such a predicament? Often a combination of political pressure leads elected officials to cut payments to a fund during boom years, and a lack of political support to worsen a state’s budget shortfall prevents officials from increasing payments during a recession.\textsuperscript{81} During the market boom and subsequent pension plan investment returns of the 1990s, many governments grew accustomed to easily making their Annual Required Contributions (ARC), which are the actuarially calculated annual contribution amount that would maintain or improve their funded status.\textsuperscript{82} After this market boom, fund managers increasingly allocated their investments in equity. To illustrate, in 1990, only 38 percent of state and local pension plan investments were in equities, while in 2007, 70 percent were in equities.\textsuperscript{83}

As fund managers were making a shift towards heavier investments in equities, governments added benefits during rosy times, reduced retirement ages, and shortened vesting periods, amongst other actions, perhaps thinking the 1990s boom would last forever.\textsuperscript{84} Unfortunately, the dot-com bust, the 9/11 tragedies, and the ensuing weakened economy during the early 2000s drove investment returns down.\textsuperscript{85} This subsequent decrease in funded ratios increased the amount that governments would have to contribute out of their own pockets.\textsuperscript{86} As recently as 2006, one GAO report found that only 54 percent of state and local plans in its data set contributed 100 percent of their ARC.\textsuperscript{87} The problem is further compounded because delaying contributions is encouraged by accounting rules for state and local governments, which allow governments to use amortization periods of up to thirty years to close funding gaps.\textsuperscript{88}

Another issue is that some contribution rates are fixed by constitution or statute and do not change in response to changes in pension ARCs.\textsuperscript{89}

\textsuperscript{81} Froomkin, supra note 76.
\textsuperscript{82} BOVBJERG ET AL., supra note 74, at 8–9, 19; BOVBJERG ET AL., supra note 18, at 22 n.39 ("The ARC is made up of the amount of future benefits promised to plan participants that accumulated in the current year, plus a portion of any unfunded liabilities. Although the ARC refers to the annual required contribution, the use of the word "required" can be misleading because governments can choose to pay more or less than this amount.").
\textsuperscript{83} BARRETT ET AL., supra note 31, at 8.
\textsuperscript{84} See id.; Froomkin, supra note 76 (summarizing the causes of the current situation as "[c]hronic underinvestment (particularly in the bubble years), poor management of assets before and during the financial crisis, and, in some cases, unfunded benefit increases have put many pension funds wildly out of balance.").
\textsuperscript{85} BARRETT ET AL., supra note 31, at 8.
\textsuperscript{86} BOVBJERG ET AL., supra note 74, at 19.
\textsuperscript{87} BOVBJERG ET AL., supra note 74, at 17, 18 fig.4.
\textsuperscript{88} Laing, supra note 14.
\textsuperscript{89} BOVBJERG ET AL., supra note 18, at 23.
Even if a contribution rate is not fixed, it can take time for the legislative process to react to economic conditions and increase contributions. Additionally, some states may not be committed to pre-funding their pension plans because the states place a higher priority on other initiatives. Yet another recurring problem is that state and local governments often grant large raises to an employee during his or her final year of employment to boost his or her benefits. Because employees' retirement benefits are often based on the salary they earned in their last year, this "spiking" dramatically increases pension benefits. Finally, as explained below, expected rates of return can play an important role in public pension problems because, if improperly set, these rates can hide the fact that a problem exists.

Additionally, state and local governments traditionally have a much lower retirement age, which places more strain on a pension's funding requirements. Despite the fact that there is an oncoming bulge of Baby Boomers who are going to live longer than previous generations, state and local governments continue to allow retirements with full benefits at a much younger age than the federal government or private employers. A 2005 study indicated that almost 98 percent of the plans studied offered full retirement benefits at the age of sixty-two or earlier for employees with long service. It would appear that state employees take advantage of this opportunity, as the average age of retirement is sixty.

It might give residents of the United States some solace to realize that they are not alone in facing this struggle. In twenty years, half of the Western European population will be over fifty. Europe spends one and a half

90. Id. (noting that in spite of this problem, many states have been increasing their contribution rates in recent years).
91. Id.
92. Schwarzenegger, supra note 2.
93. Id.; see also SUMMERS, supra note 5, at 17 (noting that although California passed legislation to making spiking more difficult, loopholes in state law make pension spiking easy and legal (internal quotations removed)).
94. See infra notes 106–124 and accompanying text.
95. BARRETT ET AL., supra note 31, at 12.
96. Id.
97. Id. (citing a Wisconsin Legislative Council study).
98. Neumann et al., supra note 7.
times as much as the United States on retirement, measured in terms of Gross Domestic Product. As one example, France’s state pension plan is running an annual deficit of about $55 billion, roughly 1.7 percent of its GDP. To combat this pension deficit, France’s parliament recently adopted legislation raising the minimum retirement age from sixty to sixty-two and raising the age for full pension benefits from sixty-five to sixty-seven. The French government claims that raising retirement ages will save the government €70 billion. In reaction to that two-year increase in the retirement age, France’s citizens have held at least eight national strikes.

2. Expected Rates of Return for Pension Funds as a Contributing Factor

A pension plan’s expected rate of return estimates how much the plan will grow from its investments. An increase in a plan’s liabilities in any given year can be partially offset, or even surpassed, by the growth of the plan’s investments. Thus, a lower rate of return may lead plan administrators to believe that outside funds (i.e., contributions) are necessary to maintain funding status. Conversely, a higher rate of return will lead plan administrators to believe that smaller contributions are necessary to maintain the plan’s funding status. Additionally, because government plans use their expected return rate as their discount rate—the rate used to discount percent of its value while Japan’s more conservatively invested Government Pension Investment Fund only lost 7.6 percent in FY ending March 31, 2009). Thus, it might be prudent for the United States to pay attention to how Japan copes with its pension asset allocation in relation to its aging population.

100. Pohjanpalo, supra note 99 (according to Standard and Poor’s).


future pension liabilities—and because lowering a discount rate can increase a plan’s obligations, public plans have yet another reason to hesitate before cutting those rates. Thus, using high rates of return can hide pension shortfalls in a declining economy.

