

JENNER & BLOCK

Practice Series

Illinois Pension Law
Handbook

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INTRODUCTION

The funding issues facing Illinois' pension plans have received increasing attention and scrutiny over the last few years from the press, commentators, legislators and plan sponsors and participants. Various reform proposals have been advanced, and certain reforms have been enacted, including a reduction in benefits for new employees hired on or after January 1, 2011. The consensus, however, remains that more needs to be done to solidify the financial footing of many of Illinois' pension plans. In the first edition of this outline, we provide a detailed analysis of the various Illinois pension plans and their funding status. Our objective is to provide a framework to help advance the discussion within Illinois about the current condition of Illinois' pension plans.

In Section I, we provide an overview of the constitutional and statutory provisions governing the various Illinois pension plans. This analysis includes a discussion of: funding rules for government and employee contributions; benefit accrual rules; vesting and retirement age rules; cost of living adjustment rules; and how Illinois pension plans are governed and the fiduciary duties imposed on plan trustees. As part of our discussion of these issues, we provide a comparison of how Illinois' pension plans are structured and operated to how corporate pension plans are governed pursuant to the Employee Retirement Income Security Act of 1974 ("ERISA"). We believe it is instructive to look to the private sector to help identify the strengths and weaknesses of the Illinois pension plans and to identify potential areas for improvement.

In Section II, this outline identifies and discusses various reform proposals advanced by legislators and other civic organizations to help remedy the financial problems affecting Illinois' pension plans. As part of this discussion, where applicable, we provide examples of legislative reforms enacted in other states to remedy their pension problems.

In Section III, this outline discusses certain significant legal issues that often arise as part of the dialogue about how to remedy Illinois' pension funding situation. For example, whether the Pension Protection Clause in the Illinois Constitution permits a reduction in benefits for current employees. There is no definitive answer from the courts to most of these legal issues. In this outline, we do not advocate for or against any particular reform proposals or legal positions. Rather, we seek only to provide a balanced discussion of the different positions advanced in order to further the debate about how best to address the current problems.

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TABLE OF CONTENTS

- I. OVERVIEW OF ILLINOIS PENSIONS AND KEY PROVISIONS OF THE ILLINOIS PENSION CODE 1
 - A. CONSTITUTIONAL AND STATUTORY PROVISIONS GOVERNING ILLINOIS PENSION LAW 1
 - 1. The Illinois Pension Code 1
 - a. Article I 1
 - b. Provisions for Each Illinois Public Pension 1
 - c. Categories of Illinois Pensions 2
 - 2. The Pension Protection Clause of the Illinois Constitution 3
 - B. FINANCING ILLINOIS PENSIONS: FUNDING RULES FOR GOVERNMENT AND EMPLOYEE CONTRIBUTIONS 3
 - 1. Overview 3
 - 2. Elements of Pension Funding 3
 - 3. Summary of Basic Funding Rules 5
 - a. Illinois State Revenue 5
 - b. Local Property Taxes 5
 - c. Employee Contributions 5
 - 4. The Actuarial Basis of Illinois Pension Financing 6
 - 5. Historical Underfunding and Legislation to Increase Funded Ratios 7
 - a. Problems with Increased Funding 8
 - i. Increase Taxes 9
 - 6. Funding Procedure 9
 - a. Illinois State Pensions 9
 - b. Chicago Public Safety Pensions 9
 - c. Local Public Safety Pensions 9

7. ERISA Private Sector Rules: A Comparison of Funding Rules	10
C. BENEFIT ACCRUAL RULES	11
1. Benefit Accrual Rules Generally	11
2. Illinois Benefit Accrual Rules.....	12
3. Problems with Final Pay Rules and Spiking.....	13
4. Illinois Final Average Salary Rules and Spiking.....	13
a. Pension Reform.....	14
b. Creditable Service.....	14
5. Additional Challenges Posed by Benefit Accrual Rules.....	14
6. ERISA Private Sector Rules: Benefit Accruals	15
D. VESTING AND RETIREMENT AGE RULES.....	15
1. Overview.....	15
2. Pension Reform.....	15
3. ERISA Private Sector Rules: Vesting.....	17
E. COST OF LIVING ADJUSTMENT RULES.....	17
F. ILLINOIS PENSION GOVERNANCE	18
1. Introduction.....	18
a. Board of Trustees Composition	18
b. Responsibilities.....	18
c. Training.....	19
2. Additional Layers of Governance.....	19
a. Illinois State Board of Investment	19
b. Illinois Department of Insurance	19
3. Fiduciary Duties.....	20
a. Statutory Language in the Pension Code.....	20

b. Defining Fiduciary Duties: Pension Code Section 1-109	20
c. Judicial Interpretation of Fiduciary Duty Provisions of the Illinois Pension Code	21
d. Recent Legislation Altering Plan Governance and Fiduciary Rules	23
i. Substantive Provisions	23
ii. Heightened Penalties for Prohibited Transactions	23
iii. Expanded Rules Governing Consultants and Investment Managers	23
iv. Additional Reforms.....	24
II. ILLINOIS REFORM: PROPOSALS FOR ILLINOIS AND EXAMPLES FROM OTHER STATES.....	24
A. INTRODUCTION	24
B. THE SCOPE OF THE CRISIS	24
1. Funded Ratio	25
2. Demographic Problems.....	26
C. PROPOSALS TO STRENGTHEN ILLINOIS PENSION SOLVENCY	26
1. Reducing the Rate that Workers Accrue Pension Benefits.....	26
2. Increasing Retirement Age or Vesting Rules.....	28
3. Changing the Final Average Salary Formula.....	32
4. Increasing Employee Contributions.....	34
5. Increasing Employer Contributions	38
6. Actuarial Assumption Reforms.....	39
7. Reducing or Capping Cost of Living Adjustment Payments to Active Retirees	40
8. Preventing Public Sector Retirees from Simultaneously Drawing a Salary and Pension Benefits.....	43
a. Drawing Pension Benefits and Salary by Moving Across State Lines.....	44
9. Improving Pension Plan Governance and Oversight	45

10. Taxing Pension Payments	47
D. TRANSITION TO A NEW A NEW PUBLIC SECTOR RETIREMENT PARADIGM	47
1. Review of Other Retirement Plan Options	47
a. Portable Defined Contribution Plans	48
b. Cash Balance Plans and Hybrid Plans	48
2. Proposals to Transition Illinois to a New System.....	48
3. Reform Proposals and Examples From Other States	49
a. Defined Contribution Plans.....	49
b. Defined Contribution Option	51
c. Hybrid Plans.....	52
d. Cash Balance Plans	54
e. Private Sector Transition Away from a Defined Benefit Model	55
III. LEGAL ISSUES AFFECTING POTENTIAL REFORM PROPOSALS	57
A. THE PENSION PROTECTION CLAUSE IN THE ILLINOIS CONSTITUTION	58
B. WHETHER REDUCING BENEFITS FOR CURRENT EMPLOYEES IS CONSTITUTIONAL.....	59
1. Authority Holding That Reducing Benefits Is Constitutional	59
2. Authority Holding That Reducing Benefits Is Not Constitutional	62
3. Application of Contract Law	65
a. Employees Are Entitled to Increased Pension Benefits Once Their Rights Under New Legislation Vest.....	65
b. Vested Rights Can Only Be Modified if Both Parties Consent	66
c. Interfering with Vested Rights Under the Police Power.....	67
C. WHETHER THE ILLINOIS CONSTITUTION CAN BE AMENDED TO REDUCE BENEFITS TO CURRENT EMPLOYEES	68

D. WHETHER THE PENSION PROTECTION CLAUSE REQUIRES A CERTAIN LEVEL OF FUNDING70

1. The Illinois Supreme Court Has Consistently Held that the Pension Protection Clause Does Not Require a Certain Level or Method of Funding for Pension Programs70

2. The Drafters of the Pension Protection Clause Did Not Intend to Require a Certain Level of Funding for a Pension System71

APPENDIX 1. GLOSSARY OF TERMS A-1

APPENDIX 2 BIBLIOGRAPHY A-3

I. OVERVIEW OF ILLINOIS PENSIONS AND KEY PROVISIONS OF THE ILLINOIS PENSION CODE

The Illinois public pension system is a vast labyrinth. The system provides benefits to most Illinois public employees, ranging from the employees of the State of Illinois to the employees of the City of Chicago. The system includes both large pension plans funded with Illinois tax dollars that cover thousands of workers with billions of dollars in trust and modest municipal pension plans funded by local revenues that provide benefits to a small group of local firefighters or police. While each Illinois pension is unique, all public pensions are subject to the provisions of the Illinois Pension Code, 40 ILCS 5/1-5/24 (“Pension Code”). The Pension Code contains provisions that apply generally to all Illinois pensions such as those contained in 40 ILCS 5/1, along with provisions which apply separately to each of the numerous pensions established by Illinois law. To be clear, the Pension Code applies to every public pension in the State of Illinois.

This section discusses the structure of the Illinois pension system and the rules governing the benefits it provides to Illinois public sector employees. First, this section provides an overview of Illinois pension law and the overarching structure of Illinois pensions. This section then provides a detailed review of Illinois Pension Code rules governing funding, vesting and benefit accruals. This section also provides an overview of analogous provisions from ERISA, the statute that governs private sector pensions. Next, this section reviews both recent proposals to reform Illinois pensions and similar reform practices from other states. Finally, this section analyzes the constitutional basis of Illinois pension funding and the role that the Illinois Constitution plays in debates over pension reform.

A. CONSTITUTIONAL AND STATUTORY PROVISIONS GOVERNING ILLINOIS PENSION LAW

1. The Illinois Pension Code

a. Article I

The Pension Code consists of 24 separate articles. Article I provides general rules that govern all Illinois public pensions. For example, Article I establishes fiduciary standards, ethical guidelines for investing pension assets, rules for prohibited transactions, and limits on the types of investments that pension funds may purchase. Most of the remaining articles contain the provisions governing each separate Illinois pension.

b. Provisions for Each Illinois Public Pension

The Illinois Pension Code features separate provisions for each of eighteen different pension schemes. Two of these sections provide the basis for the hundreds of small local fire and police public safety pensions. The other sixteen sections of the Pension Code establish rules for individual Illinois State, Chicago, and downstate pension programs for public sector employees. Each individual provision provides different rules for subjects such as pension funding, employee contributions, pension governance via boards of trustees, along with standards for participant vesting and benefit accruals. While each pension has its own

specific and separate rules, all pensions are governed by the general provisions of Article I of the Pension Code.

c. Categories of Illinois Pensions

The Pension Code provides for five broad categories of public pensions. While the Pension Code has separate specific provisions for each pension, Illinois pensions are best understood as falling into these categories: (1) four separate Illinois State employee pensions, (2) eight Chicago and Cook County employee pensions, (3) three non-Chicago municipal employee pensions, (4) two teacher pensions, and (5) transit pensions. Each group shares similarities in geographic, worker, and funding profiles. For example, the State employee pension plans receive Illinois tax funding as the main source of financing. Similarly, the Chicago and Cook County pensions provide retirement benefits to workers employed by Chicago or Cook County municipal entities; all of these pensions rely heavily on property taxes for financing. Funding details are explored in more detail in subsequent sections of the outline.

Pension Plan	Pension Code Section
<i>State Employee Pension Plans</i>	
State Employees' Retirement System	40 ILCS 5/14
State Universities Retirement System	40 ILCS 5/15
Judges' Retirement System	40 ILCS 5/18
General Assembly Retirement System	40 ILCS 5/2
<i>Teacher Pensions</i>	
Illinois Teachers' Retirement System	40 ILCS 5/16
Chicago Public School Teachers' Pension	40 ILCS 5/17
<i>Chicago & Cook County Municipal Worker Pensions</i>	
Chicago Municipal Employees' Fund	40 ILCS 5/8
Chicago Laborers' Fund	40 ILCS 5/11
Park Employees' Fund	40 ILCS 5/12
Policemen's Annuity & Benefit Fund	40 ILCS 5/5
Firemen's Annuity & Benefit Fund	40 ILCS 5/6
Cook County Employees' Fund	40 ILCS 5/9
Water Reclamation District Fund	40 ILCS 5/13
Forest Preserve District Employees' Annuity & Benefit Fund	40 ILCS 5/10
<i>Non-Chicago Municipal Worker Funds</i>	
Municipal Police Pension Fund (local)	40 ILCS 5/3
Municipal Fire Pension Funds (local)	40 ILCS 5/4
Illinois Municipal Retirement Fund	40 ILCS 5/7
<i>Transit Pension Funds</i>	
Chicago Transit Authority	40 ILCS 5/22 div. 1

2. The Pension Protection Clause of the Illinois Constitution

The Illinois Constitution provides that “Membership in any pension or retirement system of the State, any unit of local government or school district, or any agency or instrumentality thereof, shall be an enforceable contractual relationship, the benefits of which shall not be diminished or impaired.” Ill. Const., art. XIII § 5. The clause became effective upon ratification of the Illinois Constitution in 1970.

B. FINANCING ILLINOIS PENSIONS: FUNDING RULES FOR GOVERNMENT AND EMPLOYEE CONTRIBUTIONS

1. Overview

This portion of the outline focuses on the funding rules for each Illinois public pension. At the end of the Illinois rules is an overview of the analogous ERISA private sector funding rules. The ERISA private sector pension funding rules provide an instructive and helpful contrast when analyzing Illinois pension funding problems.

2. Elements of Pension Funding

In Illinois, pension plans receive funding from varying sources that include employer contributions – made up of either State taxes or local property taxes depending on the pension – and employee payroll contributions. With most of the Illinois public pension plans suffering serious funding shortfalls, the Illinois legislature has used a number of strategies to address the budget gap. These include passing legislation to increase the employer contribution over time via funding ramps and other similar funding vehicles to increase the employer contribution. In addition to the employer and employee contributions, pension plans rely heavily on the growth of investments in the pension plan. The following chart provides a summary of the current funding status of each pension along with rules for funding.

