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Re: Proposed Merger

Dear Mr. Nelson and Mr. Jernudd:

The Law Enforcement Officers and Firefighters Retirement System Plan 1 ("LEOFF 1") and the Law Enforcement Officers and Firefighters Retirement System Plan 2 ("LEOFF 2") are defined benefit pension plans. LEOFF 2 is governed by a Board of Trustees ("LEOFF 2 Board"). It is our understanding that the LEOFF 2 Board has been asked to review the legal issues raised by a merger of LEOFF 1 and LEOFF 2. Our firm has been asked to provide analysis and advice on a proposed merger of LEOFF 1 and 2.

This memorandum will address whether the Contracts Clause of the Washington Constitution would limit, preclude or affect the merger of these two public pension plans in Washington. As part of this analysis, we will address the following:

- Whether the funded status of the plans, both before and after merger, would impact these issues;
- Whether the open or closed status of the plans, both before and after merger, would impact these issues;
- Whether a reduction in the aggregate amount of State contributions after merger would impact these issues;

- Whether a change in the character of employer sponsors for the merged plan would impact these issues;
- Whether a change in plan governance for the merging plans would impact these issues;
- Whether the legislature may repeal or reduce the current LEOFF 1 Cost Of Living Adjustment;
- Whether the legislature may impose employee contributions on active LEOFF 1 members; and
- Whether there are Washington state law fiduciary issues when the legislature approves the merger of two public pension plans

We understand that there is no bill language covering or describing the proposal. For purposes of our analysis, therefore, we make several assumptions. First, we assume that the proposed merger will combine the assets and liabilities of LEOFF 1 and LEOFF 2 into a single pension plan. Thus, all assets of the new plan will be available to pay all liabilities of the same plan. Second, we assume that the combined assets of the new plan will continue to be invested by the Washington State Investment Board on a commingled basis consistent with current law. Third, we assume that the existing benefit levels and formulas for all LEOFF 1 and LEOFF 2 members will remain the same after the merger. Fourth, we assume that merger legislation will authorize the State of Washington to make a reduced contribution to LEOFF 2 for two years after the merger. Fifth, we assume that the new plan will satisfy the requirements of the Internal Revenue Code for tax-qualified employee benefit plans. Finally, we assume that there are no collective bargaining agreements or memoranda of understanding that bear on the issues analyzed here.

I. Background

In 1969, the Washington Legislature enacted a comprehensive benefits plan for police officers and firefighters in the state. Laws of 1969, 1st Ex. Sess., ch. 209. The "Washington Law Enforcement Officers' and Fire Fighters' Retirement System Act" created this new plan, known as LEOFF, which was administered by the state Department of Retirement Systems. *McAllister* v. *City of Bellevue Firemen's Pension Bd.*, 166 Wn.2d 623, 627 (2009). In 1977, the Legislature amended LEOFF to create two classes of members. Laws of 1977, 1st Ex. Sess., ch. 294, §§ 1-2. Police officers and fire fighters employed on or before September 30, 1977 constituted one class and those employed after that date constituted another. In a subsequent amendment, the Legislature designated the former class as LEOFF 1 and the latter class as LEOFF 2. RCW 41.26.030(21), (22); see *Adams* v. *City of Seattle*, 173 Wn. App. 398, 400 fn. 4. LEOFF 2 is a "less generous retirement system" than LEOFF 1. *City of Pasco* v. *Dep't of Ret. Systems*, 110 Wn. App. 582, 587 fn. 6.

In 2002, the citizens of Washington passed Initiative Measure 790, making substantial changes in the governance of LEOFF 2. The express intent of the measure was to establish a board of trustees endowed with fiduciary duties and responsible for administration of specified pension management functions. Laws of 2003, ch. 2, § 2, codified at RCW 41.26.705. Among other duties, the LEOFF 2 Board is responsible for the actuarial functions of the plan and establishes employee, employer and State of Washington contributions to the plan consistent with the statutory ratio. RCW 41.26.725(1) ("The board of trustees shall establish contributions as set forth in this section.") and RCW 41.26.720 (board shall "adopt actuarial tables, assumptions, and cost methodologies"; provide for design and implementation of increased benefits; recommend changes in benefits to legislature; and retain professional advisors).

The Washington Legislature enacted a statute that suspends employer and employee contributions to LEOFF 1 unless "the most recent valuation study for [LEOFF 1] indicates the plan has unfunded liabilities." RCW 41.26.080(2). We understand that LEOFF 1 has not received any employer or employee contributions since 2000. See Comprehensive Annual Financial Report, Funds for the State of Washington for Year Ended June 30, 2016 ("CAFR") at 77. As of June 30, 2016, the actuarial value of assets in LEOFF 1 exceeded estimated pension liabilities by approximately $1 billion and the plan is approximately 123.7% funded on an actuarial basis. Id. at p. 64. As of the same date, LEOFF 2 is approximately 106% funded on an actuarial basis. Id. at p. 67.

Washington courts will generally defer to the legislative branch on plan design issues: "[w]e will not substitute our judgment for the Legislature's with respect to the structure of public retirement plans." *Washington Federation of State Emps.* v. *State*, 107 Wn.App. 241, 246 (2001). Nevertheless, the Contracts Clause of the Washington State Constitution restricts the power of the legislature to make changes in pension funding and benefits.

II. Overview of the Contracts Clause

Article I, section 23 of the Washington Constitution provides that "no ... law impairing the obligations of contracts shall ever be passed." The Washington Supreme Court has repeatedly held that this protection "echoes" the parallel federal Contracts Clause of the United States Constitution. *Washington Educ. Ass'n* v. *Dep't. of Retirement Systems*, 181 Wn.2d 233, 242 (2014). Thus, the state and federal Contracts Clauses are given the same effect. *Ibid.* Under these provisions, the State's attempts to impair its own contracts are given a more "stringent" review by the courts in Washington. *Ibid.*

The Washington Supreme Court has long recognized that state pension statutes can create enforceable contract rights. *Washington Educ. Ass'n*, 181 Wn.2d at 242. In *Bakenhus* v. *City of Seattle*, 48 Wn.2d 695 (1956), the Court reviewed the contract rights of a police officer whose monthly pension benefit was reduced by a city ordinance enacted after he first became employed and prior to his retirement. The court ruled that the ordinance violated the officer's contract rights to a higher pension, reasoning that "pensions are 'deferred compensation for services rendered' and therefore create a contract that can be modified only to ensure the continued flexibility and integrity of the system." *Washington Educ. Ass'n.*, 181 Wn.2d at 243, quoting *Bakenhus*, 48 Wn.2d at 698. Changes in the pension plan must be for the purpose of ensuring "continued flexibility and integrity" of the plan. *Lenander* v. *Dep't of Ret. Systems*, -- Wn.2d -- [2016 Wash. LEXIS 903, *1, *26] (2016) And "[m]odifications that have an adverse effect on employees must be accompanied by 'comparable new advantages.'" *Washington Educ. Ass'n.*, 181 Wn.2d at 243, quoting *Bakenhus*, 48 Wn.2d at 702. These principles have historically formed the Contracts Clause analysis for public pension rights in Washington.