The reported expected rates of return for public pensions are relatively high, particularly when compared with those rates of other private funds. To illustrate, public pension funds often report expected rates of return around 8 percent, though they can be as high as 8.75 percent. As a comparison, Warren Buffett has set Berkshire Hathaway Inc.’s pension fund expected return of 6.9 percent. Berkshire Hathaway uses a much lower rate, yet it is a financially strong company that, as of 2009, had averaged an annual growth in book value of 20.3 percent to its shareholders since 1965.

Not only can these hopefully high rates of return be an excuse for a state to reduce the amount that the state has to contribute to a fund, but they can induce a pension system to make questionable decisions. For example, in 2008 the Chicago Transit Authority (CTA), which was under-funded by 62 percent and had not received a hoped-for contribution from the state of Illinois, issued $1.9 billion worth of bonds with a 6.8 percent return. The CTA had calculated that it could borrow $1.9 billion, paying an interest rate of 6 percent to bondholders, and then invest those proceeds to receive an expected rate of return of 8.75 percent. Not only did the CTA end up borrowing against a higher interest rate, it only earned 2 percent on the cash for the first year after the bond sale. As a result, instead of earning

107. Id. ("Funds use a so-called discount rate to estimate the size of future obligations to retirees, and thus the contributions needed to fund them. Corporate plans use a discount rate based on corporate bond yields. But government plans use their expected return rate on all investments as their discount rate."). For a discussion on this topic with examples, see Josh Barro, The Teacher Pension Nightmare, FORBES.COM, Apr. 14, 2010, 11:27 AM, http://www.forbes.com/2010/04/14/teacher-pension-education-taxpayers-opinions-contributors-josh-barro.html.

108. SUMMERS, supra note 5, at 13–14.

109. Evans, supra note 73.

110. Id.; see also SUMMERS, supra note 5, at 14 (stating that some financial advisors have suggested that an even lower rate may be more appropriate, such as 5 percent).


112. Evans, supra note 73.

113. Id. (stating that the CTA’s actuarial firm determined that there was just a 30 percent chance of the CTA earning 8.75 percent).

an expected $52 million in the first year, the CTA ended up losing $91 million.\(^{115}\)

New Jersey provides another example of the dangers of hopeful rates of return. In 1997, the state sold $2.75 billion of bonds at an interest rate of 7.64 percent, attempting to cover an unfunded $4.25 billion pension liability.\(^{116}\) Then-Governor Christine Whitman stated that “[y]ou’d be crazy not to have done this.”\(^{117}\) Unfortunately, as of early 2009, the pension fund has earned an annualized 4.8 percent since the bond sale, resulting in a loss of $500 million.\(^{118}\) Current Governor Chris Christie is now complaining that, while private-sector unionized employees in New Jersey are experiencing high rates of unemployment, they are still being asked to pay higher property taxes to fund salary increases and free health care for public sector employees.\(^{119}\)

It is important to keep in mind that public pension plans posted a median, annualized return of 9.3 percent over the past twenty-five years.\(^{120}\) Unfortunately, over the past ten years, they have posted just a 3.9 percent return.\(^{121}\) One problem with setting the expected rate of return so high is that the annualized return of 9.3 percent, for example, was obtained by taking investment risk.\(^{122}\) If risks materialize, such as those that led to the recent 3.9 percent return over the past decade, then state taxpayers are on the hook for any shortfalls.\(^{123}\) Even more problematic, when those risks have yet to materialize it can be politically unwise for a plan to be over-funded. Contributions made to over-funded systems can become a target for lawmakers’ other ambitions, or can even be used to increase retiree benefits.\(^{124}\)

\(^{115}\) (1,900,000,000)\(\times\)0.0875 - 0.06 = $52,250,000 and (1,900,000,000)\(\times\)0.02 - 0.068 = - $91,200,000.


\(^{117}\) Evans, supra note 73.

\(^{118}\) Id.

\(^{119}\) Balz, supra note 3; see also Paul Ingrassia, Trillion-dollar Pension Crisis Looms Large over America, INSTITUTIONAL INVESTOR, Mar. 2010, http://www.iimagazine.com/article.aspx?articleID=2442415 (describing Gov. Christie’s statement that one 49-year-old state retiree contributed only $124,000 towards his pension plan, but the state owes him $3.3 million in pension payments and an additional $500,000 in retiree health care benefits).

\(^{120}\) Reilly, supra note 106 (according to Callan Associates).

\(^{121}\) Id. (according to Callan Associates).

\(^{122}\) See Novy-Marx & Rauh, supra note 76, at 8 (describing dangers of not including risk in rates of return).

\(^{123}\) Id.

\(^{124}\) BOVBJERG ET AL., supra note 18, at 19.
3. California as a Concrete Example of Pension-funding Problems

Looking at California is instructive of state pension-funding problems, and Governor Schwarzenegger’s recent Op-Ed in the Wall Street Journal, if taken at face value, reveals the state’s precarious position. California currently has $550 billion of retirement debt, although that figure includes retirement health care promises as well as pension promises. The cost of servicing that debt has grown at an annual rate of more than 15 percent for the past ten years. At this point, nearly eighty cents of every government dollar goes to employee compensation and benefits. California effectively guarantees $1 million to public employees who opt to retire at age fifty-five, providing them with a monthly, inflation-protected check of $3000 for the rest of their lives. Spending on California’s state employees over the past ten years rose at nearly three times the rate the state’s revenue grew, at the expense of, to name a few areas, higher education, environmental protection, and parks and recreation. From just a pension point of view, since 1999, California’s public pension spending has increased 2000 percent, but state revenues have only increased 24 percent. Even taking into account proposed pension reforms, a decade from now retirement costs are projected to increase from $6 billion in 2010 to nearly $30 billion per year.

