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OFFICIAL OPINION 2003-3

Department of Local Government Finance
Beth Henkel, Commissioner
Indiana Government Center North
100 North Senate Avenue 1058(B)
Indianapolis, IN 46204

RE: School corporations unfunded retirement or severance liability

Dear Commissioner Henkel:

This advisory letter responds to your request for an opinion regarding the proper interpretation and construction of recent statutory amendments embodied in P.L. 253-2001 relating to the funding of school corporation retirement or severance plans. The following is our legal analysis of the statutory codification of this public law.

ANALYSIS

P.L. 253-2001 was adopted in response to concerns that many local school corporations are contractually obligated to pay severance and retirement benefits to their employees, and that such obligations are presently unfunded liabilities of the individual school corporations. The new law requires certain retirement or severance plans to be funded on an "actuarially sound basis". In addition, P.L. 253-2001 (as amended by H.E.A. 1088, 113th Gen. Assem., 1st Reg. Sess., 2003) authorizes a school corporation with unfunded liability to issue bonds for the purpose of reducing the unfunded liabilities, on a one-time basis, on or before December 31, 2004.

The requirement that funding be done on an "actuarially sound basis" is codified at Ind. Code §§ 20-5-64-1 and 20-5-64-2, which provide:

> Sec. 1. This chapter applies to a school corporation that:
> (1) after June 30, 2001, establishes a retirement or severance plan that will require the school corporation to pay post-retirement or severance benefits to employees of the school corporation; or

> (2) includes in a collective bargaining agreement or other contract entered into after June 30, 2001, any provisions to increase:
> (A) the benefit; or
> (B) the unfunded liability;
> under any retirement or severance provisions that will require the school corporation to pay post-retirement or severance benefits to employees of the school corporation.

IND. CODE § 20-5-64-1.

> Sec. 2. (a) A school corporation must fund on an actuarially sound basis the post-retirement or severance benefits that will be paid to employees under a plan, an agreement, or a contract described in section 1(1) of this chapter or an increase described in section 1(2) of this chapter.
> (b) A school corporation must place the assets used to fund on an actuarially sound basis the post-retirement or severance benefits in a separate fund or account, and the school corporation may not commingle the assets in the separate fund or account with any other assets of the school corporation.

IND. CODE § 20-5-64-2.

The authorization for a school corporation to issue bonds to reduce its existing unfunded contractual liability for retirement or severance payments has been codified at Ind. Code § 20-5-4-1.7, which defines "retirement or severance liability" for which bonds may be issued:

> (a) For purposes of this section, "retirement or severance liability" means the payments anticipated to be required to be made to employees of a school corporation upon or after the termination of their employment by the school corporation under an existing or previous employment agreement.
> (b) In addition to the purposes set forth in section 1 of this chapter, a school corporation may issue bonds to implement solutions to contractual retirement or severance liability . . . .
> . . . .

For purposes of our analysis we have assumed that the school corporation's retirement or severance plans are "governmental plans" as defined by the Employee Retirement Income Security Act ("ERISA"):

> The term "governmental plan" means a plan established or maintained for its employees by . . . the government of any State or political subdivision thereof, or by any agency or instrumentality of any of the foregoing.

29 U.S.C. § 1002(32). Pursuant to 29 U.S.C. § 1003(b)(1), governmental plans are exempt from ERISA and its detailed requirements relating to funded and unfunded liabilities.

Neither the Indiana Code nor the Indiana Administrative Code defines "unfunded liability." However, the INDIANA PENSION HANDBOOK (Indiana Legislative Services Agency, Office of Fiscal and Management Analysis, November 2002) defines "unfunded actuarial liability", at page 210, as

> [t]he unfunded actuarial liability (sometimes called the unfunded liability) of a retirement system at any time in the excess of its actuarial liability as [sic] that time over the value of its cash and investments.

This definition is consistent with the concept of "unfunded liability" used in other jurisdictions[1]. *See, e.g., Dombrowski v. City of Philadelphia*, 245 A.2d 238, 240 (Pa. 1968), ("the amount required to provide retirement benefits for employees covered by the system based upon their service prior to the current year," for which monies have not been previously set aside or appropriated.)

QUESTIONS

1. What factors should be considered in determining what is a change in a plan that would trigger the requirement that a benefit be funded on an actuarially sound basis?