In 2014, the Washington Supreme Court reviewed these principles in *Washington Education Association* v. *Washington Department of Retirement Systems*. Noting that the *Bakenhus* test is a part of an "overarching" framework applied to all public contracts, the Court held that these contracts are analyzed using a three-part test: "(1) whether a contractual relationship exists, (2) whether the legislation substantially impairs the contractual relationship, and (3) if there is substantial impairment, whether the impairment is reasonable and necessary to serve a legitimate public purpose." *Washington Educ. Ass'n.*, 181 Wn.2d at 243-244; accord, *Lenander,* 2016 Wash. LEXIS at *25-26; see also *Retired Pub. Emps. Council of Wash.* v. *Charles*, 148 Wn.2d 602, 624 (2003). The *Bakenhus* requirements of "flexibility, integrity, and comparable new advantages" remain important, "focus[ing]" the analysis in the specific context of pension contract rights. *Washington Educ. Ass'n.*, 181 Wn.2d at p. 244; see also, *Lenander*, 2016 Wash. LEXIS at *26-27 ("While the three-prong contract impairment test forms the backbone of the analysis in pension cases, the analysis of substantial impairment is guided by the principles set forth in *Bakenhus* and its progeny.") (internal quotations omitted).

III. Contracts Clause Issues When Two Plans Merge

The "merger" of two public pension plans raises substantial Contracts Clause issues. Combining assets and liabilities of two separate plans will change the funded status of the plans unless the two plans have exactly the same funded status and the same benefit/ liability structures and durations prior to the merger. This change could also affect the method and security of funding for future benefits, the level of employee contributions, and the governance of the plans.

A. Funding Rights

Under Washington law, the terms and limitations of pension contract rights "are defined by the language of the statutes creating those rights." *Lenander*, 2016 Wash. LEXIS at *27. In *Weaver* v. *Evans*, 80 Wn.2d 461 (1972), the Washington Supreme Court applied the vested contract rights analysis to actions affecting the funding of a public pension plan.

The *Weaver* Court reviewed the constitutionality of the Governor's action "curtailing" a substantial portion of the State's contributions to Washington State Teachers' Retirement System (TRS). The Court first examined the origins and evolution of the TRS plan. The Court found that the legislature had through the years "evinced a growing concern with maintaining the actuarial soundness of the retirement system ... and determined upon a systematic amortization of the unfunded liabilities ... and a systematic computation and funding of current and future liabilities ...." *Id.* at 472. The *Weaver* court held:

> [W]here, as here, the legislature has over a span of years indicated a deep concern with the actuarial soundness of the retirement system, and that concern has culminated in the express adoption of a systematic method of funding to ultimately attain the desired soundness, *then the principle of systematic funding so adopted becomes one of the vested contractual pension rights flowing to members of the system.* This being so, it follows under *Bakenhus* that such a vested contractual right cannot be unilaterally modified except for the purpose of keeping the retirement system flexible and maintaining its integrity, which modification must in turn be reasonable and bear some material relation to the theory of a pension system and its successful operation, *else the vested contractual right becomes unconstitutionally impaired.*

Weaver, 80 Wn.2d at 478 (emphasis added). The Court concluded that the actions taken by the Governor violated the "vested contractual rights to a retirement system actuarially designed through systematic funding to meet present and future pension liabilities." *Ibid.*; followed by *Charles*, 148 Wn.2d at 625 (members of two state pension plans have "vested contractual rights to the systematic funding of the retirement system to maintain actuarial soundness").

When the Legislature established the original LEOFF plan in 1969, its purpose was "to provide for an *actuarial reserve system* for the payment of death, disability, and retirement benefits to law enforcement officers and firefighters ...." RCW 41.26.020 (emphasis added); see *Pasco*, 110 Wn. App. At 587 fn. 5. The legislation defined "actuarial reserve" as follows:

> a method of financing a pension or retirement plan wherein *reserves are accumulated* as the liabilities for benefit payments are incurred *in order that sufficient funds will be available on the date of retirement of each member to pay the member's future benefits* during the period of retirement.

RCW 41.26.030 (emphasis added). When the Legislature created LEOFF 2 in 1977, these provisions were made expressly applicable to the old LEOFF plan (now LEOFF 1) as well as the new LEOFF 2. RCW 41.26.005.

In 1989, the Legislature expressed its intent "to provide a dependable and systematic process for funding the benefits provided to members and retirees of ... the law enforcement officers' and firefighters' retirement systems ...." RCW 41.45.010; see Laws of 1989, ch. 273, § 1 (adding actuarial funding provisions). The legislature established goals of fully funding LEOFF 2 and fully amortizing the total costs of LEOFF 1 not later than June 30, 2024. RCW 41.45.010(1) and (2).

Consistent with *Weaver*, these provisions establish the legislature's intent to create actuarially sound plans. Like members of TRS, the members of LEOFF 1 and LEOFF 2 have a contractual right to a retirement plan that is systematically funded on the basis of sound actuarial principles.

B. Substantial Impairment

Substantial impairment is measured by the implied consent and comparable new advantages analysis established by the *Bakenhus* decision. *Lenander*, 2016 Wash. LEXIS at *33. "A contract is impaired by a statute which alters its terms, imposes new conditions or lessens its value." *Ibid.* (internal quotations and citations omitted). Changes in pension contract terms must be for "the sole purpose of ensuring the continued flexibility and integrity of the pension system[] [and] … [a]ny modifications that have the effect of reducing a pension benefit or have an adverse effect on members must be counterbalanced by a corresponding increase or additional benefit." *Id.* at *26. A modification of a pension contract will not result in substantial impairment "if the overall result of the change is favorable to employees." *Washington Educ. Ass'n.*, 181 Wn.2d at 250. And whether a modification is favorable "is a fact-specific question that must be measured by the totality of the circumstances." *Ibid.*

LEOFF 1 members have a contract right to a retirement plan that is systematically funded on an actuarially sound basis. After merger, the general system of funding the retirement benefits of these members will not be affected. The new plan will, however, have a funded status that is lower than the current funded status of LEOFF 1. As a result, there will be fewer assets available to pay the future benefits of LEOFF 1 members. Compare CAFR at 64 (LEOFF 1 is 123.7% funded) with *id.* at 67 (LEOFF 2 is 106% funded). There is a risk that a court could consider this action a reduction in the value of the LEOFF 1 contract.