D. Financial Burdens of Private Pension Plans on the PBGC

Private sector pension funds are also struggling, as evidenced by the increasing deficit of the PBGC. Because the PBGC is responsible for guaranteeing retirement benefits to employees whose companies are too under-funded, this Note will focus on the financial burden the private sector is facing from the viewpoint of the PBGC. The PBGC’s 2009 annual report states that the “breadth of business failures across sectors and re-

125. Of course, California is not the only state dealing with this problem. For examples from other similarly situated states, see Ingrassia, supra note 119 (describing New Jersey and Connecticut’s funding situations that resulted from poor decisions).

126. Schwarzenegger, supra note 2.

127. Id.

128. Id.

129. Id. (according to former Speaker of the State Assembly and San Francisco Mayor Willie Brown).

130. Id.

131. Id.

132. Ingrassia, supra note 119.

133. Schwarzenegger, supra note 2.

gions in FY 2009 was unprecedented in PBGC’s 35-year experience.”135 By the end of fiscal year 2009, the PBGC had become directly responsible for almost 201,000 new participants, about nine times the 22,000 new participants in plans taken during the fiscal year 2008.136 The new pension obligations, combined with unfavorable changes in interest factors, almost doubled the PBGC’s deficit from $11.2 billion at the end of 2008 to $21.9 billion at the end of 2009.137 Moreover, the PBGC expects terminations to continue well after the initial economic shock of the ongoing crisis.138 The GAO has designated the PBGC’s single-employer pension insurance program as “high risk” since 2003,139 but the recent economic downturn and the increase of a historic deficit surely puts the PBGC beyond “high risk”.

Yet another cause for concern is the PBGC’s newly adopted investment policy, which reduces the percentage of PBGC assets allocated to fixed-income investments, increases the PBGC’s proportional holdings in international equities, and introduces new asset classes, such as private equity, emerging market debt and equities, high-yield income, and private real estate.140 The goal of this change in policy is to reduce the current deficit through greater returns.141 Yet, as the Congressional Budget Office points out, increasing the risk within the PBGC’s asset allocation may also increase the risk that the PBGC will not have sufficient assets to cover employee benefit payments when the economy and financial markets are weak.142

Finally, the PBGC is sometimes harmed by the very companies it assists. When a company seeks bankruptcy protection,143 secured creditor claims (claims to specific assets) will be satisfied from the assets of the

135. Id. at 3 ("PBGC trustees the pension plans of household names in the finance (Lehman Brothers, IndyMac Bank), retail (Circuit City), and telecommunications (Nortel) industries. The healthcare industry was also hard-hit, with several hospital plans terminating. In the automotive industry, Delphi Corporation’s pension plans alone brought 70,000 new participants to PBGC’s rolls.").
136. Id.
137. Id. at 3, 7 (resulting largely from the difference between $68.7 billion in assets and $89.8 billion in liabilities for PBGC’s single employer program).
138. Id. at 3.
139. PBGC FINANCIAL, supra note 1, at Highlights (the GAO also expressed dismay that the PBGC board had not met in fifteen months during a time of financial crisis).
140. Id. at 9.
141. PBGC IMPROVEMENTS, supra note 1, at 23.
142. PBGC FINANCIAL, supra note 1, at 9–10.
143. Note that companies entering bankruptcy can choose not to abandon their pension obligations. General Motors, for example, recently entered and exited bankruptcy while retaining its pension obligations to the United Auto Workers union. JunoTrade, GM Has Not Learned Its Lesson, SEEKING ALPHA, Nov. 29, 2010, http://seekingalpha.com/article/239014-gm-has-not-learned-its-lesson.
company before unsecured creditors receive any asset allocation.\textsuperscript{144} The PBGC takes a back seat to these secured creditors, and indeed must struggle even amongst other unsecured creditors for assets.\textsuperscript{145} Companies filing for chapter 11 bankruptcy often do so immediately before mandatory payments are due to the PBGC. For example, Northwest Airlines filed for bankruptcy one day before a payment of $65 million was due to the PBGC, essentially making the PBGC an unsecured creditor for that amount.\textsuperscript{146} In this way, companies entering bankruptcy can shift certain portions of their pension obligations to the PBGC’s balance sheet.

Although Congress has taken some action to help reduce the burden on the PBGC, funding gaps remain a problem.\textsuperscript{147} For example, the Deficit Reduction Act of 2005 and the Pension Protection Act of 2006 (PPA) were intended, in part, to help deal with the PBGC’s exposure to under-funded pensions.\textsuperscript{148} The PPA allows companies seven years to fully fund their pension promises.\textsuperscript{149} However, a recent GAO report states that the PPA did not fully close potential funding gaps.\textsuperscript{150} Moreover, the Worker, Retiree, and Employer Recovery Act of 2008, intended to help pension plans weather the current economic downturn, will result in lower plan contributions than employers would have had to make under the PPA.\textsuperscript{151} This temporary reduction of contributions will likely increase the PBGC’s risk exposure.\textsuperscript{152}

III. BREACH OF LEGAL OBLIGATIONS: TRADITIONAL MECHANISMS INSUFFICIENT TO COMBAT PENSION UNDER-FUNDING

Employees should be wary of assuming that their employers’ legal obligations to fund pension plans will provide a sufficient mechanism to ensure employees receive their retirement benefits. State and local governments currently fail to make sufficient contributions to plan funds,
yet the following sections demonstrate that forcing states and local governments through the court system to make large enough contributions is a futile exercise. Additionally, although the PBGC could dramatically increase employer contributions to reduce its deficit, such action would have potentially harmful effects on companies that are already suffering. Thus, the size of pension-underfunding coupled with the current economic downturn threatens to leave employees with no viable traditional mechanism for receiving their benefits.

A. Traditional Mechanisms for Under-funded Public Pension Plans

Unfortunately, many state and local plans currently face increased benefit costs and insufficient employer contributions.\textsuperscript{153} More recently, the current economic downturn has had a more pronounced impact on state and local pension plans, with plan managers reporting that in the short period from June to December 2008 public sector pension plans lost nearly a quarter of their asset value.\textsuperscript{154} Still, plans report that they have sufficient assets to cover years of benefit payments.\textsuperscript{155} The problem is that while these plans may be able to make payments in the near future, they do so at the expense of future generations who will either have to make higher contributions to make up for the lack of contributions today, or receive smaller benefits.