Ind. Code § 20-5-64(1) requires that a retirement or severance plan "*established after June 30, 2001*" be funded on an actuarially sound basis. In this instance, the appropriate focus is on whether an existing plan is amended or whether a new plan is established. The Federal Circuit Court of Appeals and the U.S. Court of Federal Claims have recently addressed this issue in *LTV Steel Company, Inc. v. United States*, 215 F.3d 1275 (Fed. Cir. 2002), *on remand*, 89 A.F.T.R.2d 2002-2733 (Ct. Cl. 2002).

In 1986, LTV Corporation filed for Chapter 11 reorganization and terminated three pension plans having unfunded liabilities in excess of $2 billion. In 1987, LTV reached an agreement with the Steelworkers union pursuant to which LTV made payments to an Individual Account Trust ("IAT") [an unqualified plan under 26 U.S.C. § 401] that would fund the difference between what the Pension Benefit Guaranty Corporation ("PBGC") was paying beneficiaries under the terminated plans and what the beneficiaries would have received had the plans not been terminated. The ultimate issue became whether the benefits paid pursuant to the 1987 IATs were subject to FICA and

[1] The term is also defined at 29 U.S.C. § 1002 (29) and (30), but is more specifically tailored to ERISA's statutory scheme.

FUTA taxes, or whether the payments were made "in the case of an agreement in existence on March 24, 1983", in which case the payments would be tax exempt. The Court of Appeals analysis is particularly helpful:

> The 1987 agreements terminated the beneficiaries' rights under the pre-1983 agreements and replaced them with a new and significantly different set of rights under the IAT programs. . . . Amending an on-going plan, however, is quite different from terminating a plan and resuming the payment of benefits under a new and different plan. *Under ERISA, plans are frequently amended in response to statutory changes, economic conditions and agreements between the parties, and the parties are free to amend plans within broad statutory limits.*

215 F.3d at 1278, 1279 (emphasis added). We find this logic persuasive, and are of the opinion that amendments to plans in existence prior to June 30, 2001 do not necessarily result in the establishment of a "new" plan under Ind. Code § 20-5-64 (1).

However, if an existing plan is amended pursuant to a collective bargaining agreement or other contract after June 30, 2001 so that there is an increase in an existing benefit or a new benefit is added, then the increases must be funded on an actuarially sound basis.

2. Would provisions providing for payment of accumulated sick pay or severance or retirement or self-insured health care benefits for retirees constitute unfunded liabilities?

The specific collective bargaining agreement and the applicable retirement plan provide relating to the specific benefit must be analyzed on a case-by-case basis. If these are "payments anticipated to be required to be made to employees of a school corporation upon or after termination" of employment, then they are a "retirement or severance liability" defined in Ind. Code § 20-5-4-1.7(a). As a general proposition, it would seem that retirement benefits (which we assume are monthly cash benefits payable under TIRA), self-insured health care benefits (if the school corporation is required to make payments on behalf of the teacher for continuation of such coverage), and severance pay are each a "retirement or severance liability" under Ind. Code § 20-5-4-1.7(a). *See, e.g., Crawford County Community School Corporation v. Enlow*, 734 N.E.2d 685, 691 (Ind. Ct. App. 2000) holding that a teacher's "eligibility to receive a pension from the Indiana state teachers' retirement fund is a separate issue from his eligibility to receive severance pay under the 1993-1997 collective bargaining agreement" but concluding that under the applicable collective bargaining agreement, the teacher was entitled to severance pay upon his retirement from the school district.

Whether accumulated sick leave is a "retirement or severance liability" is more problematic. Several cases brought under ERISA have held, on a fact-specific basis, that

accrued sick leave is not an "employee benefit" but a "payroll practice" paid out of [the employer's] general assets. *See, e.g., McGraw v. FD Services, Inc.,* 811 F. Supp. 222 (D. S.C. 1993); *Abella v. W.A. Foote Memorial Hospital, Inc.*, 740 F.2d 4 (6th Cir. 1984). But, if a teacher is typically entitled to a cash payment for accumulated sick days upon retirement, then such payment would be a "retirement or severance liability" within the meaning of the statute.

3. If a school corporation has an existing retirement or severance plan as of June 30, 2001, and thereafter enters into a new contract that contains the same retirement or severance plan after June 30, 2001, but costs of the retirement or severance plan have increased, would the new contract be subject to the requirement that the unfunded liabilities be funded on an actuarially sound basis?

If the new collective bargaining agreement does not contain a provision that increases an existing benefit[2], or whose effect is not to increase the unfunded liability, then actuarially sound funding would not be required. An increase in the cost of providing a benefit (i.e., an increase in health insurance premiums) would not be considered an increase in the benefit itself. *Cf., Blue Cross of Massachusetts, Inc. v. Commissioner of Insurance*, 465 N.E.2d 252, 255-56 (Mass. 1984). However, any incremental increase in unfunded liability would be subject to the actuarially sound funding requirements.

4. Is continuation of an automatic escalator clause in a collective bargaining agreement or contract entered into after June 30, 2001 a "change in plan" triggering the requirement that such a liability be funded on an actuarially sound basis? For example, assume a contract sets sick pay based upon the pay for substitute teachers, which may increase over time, and also provides that a teacher, upon severance or retirement, is entitled to payment for accumulated sick days. If that provision were carried forward in a contract entered into after June 30, 2001, would this severance or retirement benefit have to be funded on an actuarially sound basis?

Funding on an actuarially sound basis is required when a collective bargaining agreement or other contract entered into after June 30, 2001 contains provisions for the increase of (A) a benefit, or (B) the unfunded liability, under any retirement or severance provisions of an existing plan. IND. CODE § 20-5-64-1(2). It is important to note that the statute is written in the disjunctive; either an increase in benefit, or an increase in unfunded liability will trigger the enhanced funding requirements. Furthermore, we cannot conceive of a collective bargaining agreement explicitly providing for an increase in unfunded liability, and interpret subsection (B) as meaning a provision the effect of which will increase unfunded liability under an existing plan.

[2] We define "benefit" in this situation as the beneficiary's contractual entitlement.

While the continuation of an automatic escalator clause in a new contract may not be an "increase in benefit", its effect may well be to increase unfunded liability. It is our interpretation that if the post-June 30, 2001 collective bargaining agreement results in a increase in the unfunded liability of an existing plan, that incremental increase would have to be funded on an actuarially sound basis.

5. Under what circumstances must an actuarial study by performed to determine whether a retirement or severance plan adopted after June 30, 2001, is actuarially sound?

The statute does not require an actuarial study; it simply mandates that a retirement or severance plan adopted after June 30, 2001 must be funded "on an actuarially-sound basis."[3] Thus, a defined contribution plan, which "provides for an individual account for each participant and for benefits based solely upon the amount contributed to the participants account," can never have an "insufficiency of funds in the plan to cover promised benefits . . . since each beneficiary is entitled to whatever assets are dedicated to his individual account." *Hughes Aircraft Company v. Jacobson*, 525 U.S. 432, 439 (1999) (internal citations omitted). Consequently, if a defined contribution plan is adopted after June 30, 2001, no actuarial study is needed because the plan is self-funding.

On the other hand, if a retirement plan adopted after June 30, 2001 is not self-funding, then an actuarial study or some other appropriate calculation must be made to ensure that that it is funded on an actuarially sound basis.

6. If a school corporation has an existing retirement or severance plan as of June 30, 2001, and thereafter enters into a new contract that converts all unfunded liabilities into a plan funded through defined contributions, must the school corporation perform an actuarial study?

No. As explained in response to Question 5, above, a defined contribution plan is, by definition, actuarially sound.

7. Some school corporations have an existing Social Security Bridge Program for retirees. Can representatives negotiate a transition to a Section 401(a) or 403(b) defined contribution account without funding the existing benefit in an actuarially sound manner, so long as the future unfunded liability will be less than it is currently?

A qualified pension plan meeting the statutory requirements of 26 U.S.C. § 401(a) or a qualified annuity plan under 26 U.S.C. § 403(b) are subject to ERISA's requirements relating to funded liabilities, and are actuarially sound by statutory definition. If there is

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[3] An "actuarially-sound system contains monies to pay future liabilities". *City of Natchitoches v. Williams*, 657 So.2d 320, 323 (La. App. 1995).

no unfunded liability under the new plan, and if the effect of the new plan does not increase pre-existing unfunded liability, then Ind. Code § 20-5-64-1 (2) is inapplicable. That code section imposes funding requirements only on liabilities arising after June 30, 2001; it does not address liabilities already existing at that date.

We trust that the foregoing responds to your questions.

Sincerely,

Stephen Carter
Attorney General

Susan Gard
Deputy Attorney General