In addition, we assume that legislation authorizing the merger will allow the State of Washington to avoid making an actuarially determined contribution to fund LEOFF 2 benefits for at least two years after the merger. Even though the funded status and therefore security of these benefits will likely increase as a result of the merger through the transfer of "suplus" assets[1] from LEOFF 1, there is a risk that a court could consider this action a reduction in the value of the LEOFF 2 contract.

We believe that analysis of these risks is impacted by several factors.

C. Funded Status of the Plans

Consistent with actuarial standards of practice, the goal of a sound plan is 100% funded status. See., e.g., American Academy of Actuaries Issue Brief (July 2012) at 1, available at https://www.actuary.org/files/80_Percent_Funding_IB_071912.pdf ("Pension plans should have a strategy in place to attain or maintain a funded status of 100% or greater over a reasonable

[1] Surplus assets are the assets excess in value of the actuarial liabilities of the plan.

period of time."). Based on information set forth in CAFR, the new plan will remain over 100% funded.

The merger will reduce the amount of assets available to pay the future benefits of the former LEOFF 1 members. We have found no case from Washington that directly addresses whether a change in funded status through a merger of two separate plans is a "substantial impairment" of vested contractual pension rights to an "actuarially sound" plan. We have also found no Washington cases that directly considered the use of "surplus" plan assets. Cases from other jurisdictions which have considered similar changes in plan design nevertheless shed some light on these issues.

In *Koster* v. *City of Davenport*, 183 F.3d 762 (8th Cir. 1999), the Court of Appeals for the Eighth Circuit considered a constitutional challenge to a merger of local public pensions in Iowa into the statewide plan. At the time the plans were merged, each of the cities' plans was overfunded. The merger law included a provision allowing each city to use "excess" funds in the city plan to offset the city's future contributions to the statewide plan. *Id.* at 765. Reviewing the challenge under the federal Contracts Clause, the *Koster* court held that there was no substantial impairment of any contract right to an actuarially sound pension plan. Central to the court's reasoning was the funded status of the plans.

> The [challenged] statute required the plan's actuary to first determine that the assets transferred from each separate plan to the statewide plan *were more than adequate to meet the plan's accrued liabilities* before allowing the city to offset its future contributions. [Citation omitted.] Thus, the statute does not infringe on the members' rights to receive predefined benefits upon retirement and provides measures to ensure that the statewide fund remains sound.

Id. at 768 (emphasis added) (internal citation omitted). The court concluded that any impairment was not substantial because it does not "compromise the soundness of the plan." *Ibid.*

State courts in West Virginia, North Dakota, and California have reached similar conclusions.

In *Dadisman* v. *Caperton*, 186 W.Va. 627 (1991), the West Virginia Supreme Court of Appeals rejected a constitutional challenge to a statute that merged two pension "divisions." From an actuarial standpoint, the "state" division had an unfunded liability while the "non-state" division had a large surplus "which more than offset[] the state unfunded amount." *Id.* at 633. In a prior proceeding, the court had ordered the state pension plan trustees to engage an independent actuary to determine whether underfunding had rendered the plan "actuarially unsound." Two actuaries were consulted and, ultimately, both opined that the system was actuarially sound at the time of the merger, "whether the System is viewed as a whole or the former state division of the System is viewed separately." *Id.* at 632. Plaintiffs nevertheless claimed unconstitutional impairment because members of the non-state plan were "deprived" of the surplus held for the benefit of the members of that plan. The *Dadisman* court rejected these claims and ruled that the legislation was valid because (1) the assets of both divisions were "owned" by the retirement system as a whole, and (2) the system as a whole, or each division separately, has "at all times … continued to be actuarially sound." *Ibid.*

Similarly, the North Dakota Supreme Court determined that a merger of underfunded and overfunded pension plans did not violate rights of overfunded plan members because the members were not entitled to "surplus" assets and the employer was not required to continue funding to preserve a surplus. *Klug* v. *City of Minot*, 795 NW2d 906, 912 (North Dakota 2011); see also *Claypool* v. *Wilson*, 4 Cal.App.4th 646 (1992) (no substantial impairment when funds in special account were used to offset employer contributions but plan actuary had determined these funds were not necessary to the actuarial soundness of the plan).

Under the reasoning of these cases, plan assets in excess of actuarial liabilities may not be essential to the actuarial soundness of the plan. Each of the courts in these cases evaluated the consequences of the merger and, relying on the opinions of actuaries, concluded that the change in funded status did not jeopardize the actuarial soundness of the combined plan after the merger, provided that, in the opinion of responsible actuaries, the funding of benefits provided by the new plan remained sound.

The opinions in these cases supports the view that a reduction in the amount of funds available to pay the benefits of LEOFF 1 members would not substantially impair their vested contract rights, provided that new plan remained actuarially sound. The *Koster* and *Claypool* decisions also support the view that "surplus" assets in an over-funded plan may be used to offset contributions otherwise required to maintain the soundness of the plan, again provided that the plan remains actuarially sound. It appears that the funded status of the newly merged plan, post merger, would be well over 100%, which would seem to support a finding of actuarial soundness. However, a case from Alaska might cast some doubt on these conclusions.

In *Municipality of Anchorage* v. *Gallion*, 944 P.2d 436 (Alaska 1997), the court reviewed the constitutionality of an ordinance permitting the city to use surplus assets in two plans to fund the liabilities of a third plan. Each plan had a different funded level prior to this consolidation of assets and liabilities: the first two plans were funded at levels of 135% and 112%, while the third plan was funded at 89%. *Id.* at 438-439. Even though the three plans were approximately 100% funded in the aggregate after the consolidation,[2] the *Gallion* court held that the ordinance impaired the pension rights of members of the better funded pension plans.