At first glance, bankruptcy may seem like an appealing legal option for overwhelming debt; unfortunately, municipalities are the only public entities that can declare bankruptcy. Chapter 9 of the Bankruptcy Code deals exclusively with municipalities and provides them with the power to restructure their debt and ease their burdens.\textsuperscript{156} States, however, have no safe harbor in which to rest should their debts become overwhelming.\textsuperscript{157} Therefore, unless states can gather sufficient funds, they may be forced to default on their debts.

Outside of bankruptcy, an obvious traditional option for resolving the problem of under-funded public pension plans is using the judicial system to force states to contribute to their pension plans. In states that provide

\textsuperscript{153} Bovbjerg et al., supra note 18, at 22–23. Since ERISA does not apply to state pension plans, they do not have the same minimum funding requirements that ERISA requires of private pension plans. 29 U.S.C. § 1003(b)(1).

\textsuperscript{154} Governance Practices, supra note 1, at Highlights.

\textsuperscript{155} Id.


\textsuperscript{157} David A. Super, Privatization, Policy Paralysis, and the Poor, 96 Calif. L. Rev. 393, 464 (2008).
contractual rights for employees’ pension benefits, California and New
York for example, there has been some success in forcing governors and
legislators to appropriate the required amounts through lawsuit. However, a similar lawsuit failed in New Jersey, which views pension rights as
property rights.

Considering that litigation may be successful in forcing a state to con-
tribute to its failing pension plans, the question that arises is, what will an
injunction forcing contributions accomplish? The old saying that “you can’t
squeeze blood from a turnip” is apt. If, for example, a court were to order a
state to contribute $100 million to a troubled pension fund, the state would
have to get the $100 million either from new sources—such as bond sales
or raised taxes—or by taking money from other spending projects—such as
police or fire department funding. Unfortunately, a combination of the im-
minent Baby Boomer retiree influx and a stagnant or declining economy
may prevent states from being able to raise enough money through taxation
or bond sales to continue funding their pension plans and providing nec-
essary services. Thus, alternate approaches beyond litigation should be the
proper approach to addressing this looming crisis.

B. Traditional Mechanisms for Under-funded Private Pension
Plans

As discussed above, when private companies cannot meet their con-
tractual obligations to pay benefits to retirees, there is already a legislative-
ly created safeguard in the PBGC that offers protection for those retirees.

158. Walsh, supra note 1.

159. Id. In New Jersey Education Association v. State, the Superior Court of New Jersey held that
classroom teachers did not have a constitutionally protected right to a particular method of funding
their pension plans. Moreover, the court held that the benefits the teachers had accrued for past service
were property interests, not contractual rights. While those property interests were non-forfeitable, the
teachers did not have a constitutional right to future appropriations for their pension plan.

160. Bond sales can be hampered by a lower credit rating. See, e.g., Moody’s Cuts Calpine’s Credit
cuts-calpine-s-credit-rating-to-junk.html.

161. While beyond the scope of this article, it is worth noting that health care costs for retirees are
increasing. Walsh, supra note 1. While private defined benefit plans have required funding and have the
backing of the PBGC, Other Post Employment Benefits (OPEB) have no similar requirements or backing.
Howard Silverblatt, America’s Other Pension Problem, BLOOMBERG BUSINESSWEEK, Dec. 19,
2005, http://www.businessweek.com/investor/content/dec2005/pi20051219_9796_pi015.htm. Moreo-
ver, in the public arena, most states handle health care costs on a pay-as-you-go basis, as opposed to
setting aside money in advance. Walsh, supra note 1. According to a recent Pew Center report, no fewer
than twenty-one states have funded 0 percent of their retiree health care and non-pension benefits.
O’Grady, supra note 11. The GAO recently reported that state and local governments have under-
funded OPEB by at least $530 billion. Ingrassia, supra note 119 (noting that some estimates are as high
as $1 trillion).
However, with the PBGC's increasing deficit, the private defined benefit plan insurance agency may soon need its own form of insurance. To close its historic deficit without resorting to federal aid, the PBGC has three basic options: reducing the PBGC's benefit payments, increasing premiums charged, and strengthening plan funding rules. In other words, the PBGC could reduce the maximum payment amounts it guarantees retirees from the current $4,500 a month, the PBGC could increase the rates it charges private companies to remain insured by the PBGC, or the PBGC could require private companies to contribute more to their plans.

Reducing the PBGC's maximum guaranteed payment would place an increased financial burden on retirees. Notably, however, the PBGC has never reduced its maximum guaranteed payouts. Increasing private companies' insurance premiums or requiring companies to contribute more to their plans would place an increased financial burden on companies. Yet already hurting private companies would suffer just as much from increased PBGC premiums or contribution requirements as state and local governments would suffer if courts forced those governments to increase their pension fund contributions. In fact, the PBGC's own analysis reveals that achieving even a 50 percent probability of eliminating PBGC's projected 2020 deficit through its traditional methods would require drastic steps.

IV. SOME ACTION ALREADY BEING TAKEN, AND SOME POTENTIAL STEPS

Because under-funded pension obligations are of enormous proportions, state and local governments, and to a lesser extent the PBGC, will need to examine the many options available to address their funding defi-
cits. The following sections look at the steps governments have already taken to address their pension-related deficits. Additionally, the following sections discuss and evaluate some additional options public and private pension systems have to combat potential disaster, and the consequences of not taking steps to reduce pension liabilities. Finally, this Part examines some steps the PBGC can take to prevent private companies’ pension plans from ever entering into the PBGC’s control.

A. Options to Address Public Plan Under-funding

1. What States are Already Doing to Combat Pension Under-funding

Because there are no existing benefit obligations in place for future employees, states are finding it easiest to reduce the benefits for future employees. For example, New Jersey Governor Christie signed a law in 2010 that prevents future part-time employees from participating in the state’s defined benefit plan—instead requiring them to join a defined contribution plan—and Governor Christie’s new budget includes reforms partially directed towards future public-sector employees. As another illustration, Pennsylvania Governor Ed Rendell is supporting a bill which would restructure pension benefits for public employees, although he expressed his regret that “the bad news is it can only be done for future employees.”

