

## COMMENT

### State Pension Deficits, the Recession, and a Modern View of the Contracts Clause

The District Court of the City and County of Denver, Colorado, will be the first of many courts to consider an upcoming state pension fund battle. In *Justus v. State*, the district court will hear a case brought by public employees who are suing the state and the Colorado Public Employees Retirement Association (PERA) for passing state legislation adjusting contractual pension benefits of retired, current, and future employees.<sup>1</sup> As one of the latest state courts to hear a unilateral pension modification suit, the district court will likely apply a Contracts Clause balancing test typical of pension benefit cases.<sup>2</sup> Despite near uniformity in utilizing the Contracts Clause in order to weigh legislative interference with pension rights, state courts vary widely in their analyses of whether the legislature's proposed purpose justifies infringing pension protections.<sup>3</sup> Two factors make this Contracts Clause battle more interesting in the *Justus* case: the text of Colorado's law and the context of the recent financial crisis.

This Comment will examine state courts' use of the Contracts Clause in pension benefit cases through the lens of the Colorado case. After evaluating

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1. First Amended Class Action Complaint, *Justus v. State*, No. 2010-CV-1589 (Colo. Dist. Ct. Mar. 17, 2010), available at <http://saveperacola.com/resources>.
  2. The Contracts Clause is the provision of the U.S. Constitution banning state modification of contracts. U.S. CONST. art I, § 10, cl. 1. Similar provisions protecting contracts are present in nearly all state constitutions and are often modeled on the U.S. constitutional provision. See, e.g., COLO. CONST. art. II, § 11. For more on the test employed by states, see *infra* Part II.
  3. See *infra* Section II.A; see also Morrison & Foerster, LLP & Greenebaum Doll & McDonald PLLC, Index by States: Extent of Protection of Pension Interests (Sept. 25, 2007) (draft memorandum), available at <http://finance.ky.gov/NR/rdonlyres/275A2978-5DDE-4138-A7F5-AFo2D17D7F97/o/Statebystatememo10.pdf> (providing a comprehensive, fifty-state overview of the constitutional and court protections of pension rights).

the changes to the benefit system implemented by the Colorado General Assembly and briefly discussing the traditional parameters of Contracts Clause jurisprudence in benefit cases, the Comment argues that the recent financial crisis, or the “Recession,” provides a reasonable and necessary state justification for amending public employment contracts. The viability of a reasonable and necessary state justification turns on a court’s interpretation of the state’s role: sovereign power or contracting party in breach. Given the financial crisis at hand, this Comment proposes viewing the state first and foremost as a sovereign power. The Comment concludes by situating *Justus* within the broader national context and predicting that use of the Recession to justify pension modification is an inevitable—and defensible—action by the states.

## I. UNFAMILIAR TERRITORY: COLORADO’S CHANGES TO ITS PENSION SYSTEM

### A. Overview of Traditional Pension Benefits

Prior to recent legislation, Colorado’s state employee pension benefit guarantees and protections were fairly standard compared to those of other states.<sup>4</sup> Colorado primarily offers a defined benefit plan, calculating benefits based on years of service and highest average salary.<sup>5</sup> The benefits include cost-of-living adjustments (COLAs) that accrue automatically and are tied to the Consumer Price Index (CPI) for inflation.<sup>6</sup> COLAs are funded as part of the state’s existing pension liability.<sup>7</sup> Pension benefits vest once employees meet the required service and age requirements.<sup>8</sup>

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4. See AARP, FIGHTING INFLATION: HOW DOES YOUR COLA COMPARE? 3-4, 14 (4th ed. 2004) (comparing state COLA protections for retired teachers).

5. See U.S. GOV’T ACCOUNTABILITY OFFICE, GAO-07-1156, STATE AND LOCAL GOVERNMENT RETIREE BENEFITS: CURRENT STATUS OF BENEFIT STRUCTURES, PROTECTIONS, AND FISCAL OUTLOOK FOR FUNDING FUTURE COSTS 6-7, 9 (2007).

6. Colorado ties its inflation measures to a variant of the CPI, the U.S. Urban Wage Earners and Clerical Workers Consumer Price Index (CPI-W). See AARP, *supra* note 4, at iii n.2, 14.

7. See *id.* at 14.

8. A vested right is a benefit or interest immediately available to the employee and requiring no further conditions. *E.g.*, *Martin v. Simplimatic Eng’g Corp.*, 390 N.E.2d 235, 237 (Ind. Ct. App. 1979). Thus, when an employee has satisfied the service and age requirements for public employment, her right “vests,” though the benefits were accruing in nonvested form prior to completion of the requirements.