The Alaska Constitution "protects 'accrued benefits' of public employee retirement systems from diminution or impairment." *Id.* at 440, quoting Alaska Const., art. XII, § 7. The *Gallion*

[2] The actuarial calculations revealed that the funding for the new plan was either 102% or 99%, depending upon the assumptions used. *Id.* at 444.

court first noted that the separate treatment of each plan's funding was an essential part of the funding scheme of the plans. Members in the first two plans "reasonably could have expected that the product of their contributions would be used for their ultimate benefit[] [and] [c]ertainly they could not have expected that any surplus would be used for the benefit of non-plan members." *Id.* at 443. Because the funding level of the new plan was reduced from the pre-consolidation levels of Plans I and II, the court held that the ordinance "clearly impaired the inherent integrity of Plans I and II." *Id.* at 444. The court held:

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

Id. at 444 (emphasis added); compare *McDermott* v. *Regan*, 191 A.D.2d 47 (N.Y. App. Div. 1993) (legislative change in actuarial valuation method which created an actuarial "surplus" and allowed employers to "offset" contributions was unconstitutional impairment of right to independent trustee's exercise of discretion over setting contribution rates).

It is not clear whether Washington courts would adopt the *Gallion* analysis. Unlike the Washington Constitution, the Alaska Constitution contains a specific provision protecting pension rights. In a line of pension cases involving the alleged impairment of pension contract rights, the Alaska courts have rejected the reasoning of one Washington court. See *Sheffield* v. *Alaska Pub. Employees' Ass'n.*, 732 P.2d 1083, 1086-1087 (Alaska 1987) (rejecting reasoning of *King County Employees' Ass'n* v. *State Employees' Retirement Bd.*, 54 Wn.2d 1 (1959). And, in a recent case, the Washington Supreme Court acknowledged the difference in case law between the two jurisdictions. *Lenander*, 2016 Wash. LEXIS at *31-*32 fn. 9 (rationale in *Sheffield* is "incompatible" with precedent in *King County Employees' Ass'n* and is rejected).

In contrast, at least one Washington court has cited the *Koster* decision with approval in the context of a challenge to the standing of retirement plan members to file suit. See *Charles*, 148 Wn.2d at 478-479, citing *Koster*, *supra*, 183 F.3d at 767 (defined benefit plan does not entitle its members "to any use of the contributions other than to ensure the … entitlements [to a predetermined pension and an actuarially sound plan] are met").

If the Washington courts nevertheless applied the reasoning of the *Gallion* case, there is a substantial risk that the LEOFF 1 and 2 merger would be held unconstitutional. The Alaska Supreme Court was concerned with the structure of the plans and pre-ordinance authorization for consolidation of the assets and liabilities of the plans. We have found no Washington statute that specifically authorizes a merger or consolidation of the LEOFF 1 and 2 plans. Similarly, we have not found any statute or plan materials that notify LEOFF 1 members of such a merger. It is also clear that the separate structure of LEOFF 1 and 2 would not be maintained and the percentage of assets to liabilities for the LEOFF 1 benefits would be lowered. For the same reasons, the *Gallion* court held that the consolidation ordinance under its consideration was invalid.

Finally, Washington courts may look to federal law in evaluating whether a merger of LEOFF 1 and LEOFF 2 retirement plans would impair the vested rights of plan participants. Private pension plans are governed by the Employee Retirement Income Security Act, 29 U.S.C. §§ 1001 *et seq.* ("ERISA"). Section 1058 of ERISA and Internal Revenue Code section 414(l) each provide essentially similar rules concerning the merger of pension plans and requires that in the case of a merger, each participant in the newly formed plan "would (if the plan then terminated) receive a benefit immediately after the merger, consolidation, or transfer which is equal to or greater than the benefit he would have been entitled to receive immediately before the merger, consolidation, or transfer (if the plan had then terminated)." 29 U.S.C. § 1058. The Internal Revenue Service has issued regulatory guidance under section 414(l), which we understand will be addressed in a different memorandum.[3] The Code of Federal Regulations, 26 CFR 1.414(l)-1 provides that, for defined benefit plans, "if the sum of the assets of all plans is not less than the sum of the present values of the accrued benefit (whether or not vested) of all plans, the requirements of section 414(l) will be satisfied merely by combining the assets and preserving each participants accrued benefits." 26 CFR 1.414(1)-1(e). Both the ERISA statute and regulation governing plan mergers focus on the preservation of accrued benefits, and do not speak to a plan participant's entitlement to plan surplus that exists prior to merger. Since the LEOFF 1 and LEOFF 2 plans are both overfunded, it appears that the application of this law, by analogy, would not support an argument that the merger of LEOFF 1 and 2 pensions is impermissible.

Nevertheless, private plan participants have challenged plan mergers and amendments on the basis that they are entitled to the surplus assets of the over-funded pension plan in which they were a participant, or the basis that the merger or amendment impermissibly reduces the funded status of their pension plan. The federal courts, however, have generally rejected such challenges.

In *Hughes Aircraft Co. v. Jacobson*, 525 U.S. 432 (1999), the Supreme Court considered changes in the design of a defined benefit plan holding assets whose value substantially exceeded the actuarial value of the accrued liabilities. Under the plan amendments, early retirees were provided significant additional benefits while new employees were placed in a new "non-contributory" benefit structure. *Id.* at 435-436. Existing members were allowed to choose between the original benefit structure or the new one. Certain members filed suit claiming inter alia that the plan's surplus assets could not be used to fund the new non-contributory benefit

[3] The United States Department of Labor has not issued any regulations under ERISA section 1058.

structure. The Supreme Court rejected this claim, reasoning that "[t]he structure of a defined benefit plan reflects the risk borne by the employer. Given the employer's obligation to make up any shortfall, no plan member has claim to any particular asset that composes a part of the plan's general asset pool." *Id.* at 440. Thus, the Court concluded, the employer "could not have violated ERISA's vesting requirements by using assets from the surplus attributable to the employees' contributions to fund the noncontributory structure." *Id.* at 441. Similar conclusions have been reached by other federal courts. See *Systems Council EM-3 v. AT&T Corp.*, 159 F.3d 1376 (D.C.Cir. 1998) (participant in spun-off plan not entitled to residual assets that would be available upon termination of plan); *Brillinger v. General Elec. Co.*, 130 F.3d 61 (2d Cir. 1997) ("We therefore hold that the participants in the RCA plan were not entitled to have their benefits increased at the time of the merger with the GE plan, to take into account the existence of the RCA plan's residual assets.").

Governmental plans, like LEOFF 1 and 2, are of course exempt from ERISA. Nevertheless, the *Jacobson* case has been followed in two public pension cases in Washington. In *Johnson* v. *City of Tacoma*, 2016 Wash. App. Lexis 1326, *1 (June 6, 2016),[4] the Washington Court of Appeals considered a claim on employee contributions credited to the account of a member. Citing *Jacobson* with approval, the court observed that "[e]mployees who participate in a defined-benefit plan do not share in any decrease or surplus in the value of plan assets." *Id.* at *9; see *Washington Federation of State Emps.* v. *State*, 107 Wn. App. 241, 245 fn.5 (2001) (citing *Jacobson* with approval).[5]

Under this reasoning, LEOFF 1 plan members have no vested or contractual rights to the actuarial surplus of the LEOFF 1 plan and this surplus could be used to fund the benefits of LEOFF 2 plan members post merger without impairing the vested rights of LEOFF 1 members. It remains unclear whether another Washington court would apply this reasoning to the proposed merger.