Most states have followed the trend of reducing benefits for non-vested employees. During the past fourteen years, Alaska, Michigan, and the District of Columbia have eliminated defined benefit pension plans for new employees and replaced them with defined contribution plans. Six states, while still providing defined benefit plans as their primary plans for general state employees, also offer defined contribution plans as optional

167. Novy-Marx & Rauh, supra note 76, at 14 (describing actions implemented state by state, including preventing spiking, increasing employee contributions, and increasing the length of time an employee must work to be eligible); URAHN ET AL., supra note 76, at 8 (describing reforms taking place as falling into five categories: "1) keeping up with funding requirements; 2) reducing benefits or increasing the retirement age; 3) sharing the risk with employees; 4) increasing employee contributions; and 5) improving governance and investment oversight."). For a broad overview of all states’ actions with graphs, see RON SNELL, NAT’L CONFERENCE OF STATE LEGISLATURES, STATE RETIREMENT LEGISLATION IN 2010, at 2-13 (2010), available at http://www.ncsl.org/documents/labor/Snell_Pensions_LegSum2010.pdf.


169. Balz, supra note 3.

alternatives to their primary plans that employees can opt into.\textsuperscript{171} Georgia eliminated COLAs for new workers.\textsuperscript{172} Rhode Island raised retirement ages for all employees who are not yet eligible for pension benefits, while Iowa raised the retirement ages for all non-vested employees.\textsuperscript{173} Vermont appears to be the only state that has implemented a system wherein benefits are reduced for employees who retire before the normal retirement age such that the present value of their benefits equals the present value of the benefits they would have received had they started to collect them at the normal retirement age—also known as assessing early retirement penalties on an actuarial basis—although the Iowa Public Employees system doubled its actuarial reductions to 6 percent per year.\textsuperscript{174}

Some states, deciding that cutting benefits for future employers alone will not be enough to save state pension systems, are attempting to cut benefits for current employees and retirees.\textsuperscript{175} For example, Colorado, Minnesota, and South Dakota (states without constitutional guarantees, but whose pensions are protected by statutes and court cases)\textsuperscript{176} have reduced their COLAs, which affects both current and future plan members, although these reductions are currently being challenged in court by pensioners.\textsuperscript{177} New Jersey Governor Christie is proposing legislation that would raise the retirement age to sixty-five, indefinitely freeze COLAs, and roll back the 9 percent increase in benefits the New Jersey legislature approved in 2001.\textsuperscript{178}

Certain states are taking more drastic measures. Governor Schwarzenegger’s pension reform goals for California include prohibiting spiking, requiring employees to increase their pension contributions, requiring transparency for the size and asset allocation of public pension funds, and using reasonable expected rates of return on fund investments.\textsuperscript{179} Certain Illinois public pension plans are selling their investments

\textsuperscript{171} Bovbjerg et al., supra note 18, at 8, 9 fig.1; see also Zelinsky, supra note 16, at 505 (pointing out that I.R.C. Section 457 supplementary defined contribution plans are available in some state and local governments).

\textsuperscript{172} Novy-Marx & Rauh, supra note 76, at 13 & n.7 (quoting from Georgia House Bill 452/ Act 82: "[L]imiting future liability of the systems by adjusting the retirement expectations of persons who are newly employed is a regrettable but necessary step toward fiscal soundness.").

\textsuperscript{173} Id. at 3.

\textsuperscript{174} Id. at 4.

\textsuperscript{175} Stephen C. Fehr, States Test Whether Public Pension Benefits Given can be Taken Away, Stateline, Aug. 10, 2010, http://www.stateline.org/live/details/story?contentId=504503 (discussing action taken or being considered in California, Illinois, South Dakota, Minnesota, and Colorado).

\textsuperscript{176} Id.

\textsuperscript{177} Novy-Marx & Rauh, supra note 76, at 13; Fehr, supra note 175 (noting that retirees in Colorado claim that changes to COLA could cause the average retiree to lose more than $165,000 in benefits over the next twenty years).

\textsuperscript{178} Dopp, supra note 12.

\textsuperscript{179} Schwarzenegger, supra note 2.
to meet their pension benefit obligations because the state has fallen behind in making payments to the funds. However, this approach merely postpones funding issues, because without available investment capital, these pension systems will not be able to participate in any market opportunities that may exist, exacerbating future problems.

The General Accounting Standards Board, the accounting board for governments, will hopefully force states to publicly adjust their calculations to reflect more realistic expected returns. However, some states are already reducing the expected rate of investment return for their pension systems, albeit by small decrements. According to a 2010 GAO report, an estimated 60 percent of large and medium state and local plans anticipate changing their investment strategies in response to the current economic downturn. Aside from borrowing to provide short-term funding relief, state and local plans appear to have moved toward investing in higher-risk assets. Although high-risk assets can be a proper part of a diversified portfolio, overweighting a fund with them increases the risk that poor asset management will exacerbate recent market losses and require increased employer contributions.

Alicia Munnell, director of Boston College’s Carroll School of Management’s Center for Retirement Research, has stated that increasing the retirement age is the single most important thing that states can do to lower future pension costs because it reduces the number of years the state is paying a benefit. Increasing retirement ages would also give states more time to invest their pension funds before they have to pay out benefits. One example of this thought being implemented is Illinois, where lawmakers

180. At least five Illinois defined benefit plans have had to sell off significant portions of their assets. Burr, supra note 73.
181. “In the current market environment, there are significant market opportunities to institutional investors with available capital. In the absence of the required contribution from the state, TRS and the other Illinois pension systems will no longer be able to participate in these opportunities.” Id. (quoting public information officer David Urbanek).
182. Froomkin, supra note 76.
183. Reilly, supra note 106 (New York State Comptroller plans on reducing the state’s pension system’s rate from 8 percent to 7.5 percent); id. (Virginia Retirement System cut its expected investment rate to 7 percent from 7.5 percent because “[t]here was a general thinking that equity markets were unlikely to repeat the period of the 1990s.”).
184. “These include pooling assets to pursue lower fees and higher quality managers, consolidating the governance structures of multiple plans to improve accountability and transparency, and issuing pension obligation bonds to overcome funding shortfalls.” GOVERNANCE PRACTICES, supra note 1, at Highlights.
185. Id. at 33; but see Browning, supra note 6 (noting that private and public pension plans are starting to reduce their exposure to the stock market).
186. The GAO doubts that many governments will be able to afford these required increased contributions. GOVERNANCE PRACTICES, supra note 1, at 33.
187. Neumann et al., supra note 7.
recently voted to increase the retirement age for most new hires from sixty to sixty-seven. This change could help bring the average retirement age for government workers—around sixty years old—closer to the average retirement age of private sector workers—around sixty-three. Ideally, pension plans would link retirement ages with life expectancy so that employees enjoying an increased lifespan bear the burden of retirement age-adjustments.