The strong protection of pension benefits, particularly vested pension benefits, makes unilateral adjustment a difficult task for legislatures. However, in light of the Recession and the continued growth of pension liabilities, many state legislatures are challenging traditional benefit structures.<sup>9</sup> Colorado Senate Bill 10-001 is an example of one such challenge.<sup>10</sup>

### *B. Senate Bill 10-001's Changes to Pension Benefits*

Recognizing the growing liabilities accruing under its traditional pension system, the Colorado General Assembly ordered the Colorado PERA to propose a solution to the state's pension deficit problem by November 1, 2009.<sup>11</sup> After careful consideration and deliberation,<sup>12</sup> PERA recommended a 2% cap on COLA benefits matched by 2% increases in scheduled employer contributions, known as the "2/2/2 Plus Package."<sup>13</sup> Colorado Senate Bill 10-001 incorporates PERA's 2/2/2 Plus Package by adjusting employee and employer contributions, age and service requirements, and the accounting of pension benefits.<sup>14</sup> The most significant adjustment in the law—and the one

For an example of a typical benefits structure plan available to employees who meet the age and service requirements, see COLO. PERA, PERA BENEFIT STRUCTURE BENEFIT ESTIMATE FACT SHEET 5 (July 2010), available at <http://www.copera.org/pdf/8/8-85a.pdf>.

9. See PEW CTR. ON THE STATES, THE TRILLION DOLLAR GAP: UNDERFUNDED STATE RETIREMENT SYSTEMS AND THE ROADS TO REFORM (2010) (providing a comprehensive overview of the pension deficits facing most states); see also Amy Merrick, *Case Tests Retirees' Pension Cuts*, WALL ST. J., Sept. 15, 2010, <http://online.wsj.com/article/SB10001424052748704190704575489872547566554.html> (detailing how states have responded to pension crises).
10. Act of Feb. 23, 2010, ch. 2, 2010 Colo. Sess. Laws 4 (codified at COLO. REV. STAT. § 24-51-101 (2010)).
11. See S.B. 09-282, 2009 Gen. Assemb., Reg. Sess. (Colo. 2009) ("On or before November 1, 2009, the board shall submit specific, comprehensive recommendations to the general assembly regarding possible methods to respond to the decrease in the value of the association's assets . . .").
12. See COLO. PERA, COLORADO PERA RETIREE REPORT 1 (Mar. 2009) (explaining PERA's need to conduct a thorough review of assets and consequences of action prior to making recommendations for reducing the funding deficit); see also COLO. PERA, COLORADO PERA RETIREE REPORT 1 (Dec. 2009) [hereinafter DECEMBER 2009 RETIREE REPORT] (updating retirees on PERA's recommendations to the Colorado General Assembly).
13. The "2/2/2 Plus Package" proposes 2% increases to the Amortization Equalization Disbursement and the Supplemental Amortization Equalization Disbursement as well as a 2% cap for COLA distributions. "Plus" refers to additional elements such as age and service requirements and salary determinations. DECEMBER 2009 RETIREE REPORT, *supra* note 12, at 3.
14. COLO. REV. STAT. § 24-51-101.

garnering national attention<sup>15</sup>—is the provision reducing COLAs for all employees, including current retirees.<sup>16</sup>

Colorado legislators recognized that decreasing future pension benefit rights would not adequately address present pension liabilities. Instead, the legislature alleviated some of the taxpayers' future burden by partially adjusting the benefits of current employees and retirees. This single action could help the state reduce the budget deficit by several billion dollars,<sup>17</sup> but it will require sacrifice from retired pensioners unprepared to risk reductions (to the tune of \$165,000 per retiree<sup>18</sup>) of their pensions. Regardless of the merits of S.B. 10-001, the public employees' resistance is consistent with historic opposition to similar initiatives: few states have attempted to modify contractual provisions for retirees whose pension benefits have already vested.<sup>19</sup>