We recommend that the Board consult with OAS and request the State Actuary to conduct an appropriate study to measure the actuarial impacts of a merger (including authorization for the State to skip its contributions for one or two years after the merger) and issue an opinion on the soundness of the new plan after merger. The results of this study will be critical to evaluating the impacts of the merger on the contract rights of LEOFF 1 and 2 members.

[4] The opinion in *Johnson* is not published in the official Washington Appellate Reports. Under Washington law, it may be cited as non-binding authority and may be given such persuasive authority as a court deems appropriate. Wash. State Court Rules, GR 14-1.

[5] This reading is reinforced by statute as well. See RCW 41.26.080(d) (Payment of salary and compensation to LEOFF 1 members less contributions "shall be a complete discharge of all claims and demands whatsoever for the services rendered ..., except his or her claim to the benefits" provided to these members).

D. Open and Closed Status

We understand that LEOFF 1 is a closed plan and therefore not accepting any new entrants. In addition, it is a very mature plan. As of June 2016, there were 62 active members and 7,431 retired members and beneficiaries receiving benefits.[6] CAFR at 46.

In contrast, LEOFF 2 is an open plan still accepting new entrants. It is also a younger plan, with 17,321 active members (both vested and non-vested) and 4,508 retired members and beneficiaries receiving benefits.[7]

Pursuant to statute, the assets of both plans are currently managed and invested by the Washington State Investment Board ("WSIB"). RCW 43.33A.10; RCW 41.26.735 (LEOFF 2). Along with the assets of other Washington pension funds, the assets of LEOFF 1 and LEOFF 2 are commingled for investment purposes in the Commingled Trust Fund ("CTF"). CAFR at 64, 66; see RCW 43.33A.170 (WSIB may establish commingled trust funds for any combination of funds under its jurisdiction). Assets in the CTF are currently allocated to different classes pursuant to the Retirement CTF Asset Allocation policy. WSIB Policy No. 2.10-050 (Feb. 18, 2016). The WSIB believes that "[t]he selection of asset classes, the amount invested in each, and the correlation of those asset classes are the greatest source of return and risk to the CTF[,]" and therefore to LEOFF 1 and LEOFF 2. *Ibid.* The WSIB aggregates the liabilities of all the pension funds in the CTF as part of its evaluation of the appropriate asset mix. *Ibid.* The current target allocations for each class of assets are as follows:

- 20% Fixed Income
- 5% Tangible Assets
- 15% Real Estate
- 37% Public Equity
- 23% Private Equity
- 0% Innovation Portfolio
- 0% Cash

Ibid.[8] The Washington Legislature set the target rate of investment return at 7.70% per year, beginning July 1, 2017, for all assets in the CTF, except for those of LEOFF 2. RCW 41.45.035(3)(c).

[6] There was also one terminated member not yet receiving benefits.
[7] In addition, there were 839 terminated members not yet receiving benefits.

[8] These are target allocations. Under the policy, the actual allocation of each class of the CTF may fluctuate between 2 and 5 %, plus or minus, of the target.

This target allocation might not be ideal for a closed, mature plan. It is designed to generate relatively higher investment returns but with higher risk and therefore more volatility. As the Washington Office of the State Actuary ("OSA") explains:

> In deciding the trade-off between risk and return, WSIB can take advantage of the long time horizon of the pension financing plan. [¶] The long time horizon for investing means that as a general matter, WSIB does not need to match pension liabilities with the short term ups and downs in the market. Instead, *WSIB can take more investment risk and seek higher expected returns* over the long term.

Office of the State Actuary's 2010 Risk Assessment (August 31, 2010) at 10 (emphasis added). Because LEOFF 1 is a closed plan and relatively mature, the duration of its liabilities is shorter than, and its cash flow needs are greater than, most of the other plans whose assets are managed by WSIB. Declines in asset values through investment losses will not be immediately replaced by incoming contributions of active members. Large investment losses could also cause the sale or liquidation of assets because of the need for cash to pay out benefits. The ability of plans like LEOFF 1 to absorb large investment losses is likely to be lower than that of an open and less mature plan. Thus, the current funding structure and target investment allocation may increase the risk of underfunding and, possibly, insolvency. (See, e.g., Office of the State Actuary 2011 LEOFF Merger Study at 20-22 (lack of ongoing funding policy requires new unfunded liabilities to be paid on a non prefunded or "pay as you go" basis and LEOFF 1 has "nearly a one in three chance of going into pay-go status at some point in the plan's life cycle.").

If LEOFF 1 is merged with LEOFF 2, the resulting new plan will be an open plan with approximately 17,383 active members and 11,939 retired members and beneficiaries. It will also be less mature and will likely have, in the aggregate, longer duration liabilities. For these reasons, the asset allocation adopted by the WSIB might be better suited to reducing the long-term risks of under funding or insolvency. Under the Contracts Clause analysis, public pension contract modifications "must be made for the sole purpose of ensuring the continued flexibility and integrity of the pension system." *Lenander*, 2016 Wash. LEXIS at *26-27, citing *Bakenhus*, 48 Wn.2d at 701. Mitigating these risks to ensure the integrity of the system likely satisfies this requirement. It is also possible that a reduction in funding risk could be considered a "comparable new advantage" to LEOFF 1 members. See *Bakenhus*, 48 Wn.2d at 702.

We recommend that OSA review the change in funding and analyze the "pay-go" risks for LEOFF 1 benefits as part of its actuarial study. This review should include an analysis of these risks both pre and post merger of the two plans.

E. Reduction In Aggregate State Contributions

Under current law, funding of LEOFF 1 is based upon statute. RCW 41.26.080 provides that every member shall make an employee contribution of 6% of the member's basic salary and every employer shall make a similar 6% employer contribution for every employee in the plan. However, no employer or member contribution is required "unless the most recent valuation study for [LEOFF 1] indicates the plan has unfunded liabilities." RCW 41.26.80(2).

Remaining liabilities of LEOFF 1 are funded by the State of Washington ("State"). RCW 41.26.80(1)(c); and RCW 41.45.010, et seq. The OSA provides preliminary actuarial valuation results to the Pension Funding Council, which in turn adopts a LEOFF 1 contribution rate for the State. This rate is recommended to the Legislature for final approval. RCW 41.45.060(1)-(3). Because LEOFF 1 has been overfunded, we understand the State has not made a contribution to LEOFF 1 for many years.