2. Additional Steps States Could Take to Combat Pension Underfunding

Since much of the finger pointing is at the state legislatures, a requirement that voters must approve any future government employee benefit increases would both serve as a check against aggressive labor unions and put the onus on the voters. Voters will probably be hesitant to approve benefit increases they know come out of their pockets as taxpayers. In California, voters in some municipalities amended their charters through referendums to add this requirement, and similar changes could be made to state constitutions. Voters in San Diego—one municipality with this amendment—recently rejected a tax increase related to pension reform.

Similarly, states could benefit from encouraging state citizens, especially former state employees, to become a watchdog group making sure pension plans are adequately funded. Eden Martin, of counsel at the law firm of Sidley Austin and president of the Commercial Club of Chicago, suggests that one way to cap excessively high benefit payouts would be to adopt a PBGC-styled system such that if a pension plan is under-funded, then retirees would get a reduced amount of their benefits, with early retir-

188. Utah is requiring new fire and public safety employees to work twenty-five years, up from twenty years, before getting a full pension; Arizona, Colorado, Minnesota, and Missouri are also making changes. Id. New York also raised its normal retirement age from fifty-five to sixty-two. Ingrassia, supra note 119.
189. Neumann et al., supra note 7.
191. SUMMERS, supra note 5, at 30 (noting that San Francisco, San Diego, and Orange County have done this).
ees receiving greater reductions. Employees would be encouraged to work longer to avoid a possible early retirement penalty, and retirees would certainly pay attention to plan funding if they knew their benefits could be reduced in any given year.

State governments can also look to the United States’ federal government’s decision to employ both a defined benefit plan and a supplementary defined contribution plan, the Thrift Savings Plan (TSP), for the Federal Employees Retirement System (FERS). Federal employees who were hired before 1984 are covered by the Civil Service Retirement System (CSRS), a solely defined benefit plan—although employees can now elect to contribute to the TSP. The Office of Personnel Management (OPM) has estimated that the cost of CSRS is about 25.8 percent of employee pay, with the federal government paying 18.8 percent of that amount, while the FERS basic annuity is about 12.3 percent of employee pay, with the federal government paying 93.5 percent of that amount. The OPM estimates that neither the CSRS nor FERS pose a danger of insolvency.

The federal government could also play a role in encouraging states to address their under-funded pensions. There are few ways for the federal government to force sinking states to contribute the required amounts to their pension systems, since ERISA expressly exempts government plans from its purview. However, there is clearly a federal interest in making sure that Americans have a secure retirement, as can be seen by the special tax treatment provided for both private and public pension funds.

Instead of simply handing out cash to under-funded plans, Richard Riordan—


197. Katelin P. Isaacs, Federal Employees’ Retirement System: Benefits and Financing, ECONOMIC LEGISLATION, Sept. 27, 2010, http://economic-legislation.blogspot.com/2010/09/federal-employees-retirement-system.html (“There are three other employer costs for employees under FERS. Both the employer and employee pay Social Security taxes equal to 6.2% of pay up to the maximum taxable amount; agencies automatically contribute an amount equal to 1% of employee pay to the TSP; and agencies make matching contributions to the TSP equal to up to 4% of pay.”).


199. 29 U.S.C. § 1003(b)(1) (“The provisions of this subchapter shall not apply to any employee benefit plan if . . . such plan is a government plan.”).

200. BOVBJERG ET AL., supra note 18, at Highlights.
former mayor of Los Angeles and California Secretary of Education— and Alexander Rubalcava—president of an investment advisory firm— suggest that the federal government borrow a page from the Education Department’s Race for the Top initiative, which provides money to states that propose significant reforms for their public school systems. Following a similar tack, the federal government could grant tax-free, federally guaranteed securities to states that cap their liabilities and adopt better management practices. If we assume, as many do, that the federal government is the entity that would have to bail out state and local governments, this proactive approach would not add any more risk to federal taxpayers, and it might give incentives to these governments to make necessary changes.

3. Going Forward: Working Cooperatively to Reduce Pension Deficits

As discussed above, successful litigation on the behalf of retirees would force state and local governments with under-funded plans to contribute funds they either do not have or could only raise painfully. An optimal solution, if all parties agree upfront that public pension systems have liabilities dramatically exceeding their assets, would be to avoid litigation and negotiate benefits down, increase pension contributions, reduce plans’ expected rates of return, increase the age of retirement in light of life expectancy tables, and enforce actuarial reductions based on early retirements. While it may be difficult to reach a consensus to enact every available method of reducing pension liabilities, employees and governments cannot afford to ignore all of these options. Voluntary action by both employers and employees aimed at reducing liabilities is the best way to retain defined benefit pensions without raising taxes or issuing even more debt on already indebted state and local governments.