Pension Plan	Pension Code Section	Funded Ratio (2010)	Employee Contribution (% Payroll)	Property Tax Multiplier	Employer Source of Funding
<i>State Employee Pension Plans</i>					
State Employees’ Retirement System	40 ILCS 5/14-131	37%	4.0%	--	<ul style="list-style-type: none"> • Illinois Tax Revenue • Employee Contributions
State Universities Retirement System	40 ILCS 5/15-155	42%	8.0%	--	
Judges’ Retirement System	40 ILCS 5/18-131	34%	11.0%	--	
General Assembly Retirement System	40 ILCS 5/2-124	26%	11.5%	--	

Pension Plan	Pension Code Section	Funded Ratio (2010)	Employee Contribution (% Payroll)	Property Tax Multiplier	Employer Source of Funding
<i>Teacher Pensions</i>					
Illinois Teachers' Retirement System	40 ILCS 5/16-158	48%	9.4%	--	<ul style="list-style-type: none"> • Illinois Tax Revenue • Property Taxes (Chicago Teachers) • Employee Contributions
Chicago Public School Teachers' Pension	40 ILCS 5/17-127	67%	9.0%	--	
<i>Chicago & Cook County Municipal Worker Pensions</i>					
Chicago Municipal Employees' Fund	40 ILCS 5/8-173	49%	8.5%	1.25	<ul style="list-style-type: none"> • Property Taxes and Other Local Revenue Sources • Employee Contributions
Chicago Laborers' Fund	40 ILCS 5/11-169	75%	8.5%	1.0	
Park Employees Fund	40 ILCS 5/12-149	62%	9.0%	1.1	
Policemen's Annuity & Benefit Fund	40 ILCS 5/5-168	36%	9.0%	2.0	
Firemen's Annuity & Benefit Fund	40 ILCS 5/6-165	36% (2009)	9.125%	2.26	
Cook County Employees' Fund	40 ILCS 5/9-169	60%	8.5%	1.54	
Water Reclamation District Fund	40 ILCS 5/13-503	56%	9.0%	2.19	
Forest Preserve District Employees' Annuity & Benefit Fund	40 ILCS 5/10-107	65%	8.5%	1.3	
<i>Non-Chicago Municipal Worker Funds</i>					
Municipal Police Pension Fund (local)	40 ILCS 5/3-125	--	9.91%		<ul style="list-style-type: none"> • Property Taxes • Employee Contributions • Local Taxes for the IMRF
Municipal Fire Pension Funds (local)	40 ILCS 5/4-118	--	8.5%		
Illinois Municipal Retirement Fund ("IMRF")	40 ILCS 5/7-171-172	83%	4.5%		
<i>Transit Pension Funds</i>					
Chicago Transit Authority	40 ILCS 5/22 div. 1	74%	6.0%		<ul style="list-style-type: none"> • Transit Revenue • Employee Contributions

3. Summary of Basic Funding Rules

a. Illinois State Revenue

Six pension funds rely on Illinois State revenue as their primary funding source. These pensions include the two teacher pension funds, the State Employees and State Universities funds, and the General Assembly and Judges' Retirement funds. As discussed in more detail below, the State has traditionally failed to adequately fund its contribution to these pensions. Accordingly, the Illinois legislature has passed legislation requiring the State to increase its annual pension contribution such that these pensions will be 90% funded by the middle of the century. *See* 40 ILCS 5/14-131(e). The Pension Code requires that this portion be measured by actuarial principles. *Id.* In addition, the CTA pension fund receives its funding from the Chicago Transit Authority, which in turn receives funding from system-generated revenue, along with transfers from the State of Illinois. 40 ILCS 5/22-101(e).

b. Local Property Taxes

The Chicago, Cook County, and downstate municipal and public safety funds receive funding primarily from local property taxes. The Pension Code provides that each municipal entity may levy taxes on property within its district to raise funds for its pension contribution. In addition to raising money from property taxes, the City may also fund its obligations from any other legally available source, "including, but not limited to, the proceeds of city borrowing." *See, e.g.,* 40 ILCS 5/11-169(f). For the Chicago and Cook County pension plans, the Pension Code requires these entities to fund based on a ratio sometimes referred to as a "tax multiplier." The formula stated in the Pension Code requires the employer to pay a certain amount of employee payroll contributions from two years prior. For example, for the Municipal Employees' Annuity and Benefit Fund, the City of Chicago uses a multiplier of 1.25 times the rate of employee contributions from two years prior to determine its annual contribution. 40 ILCS 5/8-173. Using 2010 as an example, the City is required to pay \$1.25 for every dollar that a City employee contributed via payroll deduction in 2008. For actuarial purposes, the Chicago Municipal Fund pension board has noted in its 2009 Annual Report that to fully fund the City's pension obligations, the Illinois legislature needs to raise the City's contribution ratio to 3.76. The Illinois Municipal Retirement Fund and the two downstate public safety pensions do not use tax multipliers to measure the employer contribution. As of 2015, the Chicago police and fire pensions will no longer use tax multipliers. These two pensions will receive funding from the City based on an amount that, under actuarial estimates, will be sufficient to bring the pensions to a 90% funded ratio by 2040.

c. Employee Contributions

Illinois public workers contribute varying amounts of their annual salaries to fund their pensions, ranging from 4% of salary for employees in the State Employee Retirement System to roughly 9% of salary for members of the Chicago fire and police pension systems. In some cases, unions have won the right to have the State "pick-up" the Pension Code's statutory employee contribution. While each pension provides specific pick-up provisions,

the amount that the State picks up varies based on each pension, and within each pension, based on individual collective bargaining agreements with different public sector unions.

4. The Actuarial Basis of Illinois Pension Financing

Actuarial principles play two key roles in Illinois pension funding. First, all Illinois pension funds use actuarial principles to measure their funding status. The Government Accounting Standards Board (GASB) established a method for valuing pension finances called the actuarially required contribution (ARC). All Illinois pension plans use one of two variants of the ARC – either the projected credit unit method or the entry age method – as the yardstick to measure pension finances.¹ Second, some Illinois pensions require that the employer base its contribution on actuarial principles. For example, the four Illinois State pension funds require the State of Illinois to contribute an amount, as measured by an actuary, sufficient to bring each pension to a 90% funding status by 2045. Other pensions, such as the two pensions covering teachers, along with the four public safety pensions, require employers to fund pensions sufficiently under actuarial principles that they will reach 90% funding status at some point in the middle of this century. The 90% funding goal is not consistent with ARC, which sets forth a 100% funding goal. Notably, with the exception of its fire and police pensions, none of the Chicago or Cook County pensions are required under the Pension Code to fund based on actuarial principles. As discussed above, the Chicago and Cook County pensions only pay a percentage of employee contributions from two years prior. This contribution is not based on actuarial principles. The following chart summarizes the role of actuarial principles in Illinois pension funding.

100% Funding (ARC)	Actuarially Based 90% Funding Goal	Funding Not Actuarially Based (Tax Multiplier)
<ul style="list-style-type: none"> • Illinois Municipal Retirement Fund 	<ul style="list-style-type: none"> • State Employees • State Universities • Teachers' Retirement System • General Assembly • Judges • Local Police • Local Fire • Chicago Police • Chicago Fire • Chicago Teachers • CTA 	<ul style="list-style-type: none"> • Chicago Municipal Workers • Chicago Laborers • Cook County Municipal Workers • Forest Preserve • Park Employees • Municipal Water

¹ *Pension Fund Actuarially Required Contributions (ARC): A Civic Federation Issue Brief*, (The Civic Fed., Chicago, Il) Feb. 14, 2007, at 4.

5. Historical Underfunding and Legislation to Increase Funded Ratios

Prior to 1995, the Illinois legislature had not fully funded the State’s pension obligations that it was required to fund with Illinois revenue. For many years the State’s contributions were not subject to actuarial assumptions, thus the legislature could simply pass budgets with appropriations for pension contributions at levels that it could afford.² For the five State pensions, the legislature contributed amounts on a reimbursement basis, meaning that its annual contribution reimbursed each pension for benefits that were being paid out to current retirees, without taking into account the cost of benefits accruing to current workers.³ In addition, the State’s pension contribution was subject to the annual appropriations process – meaning that the legislature funded pensions in line with what it could afford rather than providing funding that matched the annual cost of benefits that public workers had accrued.

With pension funding subject to the regular State appropriations process, the legislature routinely did not sufficiently fund the employer portion of its pensions.⁴ By 1995, the legislature recognized the depth of the funding crisis and acted by passing Public Act 88-593, colloquially referred to as “the funding ramp” or the “pension ramp.” The funding ramp requires the State to provide money to the four State employee pension plans and the Teachers’ Retirement System sufficient to bring each pension to a 90% funded level by 2045. The legislation calls for the State to contribute (1) the normal cost of its pension liabilities for the year, along with (2) an additional amount, amortized over a fifty year period, such that the pension will reach a 90% funded ratio by 2045. In addition, the legislation requires the State to contribute a smaller portion of this “additional amount” in early years (from 1996-2010). *See* 40 ILCS 5/15-155 (funding ramp standards for the State Universities Retirement System). Each year, the State’s additional contribution increases, hence the name “funding ramp.” As of 2011, Illinois pension law requires the State to provide a level additional contribution such that each State pension is 90% funded by 2045. Recently, Illinois passed legislation to bring other pension plans to a 90% funded ratio. The Pension Code requires these plans to provide a level annual additional contribution (beyond the regular contribution) to reach this funding target. The following chart illustrates which pension funds are subject to 90% funding targets.

Pension Plan	Pension Code Section	Target Date for 90% Funding	Pension Ramp or Level Contribution
State Employees’ Retirement System	40 ILCS 5/14-131(e)	2045	Pension Ramp
State Universities Retirement System	40 ILCS 5/15-155(a-1)	2045	Pension Ramp

² For a discussion of the history of Illinois State pension underfunding, *see* Dan W. Hynes, *Illinois State Pensions Continue to Put Pressure on the State Budget*, Fiscal Focus Magazine, a Publication of the Illinois State Comptroller, at 1 (January/February 2007).

³ *See* Associated Press, *History of Illinois State Pension System Woes*, Northwest Indiana Times, May 25, 2008; *see also* State Universities Retirement System, Annual Financial Report for 2010, at 83 (Dec. 13, 2010).

⁴ *See id.*

Pension Plan	Pension Code Section	Target Date for 90% Funding	Pension Ramp or Level Contribution
General Assembly Retirement System	40 ILCS 5/2-124(c)	2045	Pension Ramp
Judges' Retirement System	40 ILCS 5/18-131(c)	2045	Pension Ramp
Teachers' Retirement System	40 ILCS 5/16-159(b-3)	2045	Pension Ramp
Chicago Teachers' Pension Plan	40 ILCS 5/17-129(b)(iv)	2059	Level Annual Contribution
Chicago Fire Pension Fund	40 ILCS 5/6-165(a)	2040	Level Annual Contribution
Chicago Police Pension Fund	40 ILCS 5/5-168(a)	2040	Level Annual Contribution
Municipal Police Pension	40 ILCS 5/3-125(a)	2040	Level Annual Contribution
Municipal Fire Pension	40 ILCS 5/4-118(a)	2040	Level Annual Contribution

a. Problems with Increased Funding

Despite the legislature requiring the State to fund its pensions sufficiently under actuarial standards, problems persist. Since the pension ramp requires the State to slowly increase its annual contribution between 1996-2010, pension contributions began to crowd out State spending in other areas.⁵ As a result, rather than fully funding its pension obligations from the State treasury, the State issued pension obligation bonds and legislated what are colloquially referred to as “pension holidays.” The following table details the State’s use of debt financing over the past decade.

Year	Amount	Maturity	Interest Rate
2003-2004	\$7.3 billion	30 years	3.45%
2010	\$3.46 billion	5 years	3.854%
2011	\$3.7 billion	7 years	4.026%

In addition, in 2006 and 2007, the State passed a pension holiday to reduce its contribution to four State pensions. Specifically, rather than fully funding its contribution under the 1995 pension ramp legislation, the State amended the Pension Code to provide a reduced contribution to these four pensions. *See, e.g.,* 40 ILCS 5/15-155(a-1). The legislature recognized that it would sacrifice funding to other programs if it fully funded its pension obligations.

⁵ *See* Hal Weitzman & Nicole Bullock, *America: States of Distress*, Financial Times, Aug. 8, 2010, for a discussion of the role that increased pension contributions play in crowding out other spending. The State’s increased pension contributions come from the same general revenue sources that the State uses to fund education, infrastructure, and Illinois social spending. *Id.*

i. Increase Taxes

In addition, Illinois public entities have considered tax increases to address funding shortfalls. On January 11, 2011, the Illinois legislature raised the corporate and individual income tax rates in part to raise funds to pay for Illinois pensions. For the City pensions, which taxpayers fund largely through local property taxes, the City may need to increase property taxes in 2015 as the December 2010 pension reforms require the City to contribute a much larger share each year to fund the four City pension plans. It is estimated that Chicago will need to raise an additional \$550 million each year from property taxes to meet the new formula that the Illinois legislature imposed on the City.⁶

6. Funding Procedure

a. Illinois State Pensions

As discussed above, for many years, Illinois State pensions—the State Universities Retirement System (the “SURS”), the State Employees’ Retirement System (the “SERS”), the Judges Retirement System and the General Assembly Retirement System—were subject to the legislature’s general budgeting process. Along with legislation requiring the State to fund each of these pensions at a 90% level by 2045, the legislature required the board of trustees of each pension to “certify” the amount of the State contribution under actuarial standards. *See* 40 ILCS 5/15-165. Rather than leaving the State’s contribution subject to the annual legislative budgeting process, this provision requires the Illinois comptroller to pay a certified amount that a pension plan’s board of trustees submits to the State. *Id.*

b. Chicago Public Safety Pensions

Additionally, under new legislation, the Chicago and local police and fire funds are now subject to similar funding requirements. Specifically, under Public Act 96-1495, Chicago must fund both the normal cost of its pensions, the amount of which is to be determined by an actuary, along with an additional amount sufficient to fund the pension at a 90% level by 2040. 40 ILCS 5/168. This legislation further dictates that should the City or individual municipal entity fail to provide a sufficient annual contribution, the State will withhold its annual transfers of grant money to Chicago or the municipality. *See, e.g.,* 40 ILCS 5/5-168(a-7).

c. Local Public Safety Pensions

Like the City public safety pensions, the municipalities sponsoring local fire and police pensions must now fund these pensions under actuarial assumptions. Specifically, under Public Act 96-1945, each local public employer must provide both the normal cost of its pension along with an additional contribution sufficient to bring each pension to a 90% funded level by 2040. This legislation requires that the actuary be an enrolled actuary or certified by the Illinois State Board of Insurance. 40 ILCS 5/4-118.

⁶ John Byrne, *Police, firefighters would pay more pension costs under Daley administration proposal*, Chi. Trib., Jan. 28, 2011.

7. ERISA Private Sector Rules: A Comparison of Funding Rules

ERISA is instructive in its approach to funding pension benefits. ERISA requires that employers provide adequate funding for defined benefit plans. After a series of high-profile plan failures, Congress imposed stricter minimum funding requirements for defined benefit plans under the Pension Protection Act of 2006 (“PPA”). A comparison of ERISA’s defined benefit funding scheme with Illinois’ inconsistent public sector pension funding rules provides further insight into the nature of Illinois’ pension funding crisis.