The funding of LEOFF 2 is also set forth in statute. RCW 41.26.725(1) provides that the LEOFF 2 Board has the duty to establish the rates of contribution for employers and employees according to the funding ratio set by statute. For the year 2015, the State contributed 3.15% of payroll, employers contributed 4.73% of payroll and employees contributed 7.88% of pay. Law Enforcement Officers' and Firefighters' Plan 2 Actuarial Valuation Report 2015 ("Valuation Report") at 5. Collectively, the State and participating employers contributed $147 million to LEOFF 2 in 2015. Valuation Report at 17.

After a merger of LEOFF 1 and 2, it is likely that aggregate contributions by employees, employers and the State will be reduced from their prior levels. The assets and liabilities of both plans will be combined and the funded status of the new plan will be higher than the funded status of the former LEOFF 2. As a general matter, a higher funded status will reduce the amount of contributions needed to fund current and future pension liabilities. Provided that future rate-setting for the new plan follows the existing rules for LEOFF 2, and members, employers, and the State continue to make required contributions, a change in the aggregate amount of State and employer contributions should be consistent with the "actuarial soundness" requirements of the Contracts Clause. See *Washington Federation of State Emps.* v. *State*, 107 Wn.App. at 245 fn. 5 (sponsor of overfunded pension plan may reduce or suspend its contributions) (dicta).

However, if the State enacts a statute allowing it to reduce or avoid making otherwise required contributions after a merger, this action would raise an additional risk of a Contracts Clause violation. The Washington Supreme Court in *Weaver* declared the Governor's action "curtailing" a substantial portion of the State's contributions to the Teachers' Retirement System an unconstitutional impairment of contract. The court concluded that this diversion of contributions violated the vested contractual rights to an actuarially sound retirement system. Under the *Koster* and *Jacobson* decisions as explained above, a Washington court could adopt the view that LEOFF 1 members do not have an interest in the surplus assets of their plan. The legislature would therefore remain free to use these assets to help fund LEOFF 2 benefits, provided that the soundness of the plan is not jeopardized. A contrary view was expressed in the *Gallion* case and a Washington court following it could conclude that these assets are not a State contribution and their use to pay an otherwise required contribution impairs the contract rights of LEOFF members.

F. Character of Employer Plan Sponsors

The members of both LEOFF plans have a vested contract right to an actuarially sound pension plan. For these defined benefit plans, "[t]he employer bears the risk of investment and guarantees the distribution of the fixed benefit even if the value of plan's investments decline." *Johnson*, 2016 Wash. App. LEXIS at *8-9. Thus, the employers in the LEOFF plans are ultimately responsible for the payment of benefits to the LEOFF members. Post merger, there will be a difference in the employer sponsors responsible for the actuarial soundness of the benefits provided by the LEOFF 1 and 2 plans. It does not appear that this difference will materially affect the soundness of the new plan.

LEOFF 1 currently has 64 active employee members employed by 29 different employer sponsors. CAFR at p. 194. The City of Seattle is the primary sponsor, accounting for 37.5% of all member participants. The remaining active members are employed by a variety of cities, counties, and special districts including the City of Bellevue, King County, and the City of Pasco. Other than Seattle, no single employer accounts for more than 5% of the active membership. *Ibid.*

LEOFF 2 currently has 17,470 active members employed by 369 different employers. CAFR at 195. As with LEOFF 1, Seattle has the largest number of active employees but the percentage is much lower -- 13.4%. The remainder of employers includes cities, counties, and special districts in Washington.[9] *Ibid.*

Based upon this composition of employers, there does not seem to be a substantial change in the risk of plan funding. From the standpoint of LEOFF 1 members, the addition of more than 200 employers with active members responsible for maintaining the actuarial soundness of the new plan seems to be a favorable change. And in any event, unless this change at least "likely" harms the actuarial soundness of the system, there can be no showing that the vested contract rights of the members have been impaired. *Charles*, 148 Wn.2d at 627.

G. Change in Plan Governance

Under Washington law, the LEOFF 2 Board is clearly a fiduciary to the members of the LEOFF 2 plan, responsible for adopting actuarial standards and setting contribution rates that "will

[9] The State of Washington is also a sponsor, accounting for about 1.4% of active employees.

guaranty the viability of the plan." RCW 41.26.705. Under current law, the State "shall make" contributions to LEOFF 2 based on rates established by statute, "regardless of the level of appropriation provided in the biennial budget." RCW 41.45.050(2) and (3). Because the legislature of course may generally amend statutes, it is possible that it could modify these rules and alter contribution rates set by the Board. We understand, however, that the legislature has not exercised this authority since the creation of the LEOFF 2 Board.

The Contracts Clause may limit the legislature's authority in this area. In *McDermott* v. *Regan*, 191 A.D.2d 47 (N.Y. App. Div. 1991), the court considered a challenge to a new statute compelling the trustee of the New York State Employees' Retirement System and the New York State and Local Police and Fire System to use certain actuarial methods of calculating pension liabilities and calculating employer contribution rates. Using the new method, the funds had an actuarial surplus of about $9 billion. The legislation further authorized the contributing employers to offset their contributions against a share of this "surplus." The end result of these changes was a reduction in employer contributions and a faster depletion of the surplus. This change "essentially shift[ed] the burden of funding the retirement systems from the present to the future [and] was admittedly imposed upon the [trustee] in an attempt to ease the State's budgetary problems." *Id.* at 49. The court held the legislation an unconstitutional impairment of the members' contract rights.

> The imposition of a particular funding method, as opposed to the mere setting of guidelines for selection of a method, vitiates the members' right to have the benefit of the [trustee's] discretion in fixing the amount of contributions needed for the continued stability and security of the systems.

Id. at 51. The court further reasoned that the legislation not only imposed a dramatically different funding method on the trustee, it dictated the depletion of surplus funds, "a further usurpation of the [trustee's] authority to manage the accounts of the fund." *Ibid.* The *McDermott* court concluded that the additional changes in the actuarial valuations "strip[ped] the systems' members of their right to the [trustee's] independent judgment, and therefore they too are unconstitutional." *Ibid.*

It is unclear whether a Washington court would follow *McDermott* and hold unconstitutional a legislatively imposed reduction in the contribution rates set by the LEOFF 2 Board. Nevertheless, the fiduciary authority and responsibility of the LEOFF 2 Board to make actuarial valuations and set contribution rates independent of the State legislature or any State agencies is likely considered a valuable aspect of LEOFF 2 plan governance.