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15. See, e.g., Ron Lieber, *A Class War over Public Pensions*, N.Y. TIMES, Aug. 7, 2010, at B1; Mary Williams Walsh, *In Budget Crisis, States Take Aim at Pension Costs*, N.Y. TIMES, June 20, 2010, at A1.
  16. These decreases will reduce the COLA from between 3.25% to 3.5% per year to the lesser of 2% and the annual increase calculated by the CPI-W for that year. COLO. REV. STAT. § 24-51-1002. With compounding, this decrease can result in a difference of \$165,000 or more for a pensioner who lives twenty-five years after retirement. First Amended Class Action Complaint, *supra* note 1, at 8-9.
  17. The estimate of how much Colorado stands to recover in terms of the pension deficit is extrapolated from two economics papers examining state pension systems and their current liabilities. Compare Robert Novy-Marx & Joshua Rauh, *Public Pension Promises: How Big Are They and What Are They Worth?*, J. FIN. (manuscript at 50 tbl.4) (forthcoming 2011), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1352608](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1352608) (totaling estimated state liabilities under the taxable municipal rate and estimating Colorado's deficit to be \$62 billion), with Joshua Rauh & Robert Novy-Marx, *Policy Options for State Pension Systems and Their Impact on Plan Liabilities* 25 tbl.5 (Nat'l Bureau of Econ. Research, Working Paper No. 16453, 2010), available at <http://www.nber.org/papers/w16453> (predicting an 8% to 9% savings from reducing COLAs by 1% under the taxable municipal rate). According to Rauh and Novy-Marx's two assessments, such a reduction in Colorado's liabilities could save the state over \$5 billion.
  18. First Amended Class Action Complaint, *supra* note 1, at 9.
  19. For those states that have attempted to alter vested pension rights, courts have not responded positively. See, e.g., *Snow v. Abernathy*, 331 So. 2d 626 (Ala. 1976) (holding that state legislation cannot abridge vested rights unless it improves the pension system); *Yeazell v. Copins*, 402 P.2d 541 (Ariz. 1965) (holding that rights are vested on employment and cannot be unilaterally modified).

## II. PROTECTING PENSION BENEFITS WITH THE CONTRACTS CLAUSE

Pension benefits for public employees are protected through mechanisms that vary by state,<sup>20</sup> but the Contracts Clause of the Constitution applies throughout: “No State shall . . . pass any Bill of Attainder, ex post facto Law, or Law impairing the Obligation of Contracts.”<sup>21</sup> Like most states, Colorado has its own constitutional protection limiting impairment of contracts,<sup>22</sup> and Colorado courts have traditionally protected vested rights in the context of contracts with public employees.<sup>23</sup>

### A. *The Contracts Clause and State Interpretations*

The Contracts Clause does not protect against all legislative contractual modifications. Generally, only retroactive modifications affecting already vested rights violate the Contracts Clause.<sup>24</sup> The Supreme Court established a three-part test to determine whether state legislative modifications

20. Nine states—Alaska, Arizona, Hawaii, Illinois, Louisiana, Michigan, Missouri, New Mexico and New York—have constitutional provisions guaranteeing pension rights to participants in the state retirement system. See U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-07-1156, STATE AND LOCAL GOVERNMENT RETIREE BENEFITS: CURRENT STATUS OF BENEFIT STRUCTURES, PROTECTIONS, AND FISCAL OUTLOOK FOR FUNDING FUTURE COSTS 19 (2007). Most state public employment pension rights are protected through the Contracts Clause and court decisions. The debate over what legal mechanisms (such as contract, due process rights, and promissory estoppel) are best suited for protecting pension rights is worthy of renewed analysis in light of the Recession and evolving contractual norms. This debate is beyond the scope of this Comment, but for interesting perspectives on legal protections, see Darryl B. Simko, *Of Public Pensions, State Constitutional Contract Protection, and Fiscal Constraint*, 69 TEMP. L. REV. 1059 (1996); and Note, *Public Employee Pensions in Times of Fiscal Distress*, 90 HARV. L. REV. 992 (1977).
21. U.S. CONST. art. I, § 10, cl. 1.
22. COLO. CONST. art. II, § 11.
23. See *Police Pension & Relief Bd. v. Bills*, 366 P.2d 581 (Colo. 1961) (holding that, for pension rights that have limited vesting, the state cannot adversely change pension rights unless the alteration is accompanied by a beneficial change, or if it is actuarially necessary); *Police Pension & Relief Bd. v. McPhail*, 338 P.2d 694 (Colo. 1959) (finding that pension rights are contractual and protected). *But see* *Peterson v. Fire & Police Pension Ass'n*, 759 P.2d 720, 725 (Colo. 1988) (“In our view, the financial loss experienced by the petitioners is offset by the creation of a fund that will ensure that the petitioners’ future benefits are funded by a stable and actuarially sound pension fund.”).
24. E.g., *Md. State Teachers Ass'n v. Hughes*, 594 F. Supp. 1353, 1360 (D. Md. 1984) (“A very important prerequisite to the applicability of the Contracts Clause at all to an asserted impairment of a contract by state legislative action is that the challenged law operate with retrospective, not prospective effect.”).