Prior to 2007, these actuarial rules provided employers with more latitude in funding their pension obligations. With the PPA, Congress revised funding standards with the aim of ending employer underfunding.

The PPA simplified the actuarial assumptions that employers must use to fund defined benefit plans. Prior to the PPA, these rules gave employers significantly more discretion in valuing assets and liabilities, frequently resulting in employers underfunding their defined benefit plans.

Under the PPA, Congress requires defined benefit plans to fully fund future liabilities within seven years. Accordingly, each year, an employer must (1) fully fund the present value of benefits for the plan year and (2) pay into the plan a “shortfall amortization charge” when the plan is underfunded. Employers pay this charge over the span of seven years until the employer fully funds (100%) its defined benefit pension obligation. While Illinois pensions are subject to a similar ramp-up requiring government entities to fully fund their pensions by mid-century, the Illinois legislature has repeatedly granted exceptions to these ramp-up funding obligations.

Any plan which, under the new actuarial rules, is less than 80% funded is considered “at-risk” and subject to accelerated funding rules. These rules bar a plan sponsor from engaging in a number of activities. Most importantly, the plan sponsor may not increase benefits while the plan is considered at-risk, or less than 80% funded. 26 U.S.C. § 436. The plan sponsor is also restricted from engaging in certain activities such as paying out lump sum benefits or amending the plan to increase benefits to plan participants. *Id.* At 60% funding, ERISA provides that participants in the plan may no longer accrue benefits. Notably, under these funding standards, almost all Illinois pensions would fall into the at-risk category under federal private sector pension rules.

ERISA further provides for a system of defined benefit pension termination insurance. Specifically, Congress created the Pension Benefit Guaranty Corporation (“PBGC”) within the Department of Labor in order to provide basic protections for defined benefit plan beneficiaries. The PBGC receives insurance premiums from qualified defined benefit plans along with the assets of terminated plans. When a defined benefit plan fails, the PBGC provides limited benefits to workers who would have normally received a benefit under their employer’s plan. 29 U.S.C. § 4007. In contrast, Illinois pensions have no similar mechanism of pension insurance to provide reduced benefits for beneficiaries if a public pension plan fails.

C. BENEFIT ACCRUAL RULES

1. Benefit Accrual Rules Generally

Defined benefit pension plans provide workers with a rate at which each participant accrues benefits on a periodic basis. A benefit accrual rate, also called a benefit multiplier, is a percentage of an employee’s benefit accrued on an annual or other periodic schedule that he or she will receive on retirement. For example, if a plan provides that a participant accrues a benefit at a rate of 2% each year, after twenty years of service that participant will have accrued a benefit that is equal to 40% of that participant’s final average compensation. This final percentage is typically multiplied by the participant’s final average salary to determine that participant’s final retirement benefit. Public pensions often place an upper limit on the total percentage of benefit that a participant may accrue. The formula described here – using a participant’s benefit accrual rate, final average salary, and length of service – is similar in formula to public sector defined benefit pension plans in other states. The following table illustrates how a hypothetical State Employees’ Retirement System retiree would calculate his or her benefit based on a 1.67% annual accrual rate.

Table 2. Hypothetical Retiree Benefit: State Employees’ Retirement System	
Assumptions:	
<u>Years of Service:</u> 30	
<u>Annual Benefit Accrual Rate:</u> 1.67%	
<u>Final Ten Years of Salary:</u>	
Year 1. \$65,000	Year 6. \$ 95,000
Year 2. \$70,000	Year 7. \$100,000
Year 3. \$75,000	Year 8. \$105,000
Year 4. \$80,000	Year 9. \$120,000
Year 5. \$90,000	Year 10. \$125,000
Final Average Compensation (highest 4 consecutive years of final 10): \$112,500	
Accrued Benefit. 1.67% * 30 years = 50.1%	
Accrued Benefit	50.1%
<u>Final Avg. Comp.</u>	<u>\$112,500</u>
Annual Benefit:	\$ 56,362

2. Illinois Benefit Accrual Rules

The Illinois Pension Code provides for a regulatory scheme governing the way that workers accrue pension benefits over the course of a career. Each Illinois pension provides for different benefit accrual rules. These rules feature two basic components: (1) the percentage of pension benefit that a worker accrues per unit of service and (2) the final average pay rules, which take into account a worker's final years of compensation to calculate a worker's pension benefit. *See, e.g.*, 40 ILCS 5/14-108(b) (benefit accrual rules for the State Employees' Retirement System). In Illinois, almost all pensions use the same final average salary rules for current employees; that is, each pension uses the highest consecutive four years of pay out of a worker's final ten years of employment. In addition, each pension limits a worker's benefit accrual rate to a certain percentage of final average salary for this calculation. The following chart shows the annual rate at which workers accrue benefits under each pension. The annual benefit accrual percentages remain unchanged even for new workers entering the system. For certain pensions, such as the State Employees' Retirement System and the Illinois Municipal Retirement System, benefits are coordinated with Social Security. Participants in these plans contribute to Social Security and accordingly accrue benefits at a lower rate.⁷

Pension	Pension Code Section	Current Accrual Rate	Maximum Percent of Final Salary
State Employees' Retirement System	40 ILCS 5/14-108	1.67% (contribute to Social Security)	80%
State Universities Retirement System	40 ILCS 5/15-106	Years 1-10: 1.67% Years 11-20: 1.9% Years 21-30: 2.1% Years 30+: 2.3%	80%
Teachers' Retirement System	40 ILCS 5/16-133	2.2%	75%
General Assembly Retirement System	40 ILCS 5/2-119.01	Years 1-4: 3.0% Years 5-6: 3.5% Years 7-8: 4.0% Years 9-12: 4.5% Years 12+: 5.0%	80%
Judges' Retirement System	40 ILCS 5/18-125	Years 1-10: 3.5% Years 10+: 5.0%	85%
Illinois Municipal Retirement System	40 ILCS 5/7-142	Years 1-15: 1.67% Years 16-30: 2.0% (contribute to Social Security)	75%

⁷ See Judy Baar Topinka, 'Tier Two' Brings Change in State Pension Plans, Fiscal Focus Magazine, a Publication of the Illinois State Comptroller, at 6 (May 2007).

Pension	Pension Code Section	Current Accrual Rate	Maximum Percent of Final Salary
Municipal Police Fund	40 ILCS 5/3-111	2.50%	75%
Municipal Fire Fund	40 ILCS 5/4-109	2.50%	75%
Chicago Police Fund	40 ILCS 5/5-132	2.50%	75%
Chicago Fire Fund	40 ILCS 5/6-128	2.50%	75%
Chicago Municipal Worker' Fund	40 ILCS 5/8-138	2.40%	80%
Chicago Teachers' Pension Fund	40 ILCS 5/114.2	2.20%	75%
Cook County Municipal Workers' Fund	40 ILCS 5/9-134	2.40%	75%
Forest Preserve Fund	40 ILCS 5	2.40%	75%
Chicago Laborers' Fund	40 ILCS 5/11-134	2.40%	80%
Park Employees' Fund	40 ILCS 512-133	2.40%	75%
Metropolitan Water Reclamation District Fund	40 ILCS 5/13-302	Years 1-20: 2.20% Years 20+ 2.40%	80%
CTA Pension Fund	40 ILCS 5/22-101	2.15%	--

3. Problems with Final Pay Rules and Spiking

Depending on a state's rules, public sector employees may take steps to manipulate final average salary in a practice called "spiking." These practices arise when employees engage in tactics to artificially raise their salaries during the final average pay window. Where a pension plan permits it, employees may work excessive overtime, stockpile unused vacation time, or receive illusory promotions or discretionary bonuses during that worker's final years as a way to inflate final average pay.

4. Illinois Final Average Salary Rules and Spiking

In Illinois, current workers and beneficiaries will receive benefits based on a final average salary calculation that considers the participant's highest four consecutive years of pay for his or her final ten years of work. While pension spiking has not been a widespread problem in Illinois, recently the *Chicago Tribune* investigated pension spiking abuses in the Illinois Municipal Retirement Fund. Specifically, local government officials used end of

career raises, vacation cash-outs, bonuses, and perks such as car allowances to raise their final average salary.⁸

a. Pension Reform

In April and December 2010, the Illinois legislature enacted pension reforms that change final average compensation rules for workers that the State or a municipal entity hires after January 1, 2011 under Public Act 96-0889. Under the 2010 pension reform legislation Illinois changed its final average compensation formula from the highest four consecutive years to the highest eight consecutive years of compensation of a participant’s final ten years of employment. This rule applies to all Illinois public pensions, including the public safety pensions. In addition, for purposes of calculating a participant’s final average salary, the legislature limits a worker’s maximum annual pay to \$106,800. It is expected these changes will work to eliminate spiking for new employees.

Final Average Pay Comparison	
Pre-2011 Final Average Pay	Post-2011 Final Average Pay
Highest <u>four</u> years of a worker’s final ten years of service	Highest <u>eight</u> years of a worker’s final ten years of service

b. Creditable Service

A year of service is considered “creditable service” under the Pension Code for purposes of calculating an employee’s pension. Each pension has technical rules defining what constitutes creditable service. For example, certain pensions permit employees to credit unused sick leave and vacation days toward months of creditable service for calculating final pension payments. In addition, the Pension Code provides guidelines for whether a worker may use military leave, disability leave and other types of leave when calculating his or her accrued benefit. *See* 40 ILCS 5/14-105.1 (service rules for the SERS).

5. Additional Challenges Posed by Benefit Accrual Rules

Public sector employers frequently use benefit accrual rates to increase employee compensation without increasing worker pay. For example, a public sector employer may reason that raising benefit accrual rates by a tenth-of-a-percent is more affordable than providing a segment of workers with a pay raise. Governments regularly fail to fund this additional benefit when providing such increases, further exacerbating unfunded pension liabilities. Across an entire workforce, the effect of even a quarter-percent increase quickly adds up. Assuming a workforce of 20,000 employees eligible for the same annual pension (all of them having 20 years of service with the state and final average salaries of \$50,000), the difference between a two percent and a two-and-a-quarter percent benefit accrual rate is \$50 million dollars a year. Accordingly, even a slight decrease in benefit accrual rates can result in millions of dollars in savings. Illinois pensions have been subject to a similar

⁸ Joseph Ryan & Joe Mahr, *Retirement Perks Cost Town Millions*, Chi. Trib., Sept. 17, 2010.

upward trend. For example, the legislature raised benefit accrual rates in the Teachers' Retirement System in 1998 from 1.67% to 2.2%. *See* 40 ILCS 5/16-133. Other Illinois pensions have been subject to a similar increase in benefit accrual rates.⁹

6. ERISA Private Sector Rules: Benefit Accruals

Unlike Illinois pensions, ERISA does not mandate a particular percentage for benefit accruals. Employers establishing defined benefit plans have some latitude in providing plan guidelines for benefit accruals. ERISA is primarily concerned with preventing backloading, or allowing benefits to accrue disproportionately at the end of a participant's career. Benefit accrual guidelines govern the amount of a participant's benefit that a plan permits a worker to accrue each year. When studying Illinois pension law, the ERISA backloading rules do not necessarily provide a meaningful point of comparison. ERISA's concerns with preventing backloading are designed to prevent senior executives from receiving a disproportionate share of pension benefits. In contrast, Illinois pensions do not have anti-backloading rules, and indeed, concerns about backloaded benefits do not feature prominently in the Illinois pension funding debate.

Under ERISA, an employer may establish a tax qualified defined benefit pension plan so long as it satisfies one of three tests. These three tests are designed to prevent a plan sponsor from excessively backloading benefits. The three tests – the three percent method, the 133 1/3% rule, and the fractional rules – all require actuarial testing to ensure compliance.

D. VESTING AND RETIREMENT AGE RULES

1. Overview

Public and private sector pensions typically establish both age and vesting rules. Age rules establish a minimum age at which a participant may begin to draw retirement benefits. Vesting rules set forth the number of years that a participant must work before his or her benefits become non-forfeitable. In Illinois, the Pension Code provides unique age and vesting requirements for each public pension. Under the Illinois pension reform legislation from 2010, these rules differ significantly based on whether the employee was hired before or after January 1, 2011. Illinois public pensions typically feature a longer vesting schedule than those in the private sector. While ERISA allows private sector plan sponsors to impose up to a seven year vesting schedule, Illinois pension participants generally do not qualify for retirement benefits until completing between eight and ten years of service.

2. Pension Reform

Illinois workers hired by a public employer after January 1, 2011, are subject to new age and service rules. Among the most significant changes of the 2010 pension reform

⁹ *See, e.g.*, 40 ILCS 5/5-132 (increasing the benefit accrual rate for the Chicago police pension from 2.0% to 2.5%), 40 ILCS 5/9-134 (increasing benefit accrual rates from a graduated system based on years of service to a flat 2.40%).

legislation, these rules raise the retirement age to 67 for full pension benefits and 62 for a reduced benefit. In addition, the new rules provide a standard ten year vesting schedule. *See* 40 ILCS 5/1-160 (age and vesting rules that apply to plan participants hired after January 1, 2011). The legislature also amended the Pension Code to raise the retirement age for all Illinois police and fire pension plans. For public safety pensions, the Pension Code provides for a normal retirement age of 55 with ten years of service, and an early retirement age of 50 with ten years of service. Both the new and old age and vesting rules are summarized in the chart below.