As Initiative 790 noted, the then existing LEOFF 2 plan was "subject to policymaking by the legislature's joint committee on pension policy with ratification by the members of the legislature …." Laws of 2003, ch. 2, § 1 (codified at RCW 41.26.700). The initiative created a new plan governance that was intended, in the words of the initiative, "to give management of the retirement program to the people whose lives are directly affected by it ...." *Ibid.* The initiative created a new board -- the LEOFF 2 Board -- with authority to manage certain aspects of the system. The 11 member board is composed of three fire fighters, three police officers, three employer representatives and two legislators. At least one Board member must be a retired participant of LEOFF 2. RCW 41.26.715. Although members are appointed by the Governor, the Board has independent pension management authority. This includes authority over actuarial standards, providing for additional benefits under certain conditions, providing effective monitoring of the plan, establishing contribution rates, and authority to retain professional and technical advisors. RCW 41.26.705. The LEOFF 2 Board must "[e]xercise fiduciary responsibility in the oversight of those pension management functions" assigned to it and thus owes duties of loyalty and prudence solely to the plan members and their beneficiaries. RCW 41.26.705(3).

Unlike LEOFF 2, there is no board or other body or official that has fiduciary oversight for LEOFF 1. OSA performs an advisory role. See RCW 44.44.040. The Washington Department of Retirement Services ("DRS") is only responsible for administering the system. RCW 41.50. Neither the Washington Legislature, OSA, nor DRS is expressly a fiduciary. In *Retired Public Employees Council of Washington* v. *Charles*, the Washington Supreme Court considered whether the Public Employees Retirement System I and the Teacher's System I are considered trust funds and whether the DRS Director is a trustee or other fiduciary of the two plans. *Charles*, 148 Wn.2d at 612. Relying on a number of prior decisions, the court held that "this State's case law, recent case law in particular, has refused to characterize the retirement funds as trusts." *Id.* at 622. The court concluded that if the retirement funds are not trusts, then the DRS Director may not be considered a trustee. *Ibid.* Thus, there is no fiduciary responsibility for administration of LEOFF 1.

If the newly merged plan were governed by the current LEOFF 2 Board having the same fiduciary responsibilities and the same composition, this change in governance could well be considered a change enhancing the integrity of the system. As explained above, under Washington law public pension contract modifications "must be made for the sole purpose of ensuring the continued flexibility and integrity of the pension system." *Lenander*, 2016 Wash. LEXIS at 26-27. Merging LEOFF 1 into LEOFF 2 and placing the new system under the governance regime of LEOFF 2 would seem to clearly enhance the system's integrity. As with the change in the maturity and closed status of LEOFF 1, this modification likely satisfies the requirement that pension plan modifications must be for the purpose of ensuring the continued flexibility and integrity of the system. In addition, it might well be considered an additional benefit for LEOFF 1 members which was conferred on them by the merger of LEOFF 1 and 2.

H. LEOFF 1 Cost Of Living Adjustments

A mandatory cost of living adjustment ("COLA") to a public pension benefit can be part of the vested contractual rights of the member. Effective April 1, 1971, the Washington Legislature granted LEOFF members an annual COLA based upon percentage increases in the consumer price index. See Laws of 1970, 1st Ex. Sess., ch. 6, §16, codified at RCW 41.26.240. In 1974, the legislature made slight changes to the calculation of the allowance based, LAWS 1974, 1st Ex. Sess., ch. 120, § 13. Since then, this statutory COLA has consistently been paid each year to LEOFF 1 members.

A legislative reduction or elimination of the current COLA provided to LEOFF 1 members would likely impair their contractual pension rights.

In *Washington Education Association,* the Washington Supreme Court considered several legislative changes to COLAs provided to the PERS and TRS Plan 1 members. *Wash. Educ. Ass'n.*, 181 Wn.2d at 236. In 1972, the legislature enacted a statute providing for a COLA, "'provided that the [DRS] finds, in its sole discretion,'" that system assets were sufficient to fund the COLA. *Id.* at 236, quoting former RCW 41.32.499 and former RCW 41.40.195. Under this statutory scheme, COLAs were never granted to TRS 1 members and were granted only through 1980 to PERS 1 members. Thus, for 15 years prior to the adoption of a new COLA scheme, DRS never exercised its discretion to grant a COLA under the 1973 enactment. *Id.* at 238. In 1995, the legislature adopted a new uniform cost of living adjustments ("UCOLA") for these members (and others). Under this new scheme, the legislature repealed the 1973 COLA and replaced it with a different benefit. "To prevent a perpetual obligation to increase the COLA amount each year, the legislature included a clause that reserved its right to modify or repeal the UCOLA scheme in the future and specified that it was not creating any contract rights." *Id.* at 239, citing former RCW 41.32.489(6) and former RCW 41.40.197(6). In 2011, the legislature repealed the UCOLA statutes, eliminating a COLA for TRS and PERS 1 members who had not yet retired at the time of the repeal. These members filed suit, bringing unconstitutional impairment claims. Id. at 240-241.

The *Washington Education Association* court first considered the 2011 repeal of the UCOLA statutes. Assuming that COLAs could be considered a part of the members' contract rights, the court rejected this claim because there was no substantial impairment. The authority to repeal the UCOLA was expressly reserved in the original legislation and "the legislature could not have been more explicit in reserving the power to amend the UCOLA statute and disclaiming any grant of contractual rights." *Wash. Educ. Ass'n.*, 181 Wn.2d at at 247. Thus, the court held, no vested contractual rights were violated.

The court also considered the claim that the 1995 legislation establishing UCOLA and repealing the 1973 COLA was an unconstitutional impairment. This claim was rejected as well. The court noted that even when modifications are detrimental to plan members there is no contract impairment "so long as those disadvantageous modifications were accompanied by comparable new advantages." *Id.* at 249, citing *Bakenhus*, 48 Wn.2d at 701-703. Whether an alteration is favorable to the members "is a fact-specific question that must be measured by the totality of the circumstances." *Id.* at 250. Turning to the repeal of the 1973 COLA in 1995, the court held that the affected members received comparable new advantages through enactment of the UCOLA benefit. Because the 1973 COLA was discretionary and contingent upon adequate funding, the UCOLA system represented a "substantial improvement" over the former COLA provisions.

> Notwithstanding the reservation clause, UCOLA provided a guaranteed right to an annual COLA of increasing amounts for as long as the program remained in effect. In contrast, the 1973 COLA ... merely assured employees that the DRS would *consider* whether a COLA was practicable based on current funding levels. ... Although the UCOLA statute reserved the legislature's right to change or terminate the program, such reservation clauses are enforceable and even the creation of an undefined automated COLA system constitutes an added favorable benefit ....