unconstitutionally impair contracts. The test asks: (1) whether there is a contractual obligation; (2) if a contract exists, whether the legislation imposes a “substantial impairment”; and (3) if there is an impairment, whether the legislation is “reasonable and necessary to serve an important public purpose.”<sup>25</sup> State courts have since adopted this test in adjudications involving state legislative modifications of contracts.<sup>26</sup>

While state courts often show deference to state legislative assessments of reasonableness and necessity under state police powers,<sup>27</sup> this deference decreases in cases in which the state has self-interest at stake,<sup>28</sup> including disputes over state public employment contracts. A state court’s decision upholding or rejecting a legislative modification in this context can be interpreted as reflecting the court’s view of the state’s primary role: sovereign or contracting party. This analysis will be explored further in Part III.

Despite widespread acceptance of the three-part Contracts Clause test, the decisions of state courts applying this analysis to state pension contracts vary considerably. This variance is largely due to different assessments and standards for evaluating whether legislatures have presented reasonable and necessary justifications for altering pension contracts. Some state courts bar any modification to pensioners’ contractual rights;<sup>29</sup> other state courts find that the rights of pensioners do not merit limits on legislative exercise of sovereignty;<sup>30</sup> and some state courts analyze whether the impairments to the

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25. *U.S. Trust Co. v. New Jersey*, 431 U.S. 1, 22-27 (1977); *see, e.g., Energy Reserves Grp. v. Kan. Power & Light Co.*, 459 U.S. 400, 411-12 (1983); *Allied Structural Steel Co. v. Spannaus*, 438 U.S. 234, 244-45 (1978).
  26. *See, e.g., Mass. Cmty. Coll. Council v. Commonwealth*, 649 N.E.2d 708 (Mass. 1995); *Brennan v. Kirby*, 529 A.2d 633 (R.I. 1987).
  27. This analysis necessarily recognizes a state’s exercise of police (or reserved) power as a justification for impairment and weighs the legitimacy of the exercise on a case-by-case basis. A second permissible impairment of a state contract occurs when the state offers just compensation offsetting the limited contract rights. *See W. River Bridge Co. v. Dix*, 47 U.S. (6 How.) 507 (1848); Richard A. Epstein, *Toward a Revitalization of the Contract Clause*, 51 U. CHI. L. REV. 703, 742-44 (1984). As Colorado is not offering any true offsetting compensation, this second exception to the Contracts Clause will not be explored in depth here.
  28. *See U.S. Trust Co.*, 431 U.S. at 26.
  29. *E.g., Kaho’ohanohano v. State*, 162 P.3d 696 (Haw. 2007) (holding that a law decreasing the amount the state had to invest for public retirees violated the contractual rights of beneficiaries); *Nicholas v. State*, 992 P.2d 262 (Nev. 2000) (stating that, once vested and thereby contractual, retirement rights cannot be unilaterally modified by the legislature).
  30. *E.g., Pineman v. Oechslein*, 488 A.2d 803 (Conn. 1985) (holding that the State Employees Retirement Act did not create a contract absent clear legislative intent but that pension rights are subject to some due process protection); *Spiller v. State*, 627 A.2d 513 (Me. 1993)

pension system are accompanied by offsetting benefits.<sup>31</sup> This interpretive variation is not surprising as contract law is primarily a state domain; yet when deciding questions of Contracts Clause violations, courts often look to doctrinal developments in other states.<sup>32</sup> The district court in Denver will thus have a wider audience than just Colorado pensioners, particularly as other states face looming lawsuits of their own.<sup>33</sup>

### B. *Justus and the Contracts Clause*

The court's result in *Justus v. State* will likely turn on the application of the Contracts Clause to Senate Bill 10-001. The court must consider (1) whether there is a contract, (2) whether the contract has been substantially impaired, and (3) whether the impairment is justified by a necessary and reasonable state purpose. The first two prongs of the court's test for contractual impairment are easily decided in the employees' favor. Colorado has contractual obligations to state employees through the pension system. Moreover, the decreases constitute a substantial impairment to the contract, as the proposed COLA

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(finding that the legislature's modification of pension benefits during a budgetary shortfall was valid because the pension rights were not contractual).