201. Riordan & Rubalcava, supra note 114.
202. Id.
203. These authors also argue that while the growing number of retirees contributes to the current problem, the real issue is that lack of incentive to improve pension performance. Id.
204. Id.
205. Id.; see also supra note 1 and accompanying text. From one point of view, some states are already expecting federal funds to assist their funding requirements. For example, at one point, North Carolina’s FY 2011 budget included a contingency plan to fill the $500 million gap that would be left without federal funds, at least partially, by reducing contributions to the state retirement systems. NICHOLAS JOHNSON, PHIL OLIFF & ERICA WILLIAMS, AN UPDATE ON STATE BUDGET CUTS (2010), available at http://www.responsibletaxes.org/resources/an-update-on-state-budget-cuts/.
206. See supra notes 158–160 and accompanying text.
Fortunately, there seems to be a growing consensus in the political, business, and academic circles, as well as the media, that we must take steps to decrease our pension liabilities.\textsuperscript{207} For some public plans, several voluntary changes have already been made.\textsuperscript{208} In one example, the executive director of the public employee union American Federation of State, County, and Municipal Employees in Minnesota stated that his board was accepting COLA reductions for current retirees so that "we don't kill the goose that lays the golden egg."\textsuperscript{209}

Of all of the solutions discussed or being enacted, linking retirement ages to average life expectancy and enforcing actuarial reductions based on early retirements would have the added benefit of addressing the Baby Boomer retirement wave. Just as COLAs can adjust for changing rates of inflation in order to maintain and ensure a retiree's purchasing power, these two modifications would: (1) adjust for changes in life expectancy to ensure equal treatment between generations, and (2) prevent retirees from retiring early without penalties to ensure equal treatment within generations. Of course, these changes could benefit private plans as well and reduce future burdens on the PBGC.

While these two adjustments may not seem favorable to Baby Boomers who planned on retiring at the same age their parents did, Baby Boomers must keep in mind that their longer life spans would allow them to enjoy their benefits far longer than their parents did. Additionally, these modifications are not directed solely at Baby Boomers—they have the great benefit of being long lasting changes that would continue to serve their purpose for all future generations. After examining all of the methods available to reduce pension plan liabilities, hopefully employees will be willing to agree to these two initial steps, which are not as harsh as reducing benefits outright or increasing employee contributions. Yet, if the immense size of pension under-funding is not enough to incentivize employees to take some initial steps towards liability reduction, perhaps the fear of unilateral state action will be.

\textsuperscript{207} See supra note 1 and accompanying text.


\textsuperscript{209} Novy-Marx & Rauh, supra note 76, at 14 n.5 (noting that this and other evidence seems to indicate that some unions and public officials seem to understand that taxpayers are bankrolling generous retirement plans).
4. The Danger of Not Acting Cooperatively: The Contract Clause

If state and local governments and their employees do not come to a consensus on steps they can take together to reduce pension obligations and corresponding government deficits, states may be forced to resort to changing pension contracts. Roughly half of the states either follow the federal law concerning contract impairment or have a less stringent standard. For those states restricted by their contractual obligations to retirees, there is the possibility of retroactively changing their pension plans.

Under United States Trust Co. of New York v. New Jersey, the Supreme Court held that the Contract Clause in the Constitution does not "prohibit the States from repealing or amending statutes generally, or from enacting legislation with retroactive effects." Although the Contract Clause appears to proscribe "any" impairment, "the prohibition is not an absolute one and is not to be read with literal exactness like a mathematical formula." The Court in United States Trust went on to explain that legislation that adjusts the rights and obligations of contracting parties must be based upon "reasonable conditions and of a character appropriate to the public purpose justifying its adoption." However, in reviewing economic and social regulation, courts should defer to the legislature's judgment as to the necessity and reasonableness of a particular adjustment.

Two cases decided in the Fourth Circuit under the Contract Clause with very different results are instructive. In Baltimore Teachers Union, American Federation of Teachers Local 340 v. Mayor and City Council of Baltimore, the court of appeals held that legislation requiring furloughs for Baltimore teachers, which equated to a cut in a contractually agreed salary, did not violate the Contract Clause. The court reasoned that although "[i]n the employment context, there likely is no right both more central to the contract's inducement and on the existence of which the parties more especially rely, than the right to compensation at the contractually specified level" the legislation reducing salaries was necessary and reasonable in light of the City's problems.

212. Id. at 21 (quoting Home Building & Loan Ass'n v. Blaisdell, 290 U.S. 398, 428 (1934)).
213. Id. at 22 (internal citations omitted).
214. Id. (internal citations omitted).
215. 6 F.3d 1012, 1018, 1022 (4th Cir. 1993).
216. Id. at 1018. "In light of the magnitude and timing of the proposed cuts in state funding that prompted the City's salary reductions, the undisputed legitimacy of the City's need to balance its budget, the City's concerted efforts to exhaust numerous alternative courses of cost reduction before resorting to the challenged reductions, the circumscribed nature of the furlough plan, and the City's
Three years later in *Andrews v. Anne Arundel County, Maryland*, a district court held that legislation retroactively reducing earned retirement benefits did violate the Contract Clause.\(^{217}\) The court, keeping *Baltimore Teachers Union* in mind, stated that "[t]he diminution of pension benefits is more likely than not an even more substantial impairment than a diminution of annual salary because the individual receiving pension benefits is typically already living on a reduced income as compared to her pre-retirement earnings."\(^{218}\) Because the severity of the contract impairment measures the height of the hurdle the legislature must clear, the court concluded that the County Council had not pursued enough alternative options, such as issuing pension liability funding bonds, or demonstrated that those alternatives were not as worthwhile or feasible to make this impairment reasonable.\(^{219}\)

One of the key differences between these two cases was the level of the economic crisis. The court in *Andrews* noted that courts have typically upheld extreme modifications only in the face of emergency or temporary situations.\(^{220}\) Thus the emergency situation present in *Baltimore Teachers Union*, which, according to the City, "was approaching the point where it [had] to begin cutting basic services and initiating the breakdown of government," merited an extreme modification to a contract.\(^{221}\) The defendant county government in *Andrews*, however, admitted that the county was not in a state of emergency.\(^{222}\)

As has been pointed out throughout this Note, the challenges that local and state governments face could soon rise to the level of an emergency, requiring so much to be spent on pension benefits that these governments will begin cutting basic services. Alternatively, and just as disastrously, these governments may find that they cannot honor both their pension and bond obligations. Should that happen, retirees may find themselves wishing that they had renegotiated their pension benefits instead of having states unilaterally alter them.