Id. at 250 (italics in original). Thus, the court held, replacement of the 1973 COLA by the UCOLA did not impair any existing contract rights.

We have found no legislative reservation of rights to modify or eliminate the LEOFF 1 COLA. Since 1971, the LEOFF COLA statute has provided that every eligible retirement allowance "shall be adjusted" to reflect changes in the consumer price index. Further, we understand that each LEOFF 1 member has received this annual adjustment since enactment of the statute. Unlike the 1973 COLA and the UCOLA considered in *Washington Education Association*, the legislature did not make the award of a COLA in any year discretionary and did not expressly reserve the right to modify or repeal the LEOFF COLA. Thus, this benefit would likely be considered a vested contractual right by Washington courts subject to impairment if the legislature reduced or eliminated it.

Under the reasoning of this case, however, it is possible that a court could consider the governance and demographic changes addressed in sections D. and G., supra, as an added favorable benefit and thus find no impairment. New benefits typically must be "comparable" to the detriment suffered to avoid a finding of impairment. See *id.* at 447; see also, e.g., *Bowles*, 121 Wn.2d at 65 ("modifications *reducing pension levels* must be counterbalanced with *increases in pension levels*") (emphasis added); *Wash. Fed'n of State Employees Council 28* v. *State*, 98 Wn.2d 677, 689 (1983) (legislative change eliminating a pension benefit "without giving ... employees a *comparable benefit substitute*" held unconstitutional) (italics added); *Vallet* v. *Seattle*, 77 Wn.2d 12, 21-22 (1969) (sliding scale escalator clause for pension allowance over a period of years "outweighed" a higher but fixed pension benefit). In *Washington Education Association*, the Washington Supreme Court explained this analysis further:

> [M]odification of a pension contract will not substantially impair an existing contract if the *overall result of the change is favorable to employees*. Whether an alteration is favorable to employees is a fact-specific question that must be measured by the totality of the circumstances.

Wash. Educ. Ass'n., 181 Wn.2d at 250 (emphasis added).

It is difficult to compare the loss of an annual COLA with the benefit of added fiduciary oversight, better governance, and a possible increase in the benefit security of the new plan. The former entails a direct reduction in the dollar amount of each member's benefit while the latter enhances the future security of benefit payments. Despite these differences, a Washington court might view the totality of these changes as an added benefit that outweighs the loss of a COLA. Nevertheless, elimination or reduction of the LEOFF 1 COLA remains a substantial risk under *Bakenhus* and its progeny.

I. LEOFF 1 Member Contributions

LEOFF 1 members are not obligated to pay any employee contributions, "unless the most recent valuation study for [LEOFF 1] indicates the plan has unfunded liabilities." RCW 41.26.080(2). We understand that LEOFF 1 members have not paid any employee contributions to the plan since at least 2000.

Under *Bakenhus* and its progeny, "modifications reducing pension levels must be counterbalanced with increases in pension levels." *Bowles* v. *Wash. Dept. of Ret. Sys.*, 121 Wn.2d 52, 65 (1993), following *Bakenhus*, 48 Wn.2d at 701. In *Allen* v. *City of Long Beach*, 45 Cal.2d 128, 131-133 (1955), the California Supreme Court held that an increase in the amount of an employee's contribution without a corresponding increase in benefit payments was an unconstitutional impairment of the employee's contract rights. In its opinion, the *Bakenhus* court noted this result and relied on the *Allen* decision for its conclusion that a decrease in a pensioner's benefit made without a corresponding benefit was also unconstitutional. *Bakenhus*, 48 Wn.2d at 701-702. If any existing active member of LEOFF 1 is required to pay employee contributions after the merger, it is likely this change would be held unconstitutional, unless this change were accompanied by a corresponding benefit to these members. Even a higher likelihood of payment could be grounds for a constitutional challenge. See *Charles*, 148 Wn.2d at 627 (impairment claim must at least demonstrate "likely" harm to member). Under more recent case law, a Washington court might possibly be inclined to find the "overall result" of the merger favorable to members. See section H., *supra*. However, changes that impose employee contributions on LEOFF 1 active members retain a substantial risk of contract impairment.

IV. Fiduciary Issues In Plan Mergers

The proposed merger would be effected through statutory changes enacted by the Washington Legislature. A pension plan merger is a change in plan design. In Washington, "the legislature has the authority under its police power to establish a retirement system for public employees ...." *Wash. Fed. Of State Emps.* v. *State*, 107 Wn.App. at 247 (internal quotations and citation omitted). Retirement plan design issues, such as a "lack of an independent trustee," a need for a "review and clarification" of fiduciary duties, and a need for a retirement trust "are matters for legislative, not judicial, action[.]" Id. at 246-247. Thus, "[t]he courts have repeatedly said we will not substitute our judgment for the Legislature's with respect to the structure of public retirement plans." Id. at 247. Legislative exercise of the police power is not a fiduciary function and it is unlikely that a Washington court would require to act as a fiduciary in enacting pension plan merger legislation.

This conclusion is consistent with federal law governing non-governmental plans. Under ERISA, an employer's decision to change the plan design generally does not implicate fiduciary duties. *Jacobson*, 525 U.S. at 444-445. Plan design changes are typically "trustor" or employer functions and plan sponsors who alter plan terms "do not fall into the category of fiduciaries." Id. at 445 (internal quotations omitted).[10] Under this reasoning, the Washington Legislature's actions in re-designing the LEOFF 1 and 2 plans should not be subject to fiduciary principles. As explained above, Washington courts have cited the *Jacobson* case with approval, albeit in different contexts.[11]

V. Conclusion

The Contracts Clause in the Washington Constitution provides members of LEOFF 1 and 2 with vested contract rights to an actuarially sound plan for providing their retirement benefits. Legislation merging these plans will make changes that could affect these rights. Washington courts may review changes in plan funding, plan status, contributions, plan governance, and benefits in addressing any constitutional challenge to a merger. Evaluation of these factors will shape a judicial decision whether the legislation unconstitutionally impairs the members' contract rights.

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[10] The Supreme Court recognized a potential exception for "sham transactions" -- a transaction "meant to disguise an otherwise unlawful transfer of assets to a party in interest[.] Id. at 445 (internal quotations omitted). Unless the merger legislation violated the vested contract or other constitutional rights of plan members, it is difficult to envision the merger plan being categorized as a sham under the circumstances presented here.

[11] See text accompanying footnotes 4 through 5, supra.