31. *E.g.*, *Allen v. City of Long Beach*, 287 P.2d 765, 767 (Cal. 1955) (stating that adverse changes to an employee's pension rights should be accompanied by "comparable new advantages"); *Singer v. City of Topeka*, 607 P.2d 467 (Kan. 1980) (holding that a state must offset modifications to pension plans with counterbalancing advantages). This offsetting-benefits approach can be seen as also incorporating the "just compensation" approach. *See supra* note 27.

Colorado's doctrine of protection for pension rights, demanding that adverse changes be either accompanied by beneficial changes or actuarial necessity, offers exceptions to the Contracts Clause under both the just compensation approach and the sovereign powers approach.

32. *See, e.g.*, *Police Pension & Relief Bd. v. Bills*, 366 P.2d 581, 584-85 (Colo. 1961) (citing California and Pennsylvania court cases for the positive counterbalancing precedent); *Smith v. Bd. of Trs.*, 851 So. 2d 1100, 1118 (La. 2003) (citing Minnesota's protection of retirement plans in *Christensen v. Minneapolis Municipal Employees Retirement Board*, 331 N.W.2d 740, 747 (Minn. 1983)).
33. Minnesota and South Dakota are two neighboring states facing similar litigation, though a total of sixteen states have changed their retirement plans in the last year. *See Merrick, supra* note 9; 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>; Anthony F. Maul, *Minnesota Court Delays Decision on Pension Cuts*, POMTALK: THE BLOG FOR INSTITUTIONAL INVESTORS (Sept. 22, 2010, 2:12 PM), [http://www.pomtalk.com/pomtalk/pension\\_reform](http://www.pomtalk.com/pomtalk/pension_reform).

change may result in an estimated difference of \$165,000 over the course of a retiree's lifetime.<sup>34</sup>

Though some scholars posit that any court that finds impairment of contract will rule against the stated legislative need,<sup>35</sup> courts have recognized legislative necessity and reasonableness of contractual modifications even in the face of impairment.<sup>36</sup> Colorado state courts also allow legislative action in the face of substantial impairment by noting that financial necessity can justify contractual modification in pension benefits cases.<sup>37</sup> However, contractual modification of fully vested pension rights like those enjoyed by retirees may prove to be an unsupportable legislative action, especially to courts that have previously knocked down similar changes.

Whether this particular impairment to COLAs of retirees and employees is warranted by a legitimate, necessary, and reasonable state purpose will likely depend on the *Justus* court's interpretation of the Recession's exigencies and the legislature's corresponding actions. In this case, the state and the public employee retirement board are wisely pointing to the financial crisis and an \$11 billion one-year pension loss as their justification for the contractual modification.<sup>38</sup> Though Colorado courts have historically found that vested pension rights are constitutionally protected from revision, reconsideration of the Contracts Clause doctrine is merited in light of other state courts' decisions and the severity of the Recession.

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34. See First Amended Class Action Complaint, *supra* note 1, at 9.

35. See, e.g., Amy B. Monahan, *Public Pension Plan Reform: The Legal Framework*, 5 EDUC. FIN. & POL'Y 617, 631 (2010) ("The only public pension plan cases identified that found substantial impairments to be reasonable and necessary to serve an important public purpose were cases in which the court first held that no substantial impairment occurred.").

36. See, e.g., *Madden v. Contributory Ret. Appeal Bd.*, 729 N.E.2d 1095, 1099 (Mass. 2000) ("The existence of vested contractual rights 'does not preclude reasonable modifications of the pension plan prior to the employees' retirement. Reasonable modifications are often necessary . . . to maintain the integrity of the system in order to carry out its beneficent purpose.'" (quoting Opinion of the Justices, 303 N.E.2d 320, 328 (Mass. 1973))).

37. See *Peterson v. Fire & Police Pension Ass'n*, 759 P.2d 720 (Colo. 1988) (finding that a pension plan can be changed if balanced by corresponding beneficial adjustment or actuarial necessity). Though the *Peterson* court held that the survivor benefits in question were only partially vested, the case suggests that Colorado courts might uphold a legislative impairment if presented with strong justifications of actuarial necessity.

38. See State Defendants' Motion To Dismiss Plaintiffs' First Amended Class Action Complaint at 1-2, *Justus v. State*, No. 2010-CV-1589 (Colo. Dist. Ct. May 10, 2010), available at [http://saveperacola.files.wordpress.com/2010/05/state\\_defendants\\_motion\\_dismiss-colo1.pdf](http://saveperacola.files.wordpress.com/2010/05/state_defendants_motion_dismiss-colo1.pdf).