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\(^{218}\) *Id.* at 1265 (emphasis in original).

\(^{219}\) *Id.* at 1266–7; Brief of Appellees/Cross-Appellants, 1997 WL 33544352, Nos. 96-2463(L) 96-2465 (Cross-Appeal), at *32–33 (Jan. 7, 1997) (list of suggested alternatives).

\(^{220}\) *Andrews*, 931 F. Supp. at 1266.

\(^{221}\) *Baltimore*, 6 F.3d at 1021.

\(^{222}\) *Andrews*, 931 F. Supp. at 1266.
As one example of what can happen if state legislators wait until it is too late for other options, state legislators—as well as private businesses—can look to the Greek legislature’s recent austerity measures. To combat its debt-laden pension system, Greece’s retirement age will no longer be fixed at sixty-five for men and sixty for women, but will be linked to the average life expectancy. Additionally, Greece increased the minimum number of working years required to qualify for a full pension from thirty-seven to forty years. Pensions were also reduced to prevent spiking so that they now reflect a worker’s average working pay rather than his or her final salary. Greece implemented these measures in return for a €110 billion bailout package from the E.U. U.S. state and local governments, however, may not be able to get such a sweet deal. Rather than forcing such an austerity measure through in such a short time and risking public uprising, state and local governments should view Greece’s legislation as a wake-up call to take action soon.

B. Private Plans: Keeping Companies Out of the PBGC

Private defined benefit plans already have more oversight than their public counterparts because they are regulated under ERISA. Not only does ERISA require private companies to make minimum annual contributions to their pension funds—something lacking in some public funds—it also provides the PBGC as a protective shield for private plans. However, as noted above, the traditional methods the PBGC has to reduce its deficit could hurt companies that are already suffering.

Policy-makers and the PBGC should focus, then, on assisting private companies so that the companies never need to seek shelter in the PBGC’s protective umbrella. Recent proposed legislation would extend the number of years a private company had to fully fund its plan to nine (from the sev-

225. Id.; Greece’s Austerity Measures, supra note 223.
227. Greece’s Austerity Measures, supra note 223; see also supra note 105 and accompanying text regarding France’s public protests.
228. While private companies could, on their own initiative, implement the options discussed above, supra notes 168–209, the focus of this section is on the PBGC.
229. Morse, et al., supra note 56.
230. Supra notes 162–166.
Under this extension employers would only have to make token payments for the first two years. The bill would allow employers up to fifteen years to fully fund their plans in exchange for a promise not to freeze benefits. This, of course, would increase the amount of money the PBGC would have to pay out if private companies’ pension plans eventually fail.

Additionally, a recent case provides an example of how the PBGC may take direct action to prevent having to take control of some plans. In Adams v. Pension Benefit Guaranty Corporation, the United States District Court for the District of Columbia allowed the PBGC to enter into an agreement with the chairman of Trans World Airlines (TWA) whereby the chairman agreed to fund TWA’s pension liabilities in exchange for limiting his liability should the PBGC eventually take over TWA’s plans. Thus, instead of immediately terminating the financially troubled TWA’s pension plans, the PBGC tried to craft a plan to continue their existence. While this ended poorly for TWA employees when the plans were eventually terminated at the request of the chairman, the Court held that PBGC had the statutory authority to broker such deals. The District Court reasoned that under 29 U.S.C. § 1367, the PBGC has the power to “make arrangements with [plan] sponsors and members of their controlled groups who are or may become liable under [the statute] for payment of their liability.”

Depending on the economic environment and potential investor/suitors, this kind of deal brokering could be an extremely useful way for PBGC to avoid increasing its liabilities. At the very least, the PBGC might be able to entice interested parties to take chances on companies that have good business models but were simply overpowered by a strong economic downturn.

231. Javier C. Hernandez, Bill Would Extend Time to Fund Pension Plan, N.Y. TIMES, Oct. 29, 2009, http://www.nytimes.com/2009/10/30/business/30pension.html (quoting Senator Michael B. Enzi, R-WY as saying, “[i]f we could have foreseen in 2006 the steep stock market decline coming around the bend, then there is little doubt that we would have incorporated greater flexibility in the funding rules”).
232. Id.
233. Id.
235. Adams, 332 F. Supp. 2d at 233, 236. Recall that one of the goals of the PBGC is to “encourage the continuation and maintenance of voluntary private pension plans for the benefit of their participants. 29 U.S.C. § 1302(a) (2006).
CONCLUSION

The sheer amount of America’s public and private under-funded pension liabilities is staggering. As with most serious problems, the sooner we deal with our under-funded liabilities, the better. For the private sector, while private defined benefit plans are already insured by the PBGC, this Note has suggested a proactive approach by the PBGC to prevent troubled companies’ pension plans from having to fall under the control of the PBGC. For the public sector, in the hope that readers will recognize that litigation, where possible, is not the best way to address public defined benefit pension fund shortfalls, this Note has touched on several steps policy-makers can take to improve pension fund shortfalls. Of these steps, an approach that establishes a link between employee age and pension benefits is fair and has the added benefit of alleviating the pressure that will be caused by the Baby Boomer retirement bulge.

The steps we need to take to address pension funding shortfalls will almost certainly be painful, especially for those employees who must deal with the changes mid-career or post-retirement. However, this short-term pain will be much better than a future in which debt-defaul ts look more and more likely. If we do not choose to take serious steps to reduce our pension liabilities now, we may find ourselves backed into a corner in which French or Greek-like austerity measures, and the discord those measures brought with them, are the only options to avoid defaulting on debt and sliding into another financial crisis.237

237. As mentioned above, there has been a concurrent recent increase in benefits promised and a decrease in pension funding that has contributed to this crisis. As businesses and policy-makers discuss the proper steps to address the nation’s under-funded pensions, they would be prudent to 1) evaluate how much of this debt could be eliminated simply by lowering benefits back to levels seen in the 1980s or 1990s—retirees would probably be more comfortable with a decrease in benefits that was explained as equating their benefits with recent retirees’—and 2) assess exactly how much pension debt might be alleviated by market growth—especially considering that pension funds are heavily weighted towards stocks.