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ALERT MEMORANDUM

February 27, 2015 clearygottlieb.com

N.J. State Pensions – Veto of Pension Funding Violates Public Employees' Contractual Rights

On February 23, 2015, Judge Mary C. Jacobson of the New Jersey Superior Court for Mercer County (the "Court") held that Governor Chris Christie's line-item veto of remedial funding for public-employee pensions violated those employees' contractual rights to such funding. Burgos v. State, No. MER-L-1267-14 (N.J. Super. Ct. Law Div. Feb. 23, 2015).

The opinion addresses hotly contested issues regarding the ability of governments to unilaterally revise promises of future benefits and concludes that creating contractual rights to those benefits by statute is a powerful, even constitutional, guarantee of the benefits.

Background

New Jersey has a statutory obligation to make "annually required contributions," or "ARC," to the pension funds of its public employees. The ARC comprises a normal contribution to cover pension benefits accrued in the current year and an "annual unfunded accrued actuarial liability contribution," or "UAAL" contribution, which is an amortization payment toward the pension systems' accrued unfunded liabilities.

For New Jersey, those accrued unfunded liabilities are huge. From FY 1997 through 2012, the State paid, on average, only 10% of its ARC, with the result that the unfunded liabilities of the State's pension systems increased from slightly over $10 billion in 1997 to nearly $50 billion in 2012.

In 2010 and 2011, legislation was passed aimed at remedying the underfunding. First, the Legislature established phased-in compliance with ARC by 2018 (mandating full normal and UAAL appropriations by 2018). Second, through Legislation known as "Chapter 78," 2011 N.J. Laws 78, the Legislature established phased-in increases in employee contributions.

Critically, Chapter 78 also granted employees a contractual right to the State's payments of the ARC. Specifically, Chapter 78 requires the State to pay ARC "on a timely basis" in order "to help ensure that the retirement system is securely funded and that the retirement benefits . . . will be paid upon retirement." Chapter 78 expressly declares that the failure of the State to pay ARC constitutes an "impairment" of the contractual right of each employee-participant in the pension systems. Finally, Chapter 78 establishes jurisdiction in the Superior Court to hear actions by employees against the State to enforce these rights, and forbids the State to assert sovereign immunity.

As a result of these reforms, the State faced a $2.25 billion ARC payment for FY 2015, including a $1.9 billion UAAL contribution. However, Governor Christie used a line-item veto to delete the UAAL contribution when signing the 2015 appropriations act into law, citing 2015 revenue shortfalls and the requirement of a balanced budget, as well as an inability to agree with the Legislature on additional revenue sources.

State employees and unions representing state employees ("Plaintiffs") sued the State, Governor Christie and others ("Defendants"). Plaintiffs sought a judgment that vetoing the 2015 ARC payment violated the Contract Clauses of the New Jersey and U.S. Constitutions, both of which prohibit laws impairing the obligations of contracts. Defendants sought dismissal on various grounds, including, most prominently, that the purported funding requirements of Chapter 78 were an unconstitutional encroachment on two provisions of the New Jersey Constitution, namely (a) the Debt Limitation Clause, which prohibits the Legislature from incurring debts in excess of 1% of the annual budget without a popular vote; and (b) the Appropriations Clause, which requires a unitary appropriations act each year.

The Opinion

In a 130-page opinion, the Court rejected all of Defendants' arguments and granted summary judgment to Plaintiffs. The Court focused on the question whether the Debt Limitation Clause – and to a lesser extent the Appropriations Clause – should be read strictly to prohibit enforcement of a specific contractual right to payment that was conferred by the Legislature and "cloaked" in the Contract Clause.[1] The Court endorsed a flexible reading of the New Jersey Constitution to "harmonize" the competing constitutional provisions and uphold the funding requirements set forth in Chapter 78. Thereafter, the Court concluded that the Governor's attempts to avoid those valid requirements violated the law.

Defendants argued that Chapter 78 violated the Debt Limitation Clause by requiring future Legislatures to make ARC payments in excess of 1% of the annual budgets without voter approval. The Court concluded that the clause applies only to prohibit the taking on of contract debt with interest and not to pension payments, which are best viewed as deferred compensation. To support this narrow reading of the Debt Limitation Clause, the Court relied upon (a) the history of the enactment of the clause at

[1] The Court also held that it had jurisdiction over the case, that the political question doctrine did not dictate abstaining from adjudicating the case, and that the plaintiffs stated federal claims (but that the Court, given its holding, need not pass upon their ultimate merits).

a time when governments had improvidently taken on contract debt with interest payments to finance projects; (b) the full text of the clause, which refers to debts with periodic interest payments; and (c) the New Jersey Supreme Court's consistently permissive approach to legislation testing the limits of the clause.