### III. THE REASONABLENESS AND NECESSITY OF STATE ACTION: A QUESTION OF THE STATE'S ROLE

A state court's determination of the reasonableness and necessity of legislative pension modifications—the third prong of the Contracts Clause analysis—turns on the court's interpretation of the state's role in the contract. State legislative modifications of public pension contracts are interesting phenomena; they implicate the state both as a sovereign power and as a party to the contract. In *Justus*, the district court could view Colorado's action in one of two ways. The court could view Colorado as a sovereign power making necessary and reasonable adjustments to pension benefits in the name of public policy. Alternatively, it could view Colorado as an employer trying unilaterally to modify an unfavorable contract *ex post*. Though the Recession's severity may make modifications necessary and reasonable under either approach, viewing the state in its sovereign power would lead to a more favorable resolution for the Colorado General Assembly and other state legislatures attempting to modify pensions.

#### A. State as Sovereign

If the district court views the state as a sovereign adjusting a long-term contract now largely unfair to one party (taxpayers), the court will likely uphold S.B. 10-001. There is a sound reason to view this legislature's modification as an act of sovereignty: Colorado's \$60 billion deficit.

As a sovereign, a state can modify contracts in the interest of public policy. This authority to modify includes retroactive modifications in which rights of a party to the relationship are partially impaired.<sup>39</sup> While the Colorado Supreme Court rejected the state's police power as a justification for modification in *Police Pension & Relief Board v. McPhail*,<sup>40</sup> the severity of the Recession could prompt the *Justus* court to uphold modification over vested rights in the name of public policy. This hypothesis relies on the Contracts Clause jurisprudence of other courts and on a severe financial crisis justifying a public policy exception.

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39. See *Haverstock v. State Pub. Emps. Ret. Fund*, 490 N.E.2d 357, 360 (Ind. Ct. App. 1986) (noting the existence of contractual obligations but refusing to find impairment for retroactive modifications of rights that were not "fully vested").

40. 338 P.2d 694 (Colo. 1959), *overruling* *Bd. of Trs. v. People ex rel. Behrman*, 203 P.2d 490 (Colo. 1949).

1. *Contracts Clause Exception: Financial Crisis*

Should the Colorado district court decide to take the Recession into account and uphold S.B. 10-001, the court can look to U.S. Supreme Court precedent. Notably, in *Home Building & Loan Ass'n v. Blaisdell*,<sup>41</sup> the Supreme Court held that contractual modifications to home loan payment schedules were warranted as Minnesota attempted to provide relief from mortgage foreclosure during the Great Depression.<sup>42</sup> The Court stated that “[t]he economic interests of the State may justify the exercise of its continuing and dominant protective power notwithstanding interference with contracts”<sup>43</sup> and further compared the economic crisis to the types of natural disasters (fire, flood, or earthquake) that merit extraordinary relief.<sup>44</sup> State courts have since pointed to *Blaisdell* to justify state contract modifications due to financial crises.<sup>45</sup>

Courts may also apply *Blaisdell* in the public employment context. In *Baltimore Teachers Union v. Mayor of Baltimore*, the Fourth Circuit upheld Baltimore’s cost-saving “furlough plan” for city workers.<sup>46</sup> The decision validated the city’s action of using a budget crisis to justify taking away two and a half days of pay for all public employees.<sup>47</sup> Though the decision to sanction contract impairment for reasons such as budget crises is a matter of the contract law of each individual state, these cases demonstrate that courts are more willing to allow Contracts Clause exceptions in situations of financial crisis.

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41. 290 U.S. 398 (1934). The Supreme Court examined the drafting history and purpose of the Contracts Clause and ultimately concluded that “the prohibition is not an absolute one and is not to be read with literal exactness like a mathematical formula.” *Id.* at 428.

42. *Id.* at 398.

43. *Id.* at 437.

44. *See id.* at 439-40. Although the Supreme Court has upheld legislation that violated the Contracts Clause in similar cases involving the government as a regulator, the economic justifications utilized in such instances paled in comparison to the Great Depression—the context of *Blaisdell*. *See, e.g.*, *United States v. Winstar Corp.*, 518 U.S. 839, 915-18 (1996) (discussing *Blaisdell* and other government contract cases and limiting the circumstances that merit government rescission of contracts).