Pension	Pension Code Section	Age and Vesting Rules (Pre-2011 hires)	Age and Vesting Rules (Post-2011 hires)
State Employees' Retirement System	40 ILCS 5/14-108	<ul style="list-style-type: none"> • 60 with 8 years of service • Any age with 35 years of service • Any age where years of service plus age equals the number 85 	<ul style="list-style-type: none"> • 67 with 10 years of service • 62 with 10 years of service for a reduced benefit
State Universities Retirement System	40 ILCS 5/15-136	<ul style="list-style-type: none"> • Any age with 30 years of service • 55 with 8 years of service • 62 with 5 years of service 	<ul style="list-style-type: none"> • 67 with 10 years of service • 62 with 10 years of service for a reduced benefit
Teachers' Retirement System	40 ILCS 5/16-133	<ul style="list-style-type: none"> • 62 with 5 years of service • 60 with 10 years of service • 55 with 20 years of service • 55 with 35 years of service (full annuity) 	<ul style="list-style-type: none"> • 67 with 10 years of service • 62 with 10 years of service for a reduced benefit
General Assembly Retirement System	40 ILCS 5/2-119	<ul style="list-style-type: none"> • 62 with 4 years of service • 55 with 8 years of service 	<ul style="list-style-type: none"> • 67 with 10 years of service • 62 with 10 years of service for a reduced benefit
Judges' Retirement System	40 ILCS 5/18-125	<ul style="list-style-type: none"> • 60 with 10 years of service • 62 with 6 years of service 	<ul style="list-style-type: none"> • 67 with 10 years of service • 62 with 10 years of service for a reduced benefit
Illinois Municipal Retirement System	40 ILCS 5/7-142	<ul style="list-style-type: none"> • 60 with 8 years of service • 55 with 35 years of service 	<ul style="list-style-type: none"> • 67 with 10 years of service • 62 with 10 years of service for a reduced benefit
Municipal Police Fund	40 ILCS 5/3-111	<ul style="list-style-type: none"> • 55 with 10 years of service • 50 with 20 years of service 	<ul style="list-style-type: none"> • 55 with ten years of service • 50 with ten years of service (reduced benefit)
Municipal Fire Fund	40 ILCS 5/4-109	<ul style="list-style-type: none"> • 55 with 10 years of service • 50 with 20 years of service 	<ul style="list-style-type: none"> • 55 with ten years of service • 50 with ten years of service (reduced benefit)
Chicago Police Fund	40 ILCS 5/5-167.1, 5-238	<ul style="list-style-type: none"> • 50 with 20 years of service 	<ul style="list-style-type: none"> • 55 with ten years of service • 50 with ten years of service (reduced benefit)
Chicago Fire Fund	40 ILCS 5/6-128.2, 6-229	<ul style="list-style-type: none"> • 50 with 20 years of service (reduced pension for fewer than 20, but more than 10 years of service) 	<ul style="list-style-type: none"> • 55 with ten years of service • 50 with ten years of service (reduced benefit)
Chicago Municipal Workers' Fund	40 ILCS 5/8-131-133	<ul style="list-style-type: none"> • 60 with 10 years of service • 55 with 20 years of service • 50 with 30 years of service 	<ul style="list-style-type: none"> • 67 with 10 years of service • 62 with 10 years of service for a reduced benefit

Pension	Pension Code Section	Age and Vesting Rules (Pre-2011 hires)	Age and Vesting Rules (Post-2011 hires)
Chicago Laborers' Fund	40 ILCS 5/11-128-130	<ul style="list-style-type: none"> • 60 with 10 years of service • 55 with 20 years of service • 50 with 30 years of service 	<ul style="list-style-type: none"> • 67 with 10 years of service • 62 with 10 years of service for a reduced benefit
Chicago Teachers' Pension Fund	40 ILCS 5/17-116	<ul style="list-style-type: none"> • 62 with 5 years of service • 60 with 20 years of service • 55 with 34 years of service 	<ul style="list-style-type: none"> • 67 with 10 years of service • 62 with 10 years of service for a reduced benefit
Cook County Municipal Workers Fund	40 ILCS 5/9-126-128	<ul style="list-style-type: none"> • 60 with 10 years of service 	<ul style="list-style-type: none"> • 67 with 10 years of service • 62 with 10 years of service for a reduced benefit
Forest Preserve Fund	40 ILCS 5/9-126-128	<ul style="list-style-type: none"> • 60 with 10 years of service 	<ul style="list-style-type: none"> • 67 with 10 years of service • 62 with 10 years of service for a reduced benefit
Park Employees' Fund	40 ILCS 5/12-130	<ul style="list-style-type: none"> • 60 with 10 years of service 	<ul style="list-style-type: none"> • 67 with 10 years of service • 62 with 10 years of service for a reduced benefit
Metropolitan Water Reclamation District Fund	40 ILCS 5/13-301	<ul style="list-style-type: none"> • 60 with 10 years of service • 62 with 5 years of service 	<ul style="list-style-type: none"> • 67 with 10 years of service • 62 with 10 years of service for a reduced benefit
Chicago Transit Authority	40 ILCS 5/22-101(a)	<ul style="list-style-type: none"> • 65 with 10 years of service 	—

3. ERISA Private Sector Rules: Vesting

ERISA provides that employee contributions are immediately fully vested. Employer contributions, however, need not vest immediately. Employers may therefore use vesting rules as a tool to retain workers for longer periods of time. In comparison, plan participants in Illinois pensions often do not see their interests vest for close to ten years.

For defined benefit plans, the employer may impose either “cliff” or “graded” vesting schedules. ERISA allows employers to withhold vesting under a five year cliff schedule where no portion of an employer’s contributions are vested for the first five years. Upon five years of service, that participant’s interest is then fully vested. Similarly, ERISA provides that employers may use a seven year graded schedule where employer contributions slowly vest in increasing percentages over a seven year period. The employer may also use any vesting schedule that is more generous than these two. In comparison, Illinois pensions always vest a participant’s employer portion under a cliff schedule, usually after between five and ten years of service. New rules require workers to stay at their jobs for ten years for their benefits to vest.

E. COST OF LIVING ADJUSTMENT RULES

Illinois public pensions provide annual cost of living adjustments (“COLA”) for active retirees. With the exception of the two Chicago public safety pensions, Illinois pension rules provide similar COLA benefits regardless of the pension plan. Original COLA

rules, with the exception of the public safety pensions,¹⁰ provide for an annual 3% automatic increase. COLA rules for new hires provide for the lesser of 3% or one-half of the increase in the consumer price index. For workers hired before January 1, 2011, the pension plan calculates annual COLA increases based on the current value of the participant’s retirement benefit (compound interest); under the new rules the pension plan calculates COLA based on the participant’s original retirement benefit (simple interest). The table below compares new and old COLA rules.

Rules for Employees Hired Before Jan. 1, 2011	Rules for Employees Hired After Jan. 1, 2011
Automatic 3% each year, compound interest	Lesser of 3% or one-half of the consumer price index, simple interest

F. ILLINOIS PENSION GOVERNANCE

1. Introduction

For each public sector pension plan, the Illinois Pension Code establishes a board of trustees that is tasked with managing the pension plan investments and overseeing the general administration of each pension fund.

a. Board of Trustees Composition

As a general rule, each pension fund’s board of trustees is composed of employees, retirees, and senior public sector officials. For pensions covering Illinois State workers, board members include gubernatorial appointees, current employees, retirees, and State officials. *See, e.g.*, 40 ILCS 5/14-134. Chicago and Cook County pensions have a similar board composition; for example, the Municipal Employees Retirement Fund has a five-member board made up of three employees, the City comptroller and the City treasurer. *See* 40 ILCS 5/8-192. As a general rule, each pension board is composed of employees, retirees, and senior public sector officials.

b. Responsibilities

The Pension Code imposes a variety of responsibilities on public pension boards, namely to manage the assets in the pension fund, to oversee plan administration, and to hire actuaries to certify the amount of the State’s contribution to the pension plan. The local fire and police pension boards are further required to evaluate disability applications. For the four Illinois State pensions, the Pension Code requires its trustees to certify the amount that the State of Illinois must contribute to the pension. These responsibilities are discussed in more detail above in the funding section.

¹⁰ Chicago fire and police pension participants hired before January 1, 2011 received 1.5% COLA increases based on a compound interest formula. *See* 40 ILCS 5/167.1. The December 2010 pension reform bill harmonized the COLA formula with other Illinois pensions. *Id.*

c. Training

All Illinois pension trustees must attend eight hours of ethics training. In addition, those who act as trustees to one of the hundreds of local police and fire pensions are required, under the Pension Code, to attend 32 hours of trustee training. This training broadly covers topics such as fiduciary duties, ethics, accounting, and administering pension claims. 40 ILCS 5/1-109.3.

2. Additional Layers of Governance

a. Illinois State Board of Investment

In addition to the board of trustees assigned to each pension, the Pension Code established the Illinois State Board of Investment. The Illinois State Board of Investment oversees the investments in three of the four State funded pensions: the State Employees’ Retirement System, the Judges’ Retirement System, and the General Assembly Retirement System. *See* 40 ILCS 5/22A. Each of these pensions still maintains its own individual board of trustees that is charged with overseeing pension administration and other matters. These three boards do not get involved with managing pension assets and investments. The Illinois State Board of Investment does not have authority over the State Universities Retirement System.

b. Illinois Department of Insurance

The Pension Code creates a Public Pension Division in the Illinois Department of Insurance. This department is tasked with managing the hundreds of local pensions for local fire and police workers established under Article III and Article IV of the Pension Code. This division promulgates rules and oversees the activities of each municipal police and fire pension system. *See* 40 ILCS 5/1A-101. For example, the Pension Code provides that the public pension division may examine and investigate these local pension funds with the power of subpoena. This division also provides advice to the local pension funds in administering their individual pension plans.

The following chart illustrates the additional layers of pension governance for certain pension plans governed by the Pension Code. All Illinois pensions are governed by a board of trustees; however, the following chart shows where pensions are subject to an additional layer of governance.

Illinois Department of Insurance	Illinois State Board of Investment
<ul style="list-style-type: none"> • Police Pension Fund: Municipalities 500,000 and Under • Firefighters’ Pension Fund: Municipalities 500,000 and Under 	<ul style="list-style-type: none"> • State Employees’ Retirement System • Judges Retirement System • General Assembly Retirement System

3. Fiduciary Duties

The Pension Code imposes fiduciary duties upon individuals who take certain actions with respect to the investment of public pension funds or the administration of the pension fund. In addition to the individuals described in the Pension Code, fiduciary duties are generally imposed on investment advisors, managers and consultants to the various pension funds. 40 ILCS 5/1-113.14.

a. Statutory Language in the Pension Code

Section 1-101.2 of the Illinois Pension Code defines when a person holds the position of a fiduciary with respect to a public pension fund or system. Under this section, a person is a fiduciary to the extent that the person:

- (1) Exercises any discretionary authority or discretionary control respecting management of the pension fund or retirement system, or exercises authority or control respecting management or disposition of its assets;
- (2) Renders investment advice or renders advice on the selection of fiduciaries for a fee or other compensation, direct or indirect, with respect to any moneys or other property of the pension fund or retirement system, or has any authority or responsibility to do so; or
- (3) Has any discretionary authority or discretionary responsibility in the administration of the pension fund or retirement system.

40 ILCS 5/1-101.2.

b. Defining Fiduciary Duties: Pension Code Section 1-109

Section 1-109 of the Illinois Pension Code defines the duties of fiduciaries as follows:

A fiduciary with respect to a retirement system or pension fund established under this Code shall discharge his or her duties with respect to the retirement system or pension fund solely in the interest of the participants and beneficiaries and:

- (a) For the exclusive purpose of:
 - (1) Providing benefits to participants and their beneficiaries; and

(2) Defraying reasonable expenses of administering the retirement system or pension fund;

(b) With the care, skill, prudence and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character with like aims;

(c) By diversifying the investments of the retirement system or pension fund so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so; and

(d) In accordance with the provisions of the Article of the Pension Code governing the retirement system or pension fund.

40 ILCS 5/1-109.

c. Judicial Interpretation of Fiduciary Duty Provisions of the Illinois Pension Code

A limited number of court decisions and other legal authority have attempted to define the duties a fiduciary owes to pension plan participants under the Illinois Pension Code. In doing so, the opinions have relied on ERISA, federal case law construing ERISA, and the common law of trusts. Below is a summary of why and in what context the Illinois courts and Illinois Attorneys General have used these authorities for guidance.

- ***Bd. of Trustees of Vill. of Barrington Police Pension Fund v. Dept. of Ins., 570 N.E.2d 622 (Ill. App. Ct. 1991).*** Section 1-109(a) of the Illinois Pension Code requires a fiduciary to discharge his or her duties for the exclusive purpose of providing benefits to participants and defraying reasonable expenses of administering the retirement system and pension fund. The Illinois Appellate Court for the First District stated that this provision is “essentially a codification of common law trust principles.” *Id.* at 627. According to the principles of established trust law, “a trustee must act honestly and with undivided loyalty to his trust.” *Id.* (internal quotations and citation omitted). Under Illinois law, a trustee is a fiduciary and must serve the interest of the beneficiary excluding self-interest. A trustee must not deal with trust property for his individual benefit. *Id.* In determining whether the fiduciary’s transaction was prudent under the Illinois Pension Code, the court looked to the common law rule of trusts. *Id.* at 628.

Subsection (b) requires a fiduciary to discharge his duties with the care, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of a similar enterprise. The Court regarding this subsection referred exclusively to

ERISA case law for guidance, stating “that given the lack of Illinois case law construing the relevant portions of the Pension Code, we look for guidance to analogous provisions of [ERISA] and the federal case law construing ERISA.” *Id.* at 626. The language requiring fiduciaries to invest with prudence is found in both the Illinois Pension Code and ERISA. In evaluating a fiduciary’s compliance under ERISA, a court must inquire “whether the individual trustees, at the time they engaged in the challenged transactions, employed the appropriate methods to investigate the merits of the investment and to structure the investment.” *Id.* (internal quotations and citation omitted). Citing to a Ninth Circuit opinion, the court determined that a “fiduciary’s independent investigation of the merits of a particular investment is at the heart of the prudent person standard.” *Id.* (internal quotations and citation omitted). The court then applied this standard formulated under ERISA to fiduciaries of Illinois public pension funds.

- ***Marconi v. Chicago Heights Police Pension Bd.*, 870 N.E.2d 273 (Ill. 2006).** In determining the extent of the fiduciary duty owed to plan participant, the court relied on the Illinois Pension Code and *Bd. of Trustees of Vill. of Barrington Police Pension Fund*. The court in this case pointed out that the Board owes a duty to all pension system participants, not just the plaintiff in this particular case. In carrying out such a duty, the Board must screen and reject unqualified or fraudulent disability claims so funds are not unfairly diverted.
- **1982 Op. Atty. Gen. No. 82-059, 1982 WL 42809.** This is a letter from the Attorney General to the Chairman of the Illinois State Board of Investment. The Chairman inquired whether the Board members of the Ill. State Board of Investment are fiduciaries; the Attorney General, relying solely on the Illinois Pension Code, determined that they are. The Attorney General noted that in the Senate debate on Senate Bill 1579, the amendments on the duties regarding a co-fiduciary’s breach were originally intended to bring the Illinois provisions more in line with ERISA, which contains broad provisions for the protection of employee benefits and provides a statutory basis for liability for breach of a co-fiduciary. *Id.* at *4. Thus, if pension board members insist on making an investment that is obviously not prudent, the Pension Code requires the other members use reasonable care to prevent the others from breaching their fiduciary duties. *Id.* at *5.
- **1996 Op. Atty. Gen. No. 96-030, 1996 WL 734136.** This is a letter to the Director of the Department of Insurance. In interpreting the Illinois Pension Code, the Attorney General analyzed ERISA and federal appellate case law interpreting the provisions of ERISA. The Attorney General particularly focused on the issue of what constitutes self-dealing and the prudent man standard. Using federal Courts of Appeals opinions as a guide, the Attorney General concluded that while the Illinois Pension Code should not be construed to permit self-dealing, it does permit people to serve as trustees who might, under traditional fiduciary rules, be seen as having some divided loyalties. *Id.* at *5.