The Court also focused heavily on the Legislature's unprecedented conferral upon state employees of a contractual right to payments of ARC, a right explicitly protected from "impair[ment]" by the Contract Clause. Specifically, the Court stated that its narrow reading of the Debt Limitation Clause harmonized that clause with the Contract Clause by permitting the Debt Limitation Clause to operate without nullifying plaintiffs' Contract Clause right to have their contractual entitlements maintained. In addition, the Court distinguished numerous potentially contrary precedents – including an oft-repeated prohibition upon one legislature taking on debts that a future legislature would be forced to pay – by stating that no such precedent dealt with the need to honor an "unmistakable" contractual right "enacted by the Legislature and signed by the Governor."[2]

The Court rejected Defendants' Appropriations Clause arguments with a similar reliance upon the special need to honor the Contract Clause. Defendants argued primarily that judicial enforcement of Chapter 78 would violate the Appropriations Clause by effectively ordering appropriations outside of a unitary annual appropriations act. The Court, relying upon a New Jersey Supreme Court precedent endorsing judicial enforcement of appropriations in favor of meeting the constitutional obligation to provide a "thorough and efficient system of free public schools," held that the Appropriations Clause should yield to judicial enforcement of plaintiffs' contractual rights, which themselves find constitutional protection in the Contract Clause.

Defendants responded that the Court was establishing a rule that would permit any individual with a contract with the State to bring suit under the Contract Clause and circumvent the Appropriations Clause. The Court rejected this rejoinder by noting the singular, explicit conferral of a contractual right upon Plaintiffs by statute and contrasted that right with the typical state-contract language making all payment "subject to appropriations."

[2] The Court also stated that even if the Debt Limitation Clause required the Court to invalidate Chapter 78's contractual obligations on the grounds of public policy, equity might well require enforcement of the obligations. Not only had the State itself negotiated and supported the deal (*i.e.*, higher employee contributions in return for explicit contractual rights), it had honored the deal until 2014, sealing plaintiffs' legitimate expectations to receive their benefits. In addition, allowing the State to disavow its obligations would further weaken the fiscal health of the pension systems and would further damage the State's credit rating.

As a final threshold issue, the Court held that Chapter 78 did not impinge on the Governor's veto power. The Court concluded that this case did not question the "fact" of the Governor's veto power, but simply denied his ability to use that power to affect a "constitutionally protected contract right to State pension payments." A contrary holding, in the view of the Court, would place the Governor's actions beyond the law.

Having disposed of all arguments that would have prevented it from addressing the merits question, the Court held that the State's failure to make appropriations for pension system payments did in fact impair plaintiffs' contractual rights, without any showing that such an impairment was necessary to protect the general welfare. Notably, in FY 2014, the same Court had permitted the State not to make ARC payments due to a late-in-the-year revelation that anticipated revenues would fall far short of those necessary to cover all appropriations, creating an emergency. However, for FY 2015, the Court held, the State failed to present any real evidence of an emergency situation or of its having considered any alternatives to cutting out the UAAL entirely to balance the budget. As a result, the Court concluded that the State had substantially impaired Plaintiffs' contractual rights without justification and therefore declared the FY 2015 appropriations act invalid to the extent it failed to provide for the mandated ARC payment.

Significance of the Opinion

The opinion is significant because it grapples with the much-debated issue of a government's ability to revise its commitment to fund future benefits when fiscal realities threaten to make such funding untenable. In particular, this opinion deals with the issue in the context of a state government, which is ineligible for Chapter 9 relief under the Bankruptcy Code. The opinion does allow for non-funding in emergency situations, but it is otherwise highly skeptical of all post-hoc justifications and arguments for non-funding. It remains to be seen whether the Court's legal defense of the state-employees' contractual rights is ultimately upheld as a matter of New Jersey law, but the Court's opinion stands clearly for the proposition that strongly worded promises – in particular, those cloaked in the Contract Clause – may be too strong to break.

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