45. *See, e.g.*, *Wilkinson v. Carpenter*, 561 P.2d 607 (Or. 1977); *City of Philadelphia v. Dist. Council 33*, 598 A.2d 256 (Pa. 1991).

46. 6 F.3d 1012 (4th Cir. 1993).

47. *See id.* at 1019.

## 2. *This Recession Merits State Action*

Allowing legislatures to cite financial downturns as justification for abridging state contracts is understandably risky to the state's credibility as a contracting party. However, the effects that the Recession has had on the pension deficits and the parties involved make Colorado's pension modifications worthy of the Contracts Clause exception.

### a. *Growing Liabilities*

Though pensions were in trouble before the Recession, in the last year alone state public employee pension liabilities grew from approximately \$2.5 trillion to \$3 trillion.<sup>48</sup> Even these figures mask the depth of trouble facing states like Colorado: Colorado's liabilities doubled over ten years, and by 2008 the state had lost \$11 billion, or 26% of its pension funding, due to stock market declines.<sup>49</sup> Unlike previous market downturns, when the markets crashed recently, states sustained crippling losses because many, like Colorado, had invested nearly 70% of pension funds in equities during the boom years of the 1990s—a proportion substantially greater than the 40% of pension fund assets that were invested in equities in previous decades.<sup>50</sup> Because of these investment decisions, in the last ten years most states have experienced stunning funding deficits of a magnitude not experienced in previous pension crises.

### b. *Conflicting Interests Involved*

The effects of the Recession on legislative decisions are magnified when considering the multiple, conflicting interests of the parties involved. States are recognizing that they cannot count on the pension fund's investment holdings to recover mounting pension liabilities. Without legislative measures like

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48. See Novy-Marx & Rauh, *supra* note 17 (manuscript at 5).

49. See PEW CTR. ON THE STATES, *supra* note 9, at 27. National figures can be misleading about the depth of individual state deficits because while some states struggle, others are still fully funded and, therefore, bring up the national averages in terms of funding ratios and net liabilities. See *id.* at 3.

50. See *id.* at 24; see also ROBIN PRUNTY & DAVID G. HITCHCOCK, STANDARD & POOR'S, MARKET DECLINES WILL SHAKE UP U.S. STATE PENSION FUNDING STABILITY 3 (2009), available at <http://www.nasra.org/resources/S&P0903.pdf> (describing the strong gains that pensions experienced in the 1990s by the shift to equity investments, followed by rapid declines from 2001 onwards).

Colorado's pension modifications, current or future taxpayers will have to account for the deficit.<sup>51</sup> Thus, when a state legislature considers pension contracts and promises, the legislature must think of both public employees as well as taxpayers.

The interests of state public employees are presumably well known to most state legislatures by now: both state court cases and active public employee unions serve to keep this interest group a legislative priority. As evidenced by the immediate outcry in response to the modification, Colorado public employees are incredibly dissatisfied with the new changes and view them as unilateral breaches of contract—as well as unfairly burdensome.<sup>52</sup>

In addition to state public employees, state legislatures must consider another key interest: taxpayers. Today's taxpayers may be less enthusiastic about funding pensions for public employees for a number of reasons. While pension benefits were originally instituted to induce talented workers into public employment by providing future financial security to make up for a lower salary, this salary differential is no longer constant. In fact, public employees now earn more than comparable employees in the private sector;<sup>53</sup> faced with this reality, taxpayers may balk at paying full, unadjusted pension benefits during a recession. Though taxpayer intransigence may not automatically amount to pension rescission, it may make state legislatures and courts view the concept of "legislative necessity" differently.

### B. State as Contracting Party

Given Colorado's previous case law rejecting modifications of vested pension benefits, the *Justus* court may instead view the state as a contracting party. Within Contracts Clause analysis, viewing the state as an employer—or contracting party—diminishes, but does not eliminate, the power of the Recession as a justification for contract breach.

