West Virginia Regional Jail and Correctional Facility Authority v. West Virginia Investment Management Board, No. 25134

Davis, Chief Justice, dissenting:

In my judgment, the majority opinion in this case has diminished the constitutional prohibition against governmental impairment of contracts. I believe a proper analysis of the constitutional impairment of contract doctrine emphatically requires denying the writ prayed for in this case. The majority of this Court failed to apply the proper constitutional analysis. I am compelled, therefore, to respectfully dissent.

I.

UNDER THE CORRECT IMPAIRMENT OF CONTRACT ANALYSIS HB 4072 VIOLATES THE CONTRACT CLAUSE OF BOTH THE STATE AND FEDERAL CONSTITUTIONS

Article 3, § 4 of the state constitution provides that "[n]o ... law impairing the obligation of a contract, shall be passed." A similar prohibition against governmental impairment of contracts is found in the

federal constitution.[1] The majority opinion correctly notes that we have adopted a three-step test to analyze whether legislation impairs a contract.[2] In syllabus point 4 of *Shell v. Metropolitan Life Ins. Co.*, 181 W.Va. 16, 380 S.E.2d 183 (1989), this Court set out that test as follows:

> In determining whether a Contract Clause violation has occurred, a three-step test is utilized. The initial inquiry is whether the statute has substantially impaired the contractual rights of the parties. If a substantial impairment is shown, the second step of the test is to determine whether there is a significant and legitimate public purpose behind the legislation. Finally, if a legitimate public purpose is demonstrated, the court must determine whether the adjustment is based upon reasonable conditions and is of a character appropriate to the public purpose justifying the

[1]Article I, § 10, Cl. 1 of the United States Constitution provides that "[n]o State shall ... pass any ... Law impairing the Obligation of Contracts."

[2]The three-stepped test was developed in *Energy Reserves Group, Inc. v. Kansas*

legislation's adoption.

Although the majority opinion acknowledges that a three-step test exists for analyzing statutory impairment of contract claims, the majority side-steps the correct analysis at the first step of the test by consciously applying the wrong standard. The majority opinion quotes language from the opinion in *Shell*. *Shell* stated that a minimal contractual impairment does not rise to the level of "substantial" impairment, therefore "'[m]inimal alteration of contractual obligations may end the inquiry at its first stage.'" *Shell*, 181 W.Va. at 21, 380 S.E.2d at 188, quoting *Allied Structural Steel Co. v. Spannaus*, 438 U.S. 234, 245, 98 S.Ct. 2716, 2722-23, 57 L.Ed.2d 727, 737 (1978). With this partial statement of the law in hand, the majority concludes "that House Bill 4702 does not constitute a substantial impairment to the contractual obligation of the State. The investment is of a limited amount, for a limited time, and to be repaid at an interest rate essentially equal to the rate on other already authorized investments." (Slip Opinion, at 12.)

Power & Light Co., 459 U.S. 400, 103 S.Ct. 697, 74 L.Ed.2d 569 (1983).

If the legal analysis under consideration was as simplistic as the majority asserts, I would be compelled to conclude that the majority decision is correct. However, the analysis is not that simple.

Under contract impairment analysis "substantial" has two dichotomous meanings. The initial determination is not, as the majority opinion conveniently assumes, a mere application of the substantial impairment test. The initial inquiry is a determination of whose contract is impaired by the legislation. This inquiry dictates the proper meaning to be applied to "substantial." In fact, the United States Supreme Court has been adamant in holding that "impairments of a State's own contracts would face more stringent examination under the Contract Clause than would laws regulating contractual relationships between private parties." *Allied Structural*, 438 U.S. at 244 n.15, 98 S.Ct. at 2722 n.15, 57 L.Ed.2d. at 736 n. 15. Therefore, as correctly argued by the respondent and the amicus in this case, the threshold for establishing a "substantial" impairment when evaluating a government contract is lower than the threshold for establishing

a "substantial" impairment when evaluating contractual relationships between private parties.