As the Illinois Appellate Court noted in *Barrington Police Pension Fund*, there is a lack of Illinois case law interpreting the provisions of the Illinois Pension Code. Thus, both the Attorney General Opinions and Illinois court opinions referenced above have turned to ERISA and the common law of trusts for guidance. In doing so, these legal authorities have kept in mind the distinctive factor of ERISA—particularly, that the Illinois Pension Code only applies to public pension funds whereas ERISA regulates only private employee funds. 1996 Op. Atty. Gen. No. 96-030, 1996 WL 734136, at *2.

d. Recent Legislation Altering Plan Governance and Fiduciary Rules

In recent years, numerous scandals arose in Illinois relating to the conduct of trustees and other fiduciaries overseeing the investment of certain Illinois pension funds. For example, Stuart Levine, a trustee for the Teachers' Retirement System, was indicted and later pled guilty to seeking kickbacks from investment firms to steer pension funds to their firms.¹¹ In 2009, in the wake of these ethical scandals involving Illinois pension boards, the legislature passed an ethics reform bill which both strengthened rules governing transactions involving Illinois pension funds and overhauled the composition of public pension boards.

i. Substantive Provisions

These Pension Code amendments reaffirmed pension board members' fiduciary obligations, banned gifts to board members from those doing business with the pension, and expanded penalties for engaging in fraudulent activity. *See* 40 ILCS 5/1-125-150.

ii. Heightened Penalties for Prohibited Transactions

In amending the Pension Code, the legislature imposed penalties including fines and suspensions of those who engage in prohibited transactions. The Pension Code's prohibited transaction rules generally bar fiduciaries from buying, exchanging or lending plan assets without adequate consideration, or engaging in transactions in which the fiduciary has a personal financial interest.¹² These reforms additionally prevent placement agents from receiving contingent fees for steering Illinois public pension assets toward their firms. 40 ILCS 5/1-130-145.

iii. Expanded Rules Governing Consultants and Investment Managers

The legislature further expanded rules governing consultants and those tasked with managing pension assets. Previously, the Pension Code did not require those providing

¹¹ Matt O'Connor, *Pension Kickback Alleged*, Chi. Trib., Aug. 4, 2005; *see also* Mike Robinson, *Blagojevich Campaign Donor Pleads Guilty*, Wash. Post, Oct. 27, 2006.

¹² Article I of the Pension Code details fiduciary rules and prohibited transactions. These rules, for example, bar a fiduciary from transacting business on behalf of the pension plan for less than adequate consideration and further prevent certain transactions in which the fiduciary has a personal interest. *See* 40 ILCS 5/1-110 for a complete list of prohibited transactions.

advice or asset management services to pension funds to have any specific qualifications. The new rules require that consultants, advisors and investment managers meet the definition of “investment advisor” as defined under SEC rules. 40 ILCS 5/1-113.4. Under the SEC’s 1940 Act, an investment adviser must register with the SEC, pass certain minimum competency examinations, and provide ongoing disclosures to the public and federal and state securities agencies. *See* 50 U.S.C. § 80b-3a.

iv. Additional Reforms

The legislature further altered the Pension Code to limit gifts to pension board members, to strengthen the definition of a fiduciary in the context of public pension plans, to expand the prohibited transaction rules, and to encourage pension funds to invest assets with minority, disability, and women-owned investment managers. 40 ILCS 5/1-130-145.

II. ILLINOIS REFORM: PROPOSALS FOR ILLINOIS AND EXAMPLES FROM OTHER STATES

A. INTRODUCTION

There is consensus among organizations from across the Illinois political spectrum that the Illinois pension system faces a serious funding crisis. Every organization that has addressed the issue—ranging from labor unions whose workers constitute the bulk of State pension beneficiaries to business interests like the Commercial Club of Chicago—recognize that Illinois legislators must make difficult decisions to address the crisis. A few key facts demonstrate the depth of the crisis. As of 2010, pensions covering Chicago police, fire, and municipal employees were less than 50% funded. For the same period, pensions covering Illinois State and university workers faced a similar 50% funding shortfall with an estimated 85 billion dollars in unfunded liabilities.¹³ One organization notes that in order to fully fund the State’s pensions, each Illinois citizen would have to pay \$25,000 to overcome the funding shortfall, a calculation that places Illinois at the bottom of all fifty states in pension solvency.¹⁴ The problem affects every Illinois citizen, from Illinois employees who contribute to the system, to the individual taxpayers who may shoulder the burden of increased State income and property taxes to make up for the funding shortfall.

B. THE SCOPE OF THE CRISIS

Before discussing potential reforms proposed by various parties interested in Illinois pension reform, it is worth reviewing the scale of the Illinois pension funding problem. One key indicator of the health of a defined benefit plan is a funded ratio, or the ratio of pension assets to liabilities.

¹³ Doug Finke, *Illinois House Leaders Mum on Pension Reform Talks*, Rockford Register Star, August 14, 2011.

¹⁴ The Civic Committee of the Commercial Club of Chicago, *Illinois is Broke Campaign, Among the Worst in the Nation* (2011), <http://illinoisisbroke.com/facts.aspx>.

1. Funded Ratio

Every Illinois pension faces serious funding shortfalls. In the private sector, for example, federal pension rules require corporations to fund defined benefit pension plans at a 100% level. When private sector pension funding levels fall below an 80% funded ratio, federal rules deem the pension at-risk of failure and require plan sponsors to take immediate steps to return the pension to solvency. Notably, as of 2010, almost no Illinois public pensions have a funded ratio above 80%. While some of the pensions are funded above the 50% level, some such as the State Employees' Retirement System, the State Universities System, and the Chicago fire and police pensions are below 50%. Data for the funding ratios below come from each pension's 2010 annual report unless otherwise noted.

Chicago and Cook County Pensions	Assets	Liabilities	Funded Ratio (2010)
Chicago Fire	\$1.27 billion	\$3.5 billion	36% (2009)
Chicago Police	\$3.7 billion	\$9.4 billion	36%
Chicago Municipal Workers	\$6 billion	\$12 billion	49%
Chicago Laborers	\$1.5 billion	\$2 billion	75%
Water Reclamation District	\$1.1 billion	\$2 billion	56%
Cook County Workers	\$7.9 billion	\$13.1 billion	60%
Chicago Transit Authority	\$1.9 billion	\$2.6 billion	75%
Chicago Teachers	\$10.9 billion	\$16.3 billion	67% (2009)
Park District	\$518 million	\$833 million	62%
Forest Preserve	\$184 million	\$282 million	65%
CTA	\$1.9 billion	\$2.6 billion	75%

Illinois State Employee Pensions, Municipal Pensions, and Teachers Retirement System	Assets	Liabilities	Funded Ratio (2010)
State Employees	\$10.9 billion	\$29 billion	37%
State Universities Retirement System	\$14 billion	\$33 billion	42%
General Assembly	\$66 million	\$251 million	26%
Judges' Retirement System	\$619	\$1.8 billion	34%

Illinois State Employee Pensions, Municipal Pensions, and Teachers Retirement System	Assets	Liabilities	Funded Ratio (2010)
	million		
Illinois Municipal Retirement Fund	\$24 billion	\$29 billion	83%
Teachers' Retirement System	\$37 billion	\$77 billion	48%

2. Demographic Problems

In many cases, these pensions face the dual threats of both insufficient funding and an aging worker population. For example, a February 2011 report by the Civic Federation illustrated this problem for the four Chicago worker pensions. In 2000, there were 1.64 workers for each pension participant actively drawing benefits.¹⁵ That worker-to-retiree ratio fell to 1.26 in 2010. These numbers are especially important in the context of the Illinois pension crisis, where current worker contributions are key to keeping the pension trusts solvent for current participants as more workers begin to draw pensions.

C. PROPOSALS TO STRENGTHEN ILLINOIS PENSION SOLVENCY

The following sections discuss various reform proposals to improve Illinois pension solvency. The first set of proposals involves altering various elements of the Pension Code such as benefit accrual rates and retirement age. The second part reviews proposals that either reduce or eliminate the public sector defined benefit pension system in Illinois in lieu of a different plan design.

1. Reducing the Rate that Workers Accrue Pension Benefits

One potential remedy is to reduce the current rates at which Illinois public sector employees accrue pension benefits on an annual basis. The chart below provides a summary of the current benefit accrual rates for each Illinois public pension fund.

Pension	Current Accrual Rate
State Employees' Retirement System	1.67%
State Universities Retirement System	Years 1-10: 1.67% Years 11-20: 1.90% Years 21-30: 2.10% Years 30+: 2.30%
Teachers' Retirement System	2.2%

¹⁵ *Status of Local Pension Funding Fiscal Year 2009, An Evaluation of Ten Local Government Employee Pension Funds in Cook County*, (The Civic Fed., Chicago, Il), Feb. 10, 2011, at 31.

Pension	Current Accrual Rate
General Assembly Retirement System	Years 1-4: 3.0% Years 5-6: 3.5% Years 7-8: 4.0% Years 9-12: 4.5% Years 12+: 5.0%
Judges' Retirement System	Years 1-10: 3.5% Years 10+: 5.0%
Illinois Municipal Retirement System	Years 1-15: 1.67% Years 16-30: 2.0%
Municipal Police Fund	2.50%
Municipal Fire Fund	2.50%
Chicago Police Fund	2.50%
Chicago Fire Fund	2.50%
Chicago Municipal Workers' Fund	2.40%
Chicago Teachers' Pension Fund	2.20%
Cook County Municipal Workers' Fund	2.40%
Forest Preserve Fund	2.40%
Park Employees' Fund	2.40%
Municipal Water Reclamation District Fund	Years 1-20: 2.20% Years 20+: 2.40%

According to the Public Plans Database, a data set consisting of 126 state and local pension plans compiled by the Center for Retirement Research at Boston College, the most common benefit accrual rate in 2009 was 2%. The lowest rate benefit accrual rate was 0.8% for the Maryland Public Employees Retirement System, and the highest rate was 3.0% for the New Mexico Public Employees Retirement Fund.¹⁶ In comparison, for Illinois plans where workers do not contribute to Social Security, workers typically accrue benefits at a rate of 2.4% each year, placing Illinois at the upper end of the spectrum.

Changing a pension's annual accrual rate is a powerful tool to shore up a pension's finances. As an illustration, by reducing a pension's annual accrual rate from 2% to 1%, the legislature could reduce participant's retirement benefit by 50% upon that participant's retirement.

Certain groups have proposed reducing the benefit accrual rate for both future and current hires. For example, the Civic Committee of the Commercial Club of Chicago¹⁷ has suggested reducing the accrual rate for City public safety workers – both current and future –

¹⁶ *Public Plans Database*, The Center for Retirement Research at Boston College (March 14, 2011), <http://nianticsystems.com/pls/htmlldb/f?p=PPD:14:8109209113390449::NO:RP:PA14:2000>.

¹⁷ Author Craig C. Martin is a member of the Commercial Club of Chicago.

from 2.5% to 2% per year.¹⁸ Also, the Illinois Municipal League, an organization that advocates on behalf of the interests of Illinois local government, has suggested changes to benefit accrual rates for the non-Chicago public safety pensions. To strengthen the solvency of local police and firefighter pensions, the Illinois Municipal League has proposed reducing the benefit accrual rate for these pensions from 2.5% to 2.4% for the first 20 years of service.¹⁹ After 20 years of service, public safety workers would see their benefit accrual rates fall to 1.9% each year, then 1% after 30 years of service.

Other states have taken these steps, including:

- **Pennsylvania.** Pennsylvania made a substantial change in 2010 that only affects new employees. Specifically, the State lowered its benefit accrual rate from 2.5% to 2% unless the employee is willing to increase his or her contribution by 3-4%. Act 120 of 2010 (HB 2497).
- **Louisiana.** In 2010, Louisiana reviewed benefit accrual rates throughout its pension system. Certain non-hazardous duty employees were receiving a higher benefit accrual rate than some of its employees in hazardous duty occupations. Going forward, regular State employees will accrue benefits at a rate of 2.5% each year while those working in hazardous duty occupations will accrue benefits at a rate of 3.33% for each year of service. Act 992 of 2010 (HB 1337).
- **Kentucky.** In 2008 Kentucky restructured benefit accrual rates for its public sector employees. The benefit accrual rate of 1.97% was replaced with a sliding benefit accrual rate, where workers accrue pension benefits at a rate of 1.1% for ten years of service or less. This rate gradually increases to 2% for workers with 30 years of service. Similarly, the Kentucky legislature replaced the flat 2.5% benefit accrual rate for workers in hazardous duty professions with a similar sliding scale. These hazardous duty workers with less than ten years of service accrue pension benefits at a rate of 1.3% for their first ten years of service. This accrual rate increases to 2.5% for 25 years of service or more. HB 1 of the 2008 Special Session.

2. Increasing Retirement Age or Vesting Rules

Increasing retirement age and vesting rules provides another opportunity to solve the pension funding crisis. Illinois recently took steps to raise the age and vesting rules for most of its public pensions. The following chart summarizes the current Illinois age and vesting rules.

¹⁸ *Chicago's Underfunded Pension Plans, A Report to the Commercial Club of Chicago*, (Civic Committee of the Commercial Club of Chicago), April 2010, at 24.

¹⁹ *Presentation to the Illinois House Subcommittee on Pensions*, (Illinois Municipal League), September 21, 2010, at 5.