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51. See Novy-Marx & Rauh, *supra* note 17 (manuscript at 35) ("We find the pension promises already made to state workers are worth at least \$3.20 trillion as far as taxpayers are concerned . . . . This is a conservative estimate because most state constitutions suggest that pension promises are higher in priority than general obligation debt. Also, while a federal bailout of states might affect the distribution of the tax burden across taxpayers in different states, taxpayers would ultimately bear the cost of the bailout.").
52. See generally First Amended Class Action Complaint, *supra* note 1, at 8-10.
53. See *Employer Costs for Employee Compensation, September 2009*, U.S. BUREAU OF LABOR STATISTICS (Dec. 14, 2009), [http://www.bls.gov/opub/ted/2009/ted\\_20091214.htm](http://www.bls.gov/opub/ted/2009/ted_20091214.htm); see, e.g., Jonathan Barry Forman, *Funding Public Pension Plans*, 42 J. MARSHALL L. REV. 837, 857 (2009); Dennis Cauchon, *Benefits Widen Public, Private Workers' Pay Gap*, USA TODAY, Apr. 10, 2009, [http://www.usatoday.com/money/workplace/2009-04-09-compensation\\_N.htm](http://www.usatoday.com/money/workplace/2009-04-09-compensation_N.htm).

As a party forced to adjust its contract due to exigent financial circumstances, the legislature's modification of the pension contracts might be permissible under the doctrine of excuse. The doctrine of excuse allows contractual modifications under circumstances of impossibility, commercial impracticability, and frustration of purpose.<sup>54</sup> The standard for upholding a contractual modification under the doctrine of excuse is as follows:

Where, at the time a contract is made, a party's principal purpose is substantially frustrated without his fault by a fact of which he has no reason to know and the non-existence of which is a basic assumption on which the contract is made, no duty of that party to render performance arises, unless the language or circumstances indicate the contrary.<sup>55</sup>

The *Justus* court is unlikely to allow modification under frustration of contract purpose for several reasons. The risk of financial crisis in defined benefits contracts almost necessarily falls on the state. This assignment of risk is what makes defined benefits contracts so attractive to pensioners. This assignment also precludes citing a financial downturn as an unforeseen circumstance intrinsic to the state's contract with employees. While the extent of the Recession could not have been mutually understood by the parties, the unanticipated severity of an anticipated event may not be enough to justify unilateral modification of contract.

However, viewing the state's contract with employees as a two-way contract between the legislature and the pensioner is an oversimplification; taxpayers and future employees are also involved in the bargain. Due to the complexity of pension contracts and the extent of the Recession, deference to the state as a sovereign is more appropriate and should overcome precedent that cannot fully capture the magnitude of the current economic context.

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54. The doctrine of excuse permits unilateral (or judicial) modification of private contracts for mistake, impossibility, commercial impracticability, or frustration of purpose. See *Aluminum Co. of Am. v. Essex Grp.*, 499 F. Supp. 53, 90 (W.D. Pa. 1980); Sheldon W. Halpern, *Application of the Doctrine of Commercial Impracticability: Searching for the 'Wisdom of Solomon'*, 135 U. PA. L. REV. 1123, 1125 (1987).

55. RESTATEMENT (SECOND) OF CONTRACTS § 266(2) (1979); see *Town of Fraser v. Davis*, 644 P.2d 100, 101 (Colo. App. 1982). This doctrine has also been applied to public contract cases. See *Bd. of Cnty. Comm'rs v. City of Denver*, 40 P.3d 25 (Colo. App. 2001).

**CONCLUSION**

The district court faces a difficult decision with *Justus*. In its efforts to stem pension deficits, the Colorado General Assembly has attempted an act of bravery—or foolishness—not readily undertaken by other states: unilaterally modifying the rights of existing retirees and nonvested employees. The Colorado Supreme Court has thus far struck down legislation impairing vested pension rights as unconstitutional under the Contracts Clause.<sup>56</sup> However, the Recession's depths and the reasonableness of the proposed pension modifications warrant a fresh look at the case law and perhaps a daring departure to match that of the General Assembly.

The *Justus* court is one of the first to have to consider legislative pension modifications in the shadow of the recent financial crisis. The gravity of this crisis may not be enough to persuade the Denver court, but there will be many courts hearing this issue over the next few years in states that offer varying degrees of protection to pension benefits. It is only a matter of time before a court permits a state legislature to modify contractually vested rights in the name of state solvency. And when it does, future state courts and legislatures will have a modernized Contracts Clause to interpret.

WHITNEY CLOUD

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56. See *Taylor v. PERA*, 542 P.2d 383, 385 (Colo. 1975); *Police Pension & Relief Bd. v. Bills*, 366 P.2d 581, 583-84 (Colo. 1961); *Police Pension & Relief Bd. v. McPhail*, 338 P.2d 694, 701 (Colo. 1959); *City of Aurora v. Ackman*, 738 P.2d 796, 800 (Colo. App. 1987).