In relying on the decision in *Shell*, the majority opinion did exactly what *Allied Structural* states is constitutionally *improper*. *Shell* involved legislation that was alleged to have impaired a contract between two private parties. Thus, in that decision "substantial" meant applying the standard with lesser analytical scrutiny. Whereas, in the instant case, the legislation at issue impairs a contract between the State and private parties. Therefore, the lesser analytical standard applied in *Shell* is constitutionally improper for application in this case. Unfortunately, the majority opinion applied *Shell's* lesser analytical standard to a case constitutionally required to have a heightened standard of analytical scrutiny. By using the wrong standard, it was quite easy for the majority to reach the wrong conclusion. However, when one applies the constitutionally proper meaning to "substantial" one is unequivocally lead to the conclusion that HB 4702 violates the contract impairment provision of the state and federal constitutions.

A.

HB 4702 Substantially Impairs the Contractual Rights of PERS Beneficiaries and Members

The initial inquiry is whether the statute has substantially impaired the contractual rights of the parties. The majority opinion concedes that "[t]here is no doubt that a contract exists between PERS members and beneficiaries and the State." (Slip Opinion, at 6.) The majority opinion also has concluded that HB 4702 does, in fact, impair the contract between the parties; but, that the impairment is not substantial. I disagree.

Affidavits were submitted on behalf of two eminently qualified actuaries, both of whom cautioned that the proposed withdrawal of $150,000,000 from PERS assets would cause a funding shortfall. The affidavit of actuary Thomas J. Cavanaugh provided succinctly:

> The transfer of funds contemplated by House Bill 4702 ... constitutes, in actuarial effect, a shortfall in the required contributions equal to the amount of any funds so transferred, because the

> transfer is not for investment purposes, but rather constitutes a diversion of fund assets to meet obligations other than those of the Retirement System. Any such transfer would ... render the System actuarially unsound.

The affidavit of actuary Scott L. Dennison stated the following:

> The term "actuarially sound" when used to describe a retirement system or plan may be best defined to mean that the operation of the retirement plan is being conducted and may reasonably be expected to continue to be conducted in such a manner that the fund's current assets, plus anticipated contributions and investment earnings, are expected to be sufficient to provide all benefit payments and expenses of the fund at all future points in time.... Under this definition of actuarial soundness, it is my opinion that with the passage of House Bill 4702 the West Virginia Public Retirement System has been rendered actuarially unsound.

Mr. Dennison's affidavit also exposed the critical flaw in the proposed rate of return on the money removed from PERS. The net result of this error is that no one knows the actual rate of return.[3]

[3]Mr. Dennison's affidavit stated the following:

Finally, it was clearly articulated by the respondent and amicus that the transfer of PERS assets in this instance will cause the exact same problem that resulted from the improper transfer of PERS assets in *Dadisman v. Moore*, 181 W.Va. 779, 384 S.E.2d 816 (1988). Presently, the improper funding and the improper transferring of pension funds in the *Dadisman* case is currently in litigation in federal court in the matter styled *State of*

> The Act requires "investment" WVPERS assets at a rate of return that is not well defined, since there are various ways to interpret "a rate equal to the annualized rate of return earned by the core fixed-income portfolio of the public employees retirement system over the previous five years." For example, the annual rate of return of WVPERS assets in fiscal 1995, determined with regard to the actual timing and amounts of contributions entering the trust fund and payments leaving it, was 12.93% on a market value basis, but only 6.62% on an amortized book value basis. Neither of these rates bear any simple relationship to rates of return for fiscal 1995 calculated by the investment board managing WVPERS assets during that year, since their method of calculation does not take into account the actual timing and amounts of contributions entering the trust fund and payments leaving the fund. There are thus several possible ways to determine an average rate of return over a five-year period, each suited to a particular purpose. However, the Act does not specify whether market value, book value, or amortized book value should be used, whether the timing of fund transactions should be considered in the calculations, or whether a weighted or simple average of the nominal yield of each security held during the period should be used for the calculation.

West Virginia v. United States Dep't of Health and Human Services, No. 2:97-0295 (S.D.W.Va.). The subsequent litigation involves a claim by the federal government that its contribution to PERS was improperly transferred for a use that was not permitted. That is the federal funds were to be used for PERS members and beneficiaries only. In the instant case it has been proffered without challenge, that the federal government will also challenge the transfer of its PERS contributions for use in building jails. It has been estimated that the diversion of funds in the instant case "would expose the State to a similar federal liability in the amount of $30 million." (Amicus Brief of the Attorney General, at 21.)

In view of the above evidence, the majority, using the incorrect standard for analyzing "substantial" impairment, concluded that there was no substantial impairment because "[t]he investment is of a limited amount, for a limited time, and to be repaid at an interest rate essentially equal to the rate on other already authorized investments." That conclusion by the majority is disingenuous. By utilizing the more stringent standard for "substantial" impairment that is required by *Allied Structural*, it is

patently obvious that no person or entity knows the actual rate of return that a funding shortfall will create from the transfer; that the transfer is actuarially unsound so as to threaten future beneficiaries; and that a minimum unfunded liability of $30 million will most likely be due the federal government. In the final analysis, I believe the overwhelming evidence clearly demonstrated HB 4702 substantially impaired the contract between the State and PERS members and beneficiaries.

B.

A Significant and Legitimate Public Purpose Supports HB 4702

Demonstrating that the legislation at issue in this case substantially impairs the contract under consideration does not end the inquiry. If a substantial impairment is shown, the second step of the test is to determine whether there is a significant and legitimate public purpose behind the legislation.[4] I need not delay in resolving this second step. The record shows without question that a significant and legitimate public

[4]The majority opinion never addressed the second step of the *Shell* test.

purpose motivated HB 4702. The legislation in this case is aimed at increasing the number of regional jails in the State. The increase in regional jails would help with overcrowding and questionable living conditions that currently plague our correctional system. I believe that these are significant and legitimate public purposes.

C.

HB 4702 Is Not Reasonable Legislation

Finding that a significant and legitimate purpose supports HB 4702 takes us to the third step of our test.[5] If a legitimate public purpose is demonstrated, the court must then determine whether the adjustment is based upon reasonable conditions and is of a character appropriate to the public purpose justifying the legislation's adoption. This third test is a reasonableness test. The United States Supreme Court discussed this test in *United States Trust Co. v. New Jersey*, 431 U.S. 1, 97 S.Ct. 1505, 52 L.Ed.2d 92 (1977):

[5]The majority opinion never addressed the third step of the *Shell* test.

> As with laws impairing the obligations of private contracts, an impairment may be constitutional if it is reasonable and necessary to serve an important public purpose. In applying this standard, however, complete deference to a legislative assessment of reasonableness ... is not appropriate because the State's self-interest is at stake. A governmental entity can always find a use for extra money, especially when taxes do not have to be raised. If a State could reduce its financial obligations whenever it wanted to spend the money for what it regarded as an important public purpose, the Contract Clause would provide no protection at all.

Id., 431 U.S. at 25-26, 97 S.Ct. at 1519, 52 L.Ed.2d at 112.

United States Trust clearly illustrates that courts are not to grant carte blanche deference to a legislative assessment of what is reasonable legislation. Reasonableness must filter through a more

stringent analysis. The stringency requirement was articulated in syllabus point 17 of *Dadisman.* In *Dadisman* the unanimous Court stated, in part, that "the test for reasonableness is whether the alteration to the pension scheme serves to keep the system sound and flexible." In view of *Dadisman,* I believe the amicus brief in this case is absolutely correct in stating that "[n]othing in the legislative history of the House Bill supports an inference that the proposed loan arose out of the need to maintain the flexibility or integrity of the pension plan; indeed, HB 4702 eliminates the trustees' flexibility to make prudent investments, and substantially impairs the actuarial integrity of the PERS." (Amicus Brief of the Attorney General, at 27.) All of the evidence in this matter shows that the legislature did not have the fiscal integrity of PERS assets in mind. In fact, the legislation took a route that is guaranteed to unsettle the financial well-being of PERS. Thus, I believe that HB 4702 is not based upon reasonable conditions and is not of a character appropriate to the public purpose justifying the legislation's adoption.

II.

CONCLUSION

In view of the foregoing, I believe HB 4702 violates the Contract Clause of both the state and federal constitutions. Therefore, I respectfully dissent.