Pension	Pension Code Section	Age and Vesting Rules (Pre-2011 hires)	Age and Vesting Rules (Post-2011 hires)
State Employees' Retirement System	40 ILCS 5/14-108	<ul style="list-style-type: none"> • 60 with 8 years of service • Any age with 35 years of service • Any age where years of service plus age equals the number 85 	<ul style="list-style-type: none"> • 67 with 10 years of service • 62 with 10 years of service for a reduced benefit
State Universities Retirement System	40 ILCS 5/15-136	<ul style="list-style-type: none"> • Any age with 30 years of service • 55 with 8 years of service • 62 with 5 years of service 	<ul style="list-style-type: none"> • 67 with 10 years of service • 62 with 10 years of service for a reduced benefit
Teachers' Retirement System	40 ILCS 5/16-133	<ul style="list-style-type: none"> • 62 with 5 years of service • 60 with 10 years of service • 55 with 20 years of service • 55 with 35 years of service (full annuity) 	<ul style="list-style-type: none"> • 67 with 10 years of service • 62 with 10 years of service for a reduced benefit
General Assembly Retirement System	40 ILCS 5/2-119	<ul style="list-style-type: none"> • 62 with 4 years of service • 55 with 8 years of service 	<ul style="list-style-type: none"> • 67 with 10 years of service • 62 with 10 years of service for a reduced benefit
Judges' Retirement System	40 ILCS 5/18-125	<ul style="list-style-type: none"> • 60 with 10 years of service • 62 with 6 years of service 	<ul style="list-style-type: none"> • 67 with 10 years of service • 62 with 10 years of service for a reduced benefit
Illinois Municipal Retirement System	40 ILCS 5/7-142	<ul style="list-style-type: none"> • 60 with 8 years of service • 55 with 35 years of service 	<ul style="list-style-type: none"> • 67 with 10 years of service • 62 with 10 years of service for a reduced benefit
Municipal Police Fund	40 ILCS 5/3-111	<ul style="list-style-type: none"> • 55 with 10 years of service • 50 with 20 years of service 	<ul style="list-style-type: none"> • 55 with ten years of service • 50 with ten years of service (reduced benefit)
Municipal Fire Fund	40 ILCS 5/4-109	<ul style="list-style-type: none"> • 55 with 10 years of service • 50 with 20 years of service 	<ul style="list-style-type: none"> • 55 with ten years of service • 50 with ten years of service (reduced benefit)

Pension	Pension Code Section	Age and Vesting Rules (Pre-2011 hires)	Age and Vesting Rules (Post-2011 hires)
Chicago Police Fund	40 ILCS 5/5-167.1, 5-238	<ul style="list-style-type: none"> • 50 with 20 years of service 	<ul style="list-style-type: none"> • 55 with ten years of service • 50 with ten years of service (reduced benefit)
Chicago Fire Fund	40 ILCS 5/6-128.2, 6-229	<ul style="list-style-type: none"> • 50 with 20 years of service (reduced pension for fewer than 20, but more than 10 years of service) 	<ul style="list-style-type: none"> • 55 with ten years of service • 50 with ten years of service (reduced benefit)
Chicago Municipal Workers Fund	40 ILCS 5/8-131-133	<ul style="list-style-type: none"> • 60 with 10 years of service • 55 with 20 years of service • 50 with 30 years of service 	<ul style="list-style-type: none"> • 67 with 10 years of service • 62 with 10 years of service for a reduced benefit
Chicago Laborers' Fund	40 ILCS 5/11-128-130	<ul style="list-style-type: none"> • 60 with 10 years of service • 55 with 20 years of service • 50 with 30 years of service 	<ul style="list-style-type: none"> • 67 with 10 years of service • 62 with 10 years of service for a reduced benefit
Chicago Teachers' Pension Fund	40 ILCS 5/17-116	<ul style="list-style-type: none"> • 62 with 5 years of service • 60 with 20 years of service • 55 with 34 years of service 	<ul style="list-style-type: none"> • 67 with 10 years of service • 62 with 10 years of service for a reduced benefit
Cook County Municipal Workers' Fund	40 ILCS 5/9-126-128	<ul style="list-style-type: none"> • 60 with 10 years of service 	<ul style="list-style-type: none"> • 67 with 10 years of service • 62 with 10 years of service for a reduced benefit
Forest Preserve Fund	40 ILCS 5/9-126-128	<ul style="list-style-type: none"> • 60 with 10 years of service 	<ul style="list-style-type: none"> • 67 with 10 years of service • 62 with 10 years of service for a reduced benefit
Park Employees' Fund	40 ILCS 5/12-130	<ul style="list-style-type: none"> • 60 with 10 years of service 	<ul style="list-style-type: none"> • 67 with 10 years of service • 62 with 10 years of service for a reduced benefit

Pension	Pension Code Section	Age and Vesting Rules (Pre-2011 hires)	Age and Vesting Rules (Post-2011 hires)
Metropolitan Water Reclamation District Fund	40 ILCS 5/13-301	<ul style="list-style-type: none"> • 60 with 10 years of service • 62 with 5 years of service 	<ul style="list-style-type: none"> • 67 with 10 years of service • 62 with 10 years of service for a reduced benefit
Chicago Transit Authority	40 ILCS 5/22-101(a)	<ul style="list-style-type: none"> • 65 with 10 years of service 	—

While the legislature raised the retirement age for new public workers, current workers are still subject to the prior rules. Some proponents of pension reform support extending these age and service changes to current workers as a further measure to improve pension fund solvency. For example, the Civic Committee of the Commercial Club of Chicago has consistently advocated for changing the Illinois public sector normal retirement age to 67, and to 62 for reduced benefits. The Civic Committee has supported legislation that would raise the retirement age prospectively for current workers.²⁰ In addition, under Senate Bill 512, the Illinois legislature is considering giving current State pension system participants the option of either maintaining their current pension benefits with a higher worker contribution rate, or entering the new system that the legislature implemented for Illinois public sector workers hired after January 1, 2011.²¹ Employees would also be permitted to select a new defined contribution option in lieu of a traditional pension; however, participants selecting the defined contribution plan will not be permitted to return to the defined benefit plan. According to draft legislation, these rules would apply to eight different State and City pension systems.²²

Senate Bill 512 has yet to pass out of the legislature; however, Governor Quinn recently signed House Bill 3813 which bars certain union leaders on leave from their public sector positions from receiving public pension benefits based on service accrued while on such leave.²³ This bill responds to certain abuses uncovered by the *Chicago Tribune* where two union employed lobbyists were found to have received sizable State pensions based on service accrued while working for the Illinois Federation of Teachers.²⁴

Other states have made changes to their age and vesting rules, including:

- **Pennsylvania.** Pennsylvania increased its pension vesting rules from five to ten years for all employees in the State Employee Retirement System. The State also

²⁰ *Civic Committee State Finance Priorities*, (Civic Committee of the Commercial Club of Chicago), December 2010, at 1.

²¹ For an analysis of new proposed pension legislation, see Doug Finke, *Illinois House Leaders Mum on Pension Reform Talks*, Rockford Register Star, August 14, 2011.

²² See S.B. 512 97th Gen. Assem. (Il. 2011).

²³ See H.B. 3813 97th Gen. Assem. (Il. 2011).

²⁴ Ray Long, *Union pension abuse crackdown gains steam in Springfield*, Chi. Trib., Nov. 9, 2011.

raised the retirement age for public school employees from 63 to 65. Public Act 120 of 2010 (HB 2497).

- **California.** California instituted pension reforms whereby benefit accrual rates are now tied to retirement age. New employees can still retire at age 55 under most funds, but these workers' pensions will be calculated with a lower benefit accrual rate. Other public service employees will now need to work until age 60 to receive a 2% benefit accrual rate. Participants only needed to work to age 55 to receive this accrual rate prior to reform. Chapter 3 (SB 22f) of the 6th Extraordinary Session, 2010.
- **Nevada.** Nevada raised the retirement age for most public employees to 62 and eliminated an early retirement option for firefighters. Chapter 426, Laws of 2009 (SB 427).
- **Kentucky.** Kentucky changed its retirement eligibility rules for public sector employees hired after September 1, 2008. For example, a worker could previously retire at any age with full benefits with 27 years of service. New rules permit workers to retire at age 57 with 30 years of service. HB 1 of the 2009 Special Session.

In the private sector, age limits or required years of service for corporate defined benefit plans ensure that workers retire at older ages. For example, in one survey, 21% of private companies required a retiree to reach the age of 62 to retire with full benefits; an additional 48% required the retiree to reach the age of 65.²⁵ By comparison, 21% of state and local government plans permitted retirement with full benefits at the age of 55 while a full 43% of plans had no age limit and only required service of a set number of years; 36% of all plans required 30 years or less for full benefits.²⁶ This means that in at least 57% of state and local benefit plans, a worker that began working at 25 could retire at age 55 with full retirement benefits. Workers in state and local government plans thus have a greater opportunity to simultaneously work and draw pension benefits. Further, these younger retirement ages in the public sector strain pension plan finances for plans that provide cost of living adjustments. Public pension plan finances are further strained where these earlier retirement ages provide retirees with close to an additional 10 years of benefit coverage in comparison with private sector norms.

3. Changing the Final Average Salary Formula

Since the legislature overhauled final pay rules for future workers hired after January 1, 2011, reformers similarly propose imposing these rules on current workers and beneficiaries. For example, due to the recent *Chicago Tribune* article on pension spiking in the Illinois Municipal Retirement Fund, State Representative Karen May offered a proposal to rewrite that pension's rules to end practices which artificially raise public employee final

²⁵ Ann C. Foster, *Public and Private Sector Defined Benefit Pensions: A Comparison*, Compensation and Working Conditions, at 39 (Summer 1997).

²⁶ *Id.*

average salaries.²⁷ One part of that proposal became law on August 12, 2011 when the Governor signed Illinois House Bill 1471 which obligates a municipality participating in the Illinois Municipal Retirement Fund to pay the costs associated with any end of career salary increase that the municipality gives to employees. Other aspects of her proposal to limit abuse – including limiting salary increases on the eve of retirement for employees hired before January 1, 2011 – have yet to be addressed by the Illinois legislature.

Other states have generated substantial savings by changing the way that final average pay is determined. States have generated savings, for example, by calculating benefits using the participant's final five years of salary prior to retirement instead of using the participant's final three years of salary. In addition, states can remove bonuses, overtime pay, and unused vacation time from the state pension law's final average pay formula to eliminate "spiking" or the practice of artificially raising a worker's pay before retirement with the aim of increasing such participant's final pension payment. For example:

- **Arizona.** In 2010 Arizona rewrote its final average salary rules. Specifically, Arizona increased its final average salary calculation from 36 months to 60 months of a participant's final 120 months of salary. Chapter 50, Laws of 2010 (HB 2389).
- **California.** For new employees, California will now calculate pension benefits based on an average of an employee's highest consecutive three years of salary. Prior rules allowed California public retirees to receive pension benefits based on a participant's single highest year of salary. Chapter 3 (SB 22f of the 6th Extraordinary Session).
- **New Jersey.** New employees in New Jersey will be subject to final average pay rules based on their final five years of pay; prior pension fund participants will be subject to rules that calculate benefits based on a worker's final three years of pay. Public Law 1 of 2010 (SB 2).
- **Michigan.** Michigan will now evaluate new teachers' final average salary using a formula based on a participant's final five years of salary instead of a participant's final three. Act 75 of 2010 (SB 1227).
- **Georgia.** In 2009 Georgia adopted a strict anti-spiking provision. This rule requires that any employing unit pay the full actuarial cost of any raise of 5% or more given to an employee in the 12 months before such employee's retirement. Act 83 of 2009 (HB 476).
- **Rhode Island.** Rhode Island also altered its final average salary calculation by using an employee's final five years of salary (as opposed to his final three years) for all employees retiring after October 1, 2009. Article 7, Chapter 68, Laws of 2009 (HB 5983 substitute as amended).

²⁷ Karen May, *How to Stop the Pension Problem*, Highland Park Patch, Oct. 20, 2010, available at <http://highlandpark.patch.com/articles/how-to-stop-the-pension-problem>.

- **Texas.** Texas raised its final average salary calculation period for public pensions in 2009. The rules raise the monthly final salary calculation from 36 months to 48 months. Chapter 1308, Laws of 2009 (HB 2559).
- **New Hampshire.** New Hampshire public pension rules provide that if a participant’s compensation in his or her final year of employment is more than 125% of such participant’s final average salary, the employee’s most recent state or local employing unit will be required to pay for the cost of that employee’s increased pension benefit. Chapter 300, Laws of 2008 (HB 1645).

Pension spiking—or the practice of artificially inflating pension benefits—is less of a concern in the private sector. The primary way public sector employees raise their final average salaries is by accruing high amounts of overtime. However, private corporations generally base benefits on salary or wages excluding commissions, bonuses, and overtime.²⁸ Therefore, an employee has less opportunity to “spike” his or her own base salary. Furthermore, private sector employees have less ability to manipulate their overtime wages than their public sector equivalents. Public sector employees who intend to retire occasionally receive assistance from other employees in amassing overtime, who, in turn, expect that they will receive similar treatment when they approach retirement. This phenomenon has not been observed in the private sector.

4. Increasing Employee Contributions

Another reform proposal involves asking public sector employees to contribute more of their salary towards the cost of the pension. The following chart details the current contribution rates for Illinois public sector employees.

Pension	Worker Contribution
State Employees’ Retirement System (workers contribute to Social Security)	4.0%
State Universities Retirement System	8.0%
Teachers’ Retirement System	9.4%
General Assembly Retirement System	11.5%
Judges’ Retirement System	11%
Illinois Municipal Retirement System (workers contribute to Social Security)	4.5%
Municipal Police Fund	9.91%
Municipal Fire Fund	8.5%
Chicago Police Fund	9.0%
Chicago Fire Fund	9.125%

²⁸ Edward A. Zelinsky, *The Cash Balance Controversy*, 19 VA. TAX REV. 683, 689 (2000); Michael J. Connell, *Executive Compensation: Item 402 of Regulation S-K*, 722 PLI Corp. 463, 484 (1991).

Pension	Worker Contribution
Chicago Municipal Workers' Fund	8.5%
Chicago Laborers' Fund	8.5%
Chicago Teachers' Pension Fund	9.0%
Cook County Municipal Workers' Fund	8.5%
Forest Preserve Fund	8.5%
Park Employees' Fund	9.0%
Municipal Water Reclamation District Fund	9.0%

In other states, defined benefit plans are funded primarily (if not solely) by employer contributions. In recent years, many states have either initiated an employee contribution, or where employees were already required to contribute, some states increased this required employee contribution. According to the Public Plans database, for those plans that require an employee contribution, the most common rate in 2009 was 5.9%. In general, employee pension contribution rates ranged from 4% to 7.9%.²⁹ Thus, Illinois worker contributions are higher than the rates of most of its peer states.

Under recent legislation, the Illinois legislature required Chicago to drastically increase its contributions to public safety pensions starting in 2015. Fearing that the new rules will require the City to substantially raise its property tax rate, the City in January 2011 raised the possibility of increasing employee contributions by 1% each year over the next three years, which it estimated could result in annual savings of \$240 million in 2015.³⁰

Groups such as the Civic Federation and the Civic Committee of the Commercial Club have asked the State to amend the Pension Code to increase employee contributions. Some have argued that Illinois public workers should increase contributions to at least 11% of payroll (7% for workers who also contribute to Social Security) as a way to address the current crisis.³¹ Any reforms, it suggests, should require Illinois workers to match their private sector counterparts.³² Illinois legislators are currently mulling over proposals to increase worker contributions to pensions by adopting a new system whereby current

²⁹ *Distribution of State and Local Pension Plans by Employee Contribution Rate, 2009*, The Center for Retirement Research at Boston College (March 14, 2011), <http://nianticsystems.com/pls/htmldb/f?p=198:50:3601941331347885::NO>.

³⁰ Press Release, City of Chicago, City of Chicago Proposes Changes to Public Safety Pension Funding Law (Jan. 28, 2011).

³¹ Charles N. Wheeler III, *The Pension Chasm*, Illinois Issues – A Publication of the University of Illinois at Springfield, February 2010, available at <http://illinoisissues.uis.edu/archives/2010/02/pension.html>.

³² While many private sector workers contribute nothing to an employer sponsored defined contribution retirement plan, the Congressional Research Service found that for workers who do contribute to a defined contribution plan, on average, those participants contributed 6% of their income to a 401(k) type plan. See John J. Topoleski, *401(k) Plans and Retirement Savings: Issues for Congress*, (Congressional Research Service) Jan. 7, 2011 at 2. Combined with Social Security contributions of 4.25%, private sector workers average devote an average of 10% of income to retirement under the CRS estimate.

workers would be given the option to receive the same level of benefits by increasing their annual contribution; otherwise these workers would need to transition to a defined contribution system or a system of reduced pension benefits.³³

Other states have taken steps to raise the employee contribution rate. For example:

- **Iowa.** In 2010, Iowa raised its employee pension contribution rate by .5% a year from 2011 through 2014. This legislation will accordingly raise the employee contribution from 9.35% to 11.35% over four years. The employee contribution will stay at 11.35% thereafter. The bill also raised the employer contribution considerably. Beginning in 2013 the employer contribution will increase at a rate of 2% per year for five years, from 27% to 37%. For fiscal year 2017 and thereafter the employee contribution will be the lesser of 37% or an amount sufficient to fund the system's liabilities as measured on an actuarial basis. Given these offsetting increases, employees will ultimately pay only 30% of the total contribution, down from a current 34%. House File 2518 was signed by the Governor on April 23, 2010, amending Chapter 97A.
- **Minnesota.** Minnesota increased the required employee contribution for most of its public pension funds. For example, it now requires teachers to contribute .5% more each year, raising the total contribution to 6.0%. Minnesota's highest employee contribution rate is 9.6% (up from 9.4%) for its Police and Fire Pension Plan. Chapter 359, Laws of 2010 (Senate File 2918 and House File 3281).
- **Missouri.** Missouri implemented a 4% salary contribution for new employees covered by four of its plans; prior to this change, all Missouri plans were non-contributory. House Bill 1 of the First Extraordinary Session of 2010.
- **Vermont.** Vermont increased the contribution rate for teachers by nearly 1.5%. This change raises the employee contribution rate for teachers to 5%. Act 74 of 2010 (HB 764).
- **Nebraska.** In 2009 Nebraska increased the employee contribution rate of all school employees and all judges by 1% for five years. Thus, these employees will contribute 8.28% of salary for five years to help shore up pension finances. The State further imposed a 2% employee contribution increase for state police patrol workers; this change raises their contribution rate from 13% to 15% for two years with further increases in subsequent years. LB 187, 188, and 414 of 2009.
- **New Hampshire.** Also in 2009, New Hampshire increased its employee contribution rate from 5% to 7% for all newly hired public sector employees. Chapter 144 §144.5ff, Acts of 2009 (HB 2).

³³ Kevin P. Craver, *More Pension Reform Coming?*, Northwest Herald, Feb. 10, 2011; see also Doug Finke, *Illinois House Leaders Mum on Pension Reform Talks*, Rockford Register Star, August 14, 2011

- **Texas.** Texas implemented a .5% required employee contribution for law enforcement and custodial pension plan participants; those plans had previously been non-contributory. Chapter 1308, Laws of 2009 (HB 2559).

In addition, some states have taken steps to shift the employer portion of pension contributions to employees. For example:

- **Colorado.** In 2010 Colorado enacted legislation to shift its pension contribution to its employees for one year. These rules require Colorado employees to contribute 2.5% more of their salary to pay pension costs while State employing units will contribute 2.5% less. Thus, during 2011, Colorado employees will contribute 10.5% of salary instead of 8%, and Colorado State agencies will contribute 7.65% of employee salary instead 10.15%. This policy was expected to save Colorado \$37 million for 2011.³⁴
- **New Mexico.** In 2009, New Mexico similarly shifted its State pension contributions to its employees for two years, requiring employees making more than \$20,000 to increase their contribution by 1.5% for two years. The State legislated an offsetting decrease in its employer contribution. Chapter 127, Laws of 2009 (HB 854). This legislation was expected to save \$42 million in fiscal year 2010.³⁵ In response, employee unions sued the State, claiming this increase was unconstitutional. The district court denied an injunction against the increase.³⁶
- **Vermont.** In 2008 Vermont increased public employee contributions for 10 years from 3.25% to 5%. After July 1, 2019 this employee contribution rate will fall to 4.75%. Act 116 of 2008 (HB 203). The State increased these contributions to cover funding for increased COLA benefits.

In comparison with the private sector, public sector employees contribute a much larger portion of their salaries to their pension. Indeed, private sector defined benefit pension plans rarely require employees to contribute a percentage of payroll to pension funding. For example, as of 2006, employee contributions to pension funds were found in less than 1% of defined benefit plans.³⁷ It seems employers are more likely to shift from defined benefit plans to defined contribution plans rather than initiate an employee contribution requirement to defined benefit plans. While the comparison is not necessarily appropriate, it is worth noting that private sector employees are increasingly devoting a portion of their salary to defined contribution plans; it is estimated that private sector employees devote on average

³⁴ *Pensions and Retirement Plan Enactments in 2010 State Legislature* at 3.

³⁵ Ronald Snell, *State Pension and Retirement Legislation 2009*, National Conference of State Legislatures, (Aug. 17, 2009) <http://www.ncsl.org/?tabid=17594>.

³⁶ Scott Sandlin, *Pension Increase Won't Be Halted*, Albuquerque Journal, July 23, 2009, available at <http://www.abqjournal.com/north/23235368381north07-23-09.htm>.

³⁷ See generally Alicia H. Munnell & Mauricio Soto, *State and Local Pensions Are Different from Private Plans*, 2007 Ctr. for Ret. Res. at 4, available at http://crr.bc.edu/images/stories/Briefs/slp_1.pdf.

6% of salary to a defined contribution plan where the employer provides for such an arrangement.³⁸

5. Increasing Employer Contributions

Most reformers take the position that the legislature should implement other reforms, such as increasing employee contributions, reducing benefit accruals, and raising the retirement age before demanding that the state provide additional funds toward pension contributions. Raising the employer contribution often requires a state to raise taxes or issue debt. As such, reformers view raising state contributions as a last resort after the state exhausts other proposals. This is the stance of the Civic Federation, which has advocated that Illinois engage in comprehensive pension reform before seeking new revenue sources to fund those pensions.³⁹ At the same time, public sector workers prefer that the state fund the pension shortfalls, because doing so leaves current benefit accrual, vesting, and worker contribution schedules intact. For a state to meet its increased obligations, it must generally consider the following three options, (1) raising tax revenue, (2) legislating pension holidays, and (3) using debt financing. These funding mechanisms are discussed above in the initial funding section.

Other states have taken steps to increase the employer portion of pension contributions. For example:

- **Connecticut.** Connecticut began requiring full funding of its pension obligations in 2008. The State issued \$2 billion in bonds to raise money for its underfunded teachers' retirement system. As long as those bonds remain outstanding, the State is required to fully fund its annual pension obligations.⁴⁰
- **Vermont.** Similarly, Vermont has passed legislation requiring that it fund the full actuarially required contribution to its public sector pensions each year. Act 74 of 2010 (HB 764).
- **New Jersey.** In 2010, New Jersey passed a law which will require the State to make the full actuarially required contribution to all of its State pension plans. This is made possible by a phase-in provision that increases the State's contribution by one-seventh for each of the next seven fiscal years. Public Law 1 of 2010 (SB 2).

³⁸ John J. Topoleski, *401(k) Plans and Retirement Savings: Issues for Congress* (Congressional Research Service) Jan. 7, 2011 at 2.

³⁹ Press Release, The Institute for Illinois' Fiscal Sustainability at the Civic Federation, Civic Federation Sends Illinois into Fiscal Rehab (Feb. 22, 2010).

⁴⁰ *The Trillion Dollar Gap: Underfunded State Retirement Systems and the Roads to Reform*, The PEW Center on the States, 34 (Feb. 18, 2010).

6. Actuarial Assumption Reforms

Aside from questions of how to best state the Actuarially Required Contribution (“ARC”) or whether some states can even afford to make a payment that large, it is important to recognize that the ARC is only as useful as its assumptions. California’s contribution to its Public Employee Retirement System is expected to increase by \$299 million in response to a demographic study on retiree life expectancy and expected retirement age.⁴¹ Further, if the ARC relies on an unrealistic assumption of investment returns, a state may be underfunded even if it dutifully makes the ARC. As of last year, 22 states assumed an investment return of 8%.⁴² Following the recession, assuming an 8% return on investments may be unrealistic. The downside of assuming a lower expected return is that the ARC would increase substantially, but it may have been the assumption of an unattainable rate that contributed to many states’ pension problems in the first place. The lowest rate of return currently assumed by any state is 7.25% (North Carolina and South Carolina).⁴³ In comparison, the Illinois State pension system recently reduced its assumed rates of return for the State Employees’ and Universities Retirement Systems from 8.5% to 7.75%.⁴⁴ Other Illinois pensions use higher assumed rates of return. The difference may seem negligible, but when a state’s unfunded liability is in the tens of millions of dollars, an unrealistic discount of three-quarters of a percent quickly becomes a substantial funding gap. Although many economists would suggest using a “risk-free” rate of 4%, no states have elected to do this.⁴⁵

States increasingly require actuarial assessment of any changes to pension plan benefits or funding. For example:

- ***Georgia and Oklahoma.*** In recent years both Georgia and Oklahoma have passed legislation restricting the ability of their legislatures to make benefit changes that increase pension costs. Specifically, both States now require that any legislation increasing participant benefits must be introduced one year and voted on the following year after such legislation has been reviewed by an actuary. The Georgia law goes so far as to provide that an otherwise properly passed benefit change will automatically become null and void if the change is not adequately funded. Public Retirement Systems Standards Law, Ga. Code Ann. § 47-20-50 (West 2009). Oklahoma’s law was based on the Georgia law. Oklahoma Pension Legislation Actuarial Analysis Act, Okl. St. Ann. tit. 62, §§ 3101-14 (West 2006).⁴⁶

⁴¹ *Pensions and Retirement Plan Enactments in 2010 State Legislatures* at 3.

⁴² *The Trillion Dollar Gap* at 35, Exhibit 12.

⁴³ *Id.*

⁴⁴ Kathy Bergen, *Illinois pensions cut investment expectations*, Chi. Trib., Oct. 30, 2010.

⁴⁵ See Jonathan Barry Forman, *Funding Public Pension Plans*, 42 J. MARSHALL L. REV. 837, 852-65 (2009).

⁴⁶ *Id.* at 867.

- **Tennessee and North Carolina.** Similarly, Tennessee and North Carolina require full actuarial analysis of any proposal that affects pension benefits or costs.⁴⁷
- **California.** In 2008 California created an actuarial advisory panel and began requiring State agencies to review the actuarial impact of benefit increases prior to approval. Chapter 371, Statutes of 2008 (SB 1123).

7. Reducing or Capping Cost of Living Adjustment Payments to Active Retirees

Legislators have similarly explored reducing COLA payments as a means to improving pension finances. In Illinois, for example, the legislature recently reduced the way it calculates COLA payments for new hires. Currently, Illinois allows for an automatic 3% cost of living increase for employees hired before January 1, 2011. New hires receive an increase which is the lesser of 3% or one-half of the increase in the consumer price index. The new COLA calculation uses a simple interest formula wherein the retiree’s benefit is increased based on the initial value of retiree’s pension benefit.

Rules for Employees Hired Before Jan. 1, 2011	Rules for Employees Hired After Jan. 1, 2011
Automatic 3% each year, compound interest	Lesser of 3% or one half of the consumer price index, simple interest

Other states’ pension plans take varying approaches to providing participants with cost of living increases. “There are four main types of COLAs: 1) automatic – the increase is a constant percentage that is not tied to the Consumer Price Index (CPI); 2) CPI-linked – the increase is tied to the increase in the CPI; 3) Ad-hoc – the increase is set by the legislature and revised on an ad-hoc basis; and 4) Investment-based – the increase is tied to some financial metric, generally the plan funded level or the level of assets in a special COLA fund.”⁴⁸ According to the Public Plans database, 47% of public pension plans link COLA to the consumer price index. Close to 23% of public plans provide for automatic cost of living adjustments. In 2009, several states took a variety of actions to restrict COLAs. So far, no lawsuit has been filed challenging any of those changes.

In addressing the Illinois pension funding crisis, the Civic Federation has endorsed a plan to further reduce the COLA formula for new employees.⁴⁹ In a publication that predates the 2010 pension reforms, the Civic Federation suggested that Illinois should reduce COLA

⁴⁷ *The Trillion Dollar Gap* at 36.

⁴⁸ *Distribution of State and Local Pension Plans by COLA Type, 2009*, The Center for Retirement Research at Boston College (March 14, 2011), <http://nianticsystems.com/pls/htmldb/f?p=198:50:3601941331347885::NO::>

⁴⁹ *Civic Federation Position Statement on Senate Bill 1946*, (The Civic Fed., Chicago, IL), March 30, 2010, available at <http://www.civiced.org/civic-federation/publications/sb1946positionstatement>.

increases from 3% to 2%.⁵⁰ The Commercial Club of Chicago suggests that the Illinois legislature should reduce COLA benefits in the Pension Code.⁵¹ There is little data as to the cost savings for reducing COLA increases for current workers and retirees. The Commission to Strengthen Chicago's Pension Funds analyzed the cost savings for employees that it hired after January 1, 2011 for the four pensions that Chicago funds. Assuming a reduction in COLA increases from 3% to 1.5% each year, the Commission found modest savings of \$10-\$15 million per year.⁵²

Examples of COLA reform from other states include:

- **Georgia.** Georgia prohibited any post-retirement benefit increases (COLAs) for new employees. Act 82 (HB 452).
- **Rhode Island.** Rhode Island limited COLAs for new employees to the lower of 3% or the change in the consumer price index. Article 7, Chapter 68, Laws of 2009 (HB 5983 *substitute as amended*).
- **Nevada.** Nevada capped COLAs for employees joining its public sector pension plans after January 1, 2010. These limitations cap COLA benefits at a maximum of 4% each year. Prior to reform, Nevada public sector retirees could receive a COLA of up to 5% each year. Chapter 426, Laws of 2009 (SB 427).
- **Louisiana.** Louisiana also changed its pension rules which tie COLA benefits to investment performance. For example, if the State Employee Retirement System's investments perform below actuarial assumptions (8.25%) and the plan's funding ratio falls below 80%, participants in pay status will not receive an annual COLA increase. Similarly, if the pension's investments perform below actuarial assumptions but the pension maintains an 80% funded ratio, a COLA can be given up to the increase in the CPI, but capped at 2%. Participants can receive a COLA increase of up to 3% if the fund both performs above actuarial assumptions and the pension plan's funding ratio is above 80%. Act 497 of 2009 (SB 296).

There has been class action litigation in three states over attempts to decrease or cap the COLAs that retirees had been receiving.⁵³ As with most pension benefits, once a COLA has been promised, it may be hard to take away. The plaintiffs in all three suits alleged that the reductions in COLAs violate both the contract clause and the takings clause of the U.S.

⁵⁰ *Status of Local Pension Funding Year 2008, An Evaluation of Ten Local Government Employee Pension Funds in Cook County*, (The Civic Fed., Chicago, IL), March 8, 2010, at 53.

⁵¹ *Facing Facts 2009, An Updated Report on the State of Illinois' Financial Crisis*, (The Civic Fed., Chicago, IL), February 2009, at 14.

⁵² Commission to Strengthen Chicago's Pension Funds, Volume 2, Resources, (City of Chicago) April 30, 2010, at 44.

⁵³ The plaintiffs in all three cases are represented by Stephen Pincus, an attorney with the law firm of Stember, Feinstein, Doyle, & Payne in Pittsburgh, Pennsylvania.

Constitution. The Colorado and Minnesota complaints, discussed *infra*, state “Article I, Section 10 of the United States Constitution declares that ‘[n]o state shall...pass any...law impairing the obligations of contracts...,’ and ‘The Fifth Amendment of the United States Constitution states “private property [shall not] be taken for public use, without just compensation.’ ” First Amended Class Action Complaint, *Justus v. Colorado*, 2010 CV 1589 (Colo. Dist. Ct. Mar. 17, 2010); Amended Complaint, *Swanson v. Minnesota*, No. 62-CV-10-5285 (Minn. Dist. Ct. July 2, 2010).

- **Colorado.** In Colorado, the legislature reduced 2010 COLA benefits from either 3.5% or 3.25% to the lesser of 2% or the rate of inflation. Colorado further capped COLA benefits for all future years at 2%. The State also requires retired employees to receive benefits for 12 months before they are eligible to receive a COLA. Chapter 2, Laws of 2010 (SB 1). On June 29, 2011, the Honorable Robert Hyatt, Chief Judge of the Denver County Circuit Court, granted summary judgment on behalf of the State in *Justus v. Colorado*. In his memorandum opinion, Judge Hyatt wrote that “While Plaintiffs unarguably have a contractual right to their PERA pension itself, they do not have a contractual right to the specific COLA formula in place at their respective retirement, for life without change.” *Justus v. Colorado*, 2010 CV 1589, Mem. Op. at 4 (Colo. Dist. Ct. June 29, 2011). Further, plaintiffs’ takings clause claims necessarily failed because they had no underlying contractual right to COLA increases. The plaintiffs filed a Notice of Appeal on July 25, 2011.
- **South Dakota.** South Dakota decreased its COLAs for all retirees from 3.1% to 2.1% for one year. Thereafter, South Dakota allows for CPI indexed increases above 2.1% with caps based on the total funding level of the pension system. Chapter 20, Laws of 2010 (SB 20). *Tice v. South Dakota*, Civ. No. 10-225, is pending in Hughes County District Court, with plaintiffs challenging that the change is a violation of the contract clauses of the State and Federal Constitutions. The lead plaintiff is retired South Dakota State Circuit Court Judge Merton Tice.
- **Minnesota.** Minnesota decreased COLA benefits for the majority of its plans. These changes include reductions ranging from .5% to 1.5% until the plans attain a 90% funded status. These changes further require employees to be retired for six months before receiving a COLA. Chapter 359, Laws of 2010 (Senate File 2918 and House File 3281). On June 29, 2011, the Honorable Gregg Johnson, Chief Judge of Ramsey County District Court, granted summary judgment on behalf of the State in *Swanson v. Minnesota*. In his memorandum opinion, Judge Johnson wrote that “statutes are not contracts absent plain and unambiguous terms that show an intent to contract,” and that the changes were “a minimal alteration in the calculation of future adjustments to retirees’ annuities and a reasonable response to a fiscal threat that jeopardized the long-term interests of Plan members, the State and the State’s taxpayers.” *Swanson v. Minnesota*, No. 62-CV-10-5285, Mem. Op. at 3-4 (Minn. Dist. Ct. June 29, 2011).

Cost of living adjustments are extremely rare in the private sector.⁵⁴ Accordingly, eliminating COLAs is not an option in most private defined benefit plans. Where COLAs do exist, ERISA generally treats them as vested benefits; these benefits may only be cut on a prospective basis under ERISA's anti-cutback provisions.⁵⁵

8. Preventing Public Sector Retirees from Simultaneously Drawing a Salary and Pension Benefits

Retirees currently drawing retirement benefits in a defined benefit pension plan who return to paying work engage in a practice referred to as "double dipping." In the public sector, this practice is frequently accomplished by applying for and receiving retirement benefits from one pension system, then returning to work for a different public entity. Pension plan expenses compound as the working retiree also accrues benefits in the second system. For example, if an individual is hired as a police officer for the state at the age of 19 and is able to draw a full pension after twenty years of service that individual may retire at age 39 and immediately return to work in a different department. Although the state benefits by retaining the services of a highly skilled employee, the attendant cost can be substantial. In 2009, the Utah legislative auditor released a report finding that retirees returning to work cost the State \$401 million between 2000 and 2008. The report also found that the practice would cost the State \$897 million over the following decade if the laws regarding returning to work were not changed.⁵⁶

For current retirees and workers hired before 2011, Illinois pension rules allow workers to retire from one public sector job and draw pension benefits while working in a different public sector job. Workers hired by Illinois public sector employers after January 2011 are barred under the Pension Code from simultaneously working at an Illinois public sector job while drawing a pension benefit. 40 ILCS 5/1-160(h). The Illinois legislature did not impose these reforms on the Chicago and local police and fire pension programs.

Like Illinois, other states have taken steps to reduce or eliminate the problem of workers drawing both pension benefits and a public sector salary at the same time.

- **Colorado.** Colorado began requiring retirees who return to State employment to make contributions to the pension fund equal to those of other employees, and it does not allow them to get pension credit for those post-retirement contributions. Chapter 2, Laws of 2010 (SB 1).

⁵⁴ Daniel Halperin, *Employer-Based Retirement Income- the Ideal, the Possible, and the Reality*, 11 ELDER L. J. 37, 60 (2003) (noting private sector defined benefit pension plans generally do not provide postretirement cost of living adjustments); Michael A. Stoller, *Estimating the Present Value of Pensions: Why Different Estimators get Varying Results*, J. LEGAL ECON. 49, 52 (December 1992).

⁵⁵ I.R.C. § 411(d)(6) (prohibiting the reduction of a participant's accrued benefits through plan amendment); See also *Williams v. Rohm & Haas Pension Plan*, 497 F. 3d. 710, 713-14 (7th Cir. 2007).

⁵⁶ *Trillion Dollar Gap* at 29.

- **Missouri.** Missouri now prevents retired judges from receiving their retirement benefits if they return to State employment. House Bill 1 of the First Extraordinary Session of 2010.
- **Hawaii.** Hawaii requires its public sector retirees to re-enroll in the pension system and make contributions to that system after exiting retirement to work in the public sector. Act 179, Laws of 2010 (HB 2533).
- **New Mexico.** New Mexico suspends the pension benefits of retirees in pay status who return to public sector employment. Chapter 18, Laws of 2010 (SB 207).
- **South Dakota.** South Dakota now causes a 15% reduction in benefits for the period during which any retiree returns to State employment; these rules additionally bar such returning employees from receiving a cost of living increase during that period of reemployment. Chapter 23, Laws of 2010 (SB 18).
- **Georgia.** Georgia requires teachers who return to employment to stop drawing retirement benefits and re-enroll in the retirement system. Act 275 of 2009 (HB 202).

a. Drawing Pension Benefits and Salary by Moving Across State Lines

Some public sector employees draw salary and pension benefits by moving across state lines. The *Chicago Tribune* recently completed an investigative report of “retired” superintendents who left the state of their original employment to take nearly identical jobs elsewhere.⁵⁷ Although many states have laws that would prohibit superintendents from drawing a pension and resuming work in their own state, very few, if any, states prohibit an individual from collecting a full salary while drawing an out-of-state pension. This allows superintendents willing to move to potentially double their compensation. The report showed that this occurred both with former Illinois superintendents moving out of the state and with former superintendents of other states moving into Illinois.

The way in which defined benefit pensions are often structured is the root cause of the talent flight problem. If there is a maximum on any portion of the defined benefit formula (either years worked, final average salary, or even the ultimate benefit amount), once an employee reaches that threshold and is able to retire, that employee no longer has any personal incentive to work. Even before reaching the threshold, many employees may feel that receiving a modest pension for doing no work is a better option than working full time to receive a slightly better paycheck. For very valuable employees, this puts the state in a difficult position; it would ideally wish to maintain the employee’s services, but has no way of making such a scenario economically attractive. The perceived need to re-incentivize employment that created the deferred retire option plan (“DROP”). The DROP operates by

⁵⁷ Diane Rado and Duaa Eldeib, *Rules Let Educators Cross State Lines to Get Pensions Along With Salaries* (Jan. 29, 2011), available at <http://www.chicagotribune.com/news/ct-met-superintendent-pensions-20110129,0,6037500.story>.

allowing retirement-age employees to stay on the job for a fixed period, in theory to pass on their knowledge, and that during this time they will collect a paycheck and be allowed to retain the pension funds that they would otherwise be drawing in a separate interest-bearing account. This is ideal for the employee as the interest on the fund will exceed the nominal pension benefit-increase that they would accrue by staying employed for a few more years. DROPS were very popular with state legislatures in the early 2000's and are now available to a large number of workers nationwide. It is understandable that employers want to retain talent, especially young talent with a well-developed skill set, but the costs also must be considered. Providing DROPS or allowing for retirees to simultaneously draw salary and pension payments increases costs to the state; although neither scenario technically increases the cost to the pension fund, the money that is being paid to the retired-but-rehired employee as a salary could just as easily be used to pay the cost of another employee's pension. Additionally, both of these options can end up costing the state far more than the slight increase in pension benefits that employees would accrue if they simply remained employed. Prohibiting public sector retirees from simultaneously drawing salary and pension payments and eliminating DROPS while still satisfying retention objectives would require broader reform to pension agreements.

The practice of returning to work from retirement to receive both salary and pension payments is less of a problem in the private sector for several reasons. First, the age limits or required years of service for corporate defined benefits ensure that workers retire at older ages. For example, in one survey, 21% of private companies required a retiree to reach the age of 62 in order to retire with full benefits, and an additional 48% required the retiree to reach the age of 65.⁵⁸ By comparison, 21% of state and local government plans permitted retirement with full benefits at the age of 55 while a full 43% of plans had no age limit and only required service of a set number of years; 36% of all plans required 30 years or less for full benefits.⁵⁹ In addition, private sector salaries are not subject to limits in the way that public sector employee salaries are, however, ERISA imposes upper limits on the amount of annual benefit that a plan can pay to a participant under I.R.C. § 415(b). Specifically, § 415(b) limits annual pension benefits to the lesser of \$195,000 (for 2011) or the average of a participant's highest three years of salary.

9. Improving Pension Plan Governance and Oversight

The Civic Federation has provided a detailed proposal to overhaul Illinois pension board rules. Most Illinois pension boards are made up of workers, retirees, and State officials. In the Civic Federation's view, the legislature should change the membership of each pension board to provide a stronger taxpayer voice in pension affairs.⁶⁰ In addition, the Civic Federation suggests using a multi-employer fund approach to take advantage of

⁵⁸ Ann C. Foster, *Public and Private Sector Defined Benefit Pensions: A Comparison*, Compensation and Working Conditions, at 37-38 (Summer 1997).

⁵⁹ *Id.*

⁶⁰ *Best Practices in Public Pension Board Governance*, (Civic Fed., May 5, 2010), available at <http://www.civicfed.org/civic-federation/blog/best-practices-public-pension-board-governance>.

economies of scale and efficiency.⁶¹ Specifically, this would require the local police and fire pensions to become one pension fund, and similarly require the City of Chicago to join all of its pensions into one fund. Such an approach, it argues, would reduce costs.

Like Illinois, most states run a variety of separate pension funds, each of which is administered by a separate board of trustees. In seeking to reduce costs and increase efficiency, states have reformed their governance structures by combining investment authority into a single pension committee. In some cases states have combined multiple pension funds into a single pension fund. Examples of reforms from other states include:

- ***Vermont.*** In 2005, Vermont gave the investment authority of its three pension funds to one entity, the Vermont Pension Investment Committee. This body consists of one member of each of the three pension boards, as well as two individuals appointed by the governor and the state treasurer. The purpose of the restructuring was partially to increase investment efficiency. In addition, Vermont also sought to decrease administrative costs by combining the funds' assets.⁶²
- ***Louisiana.*** Louisiana consolidated some of its smaller pension funds into larger funds in 2010. Act 992 of 2010 (HB 1337).
- ***Missouri.*** In 2009, Missouri allowed the boards of its retirement systems to combine assets from different funds for investment purposes. (HB 265).

Other states have instituted public sector pension board reforms. Some of the reforms that states have enacted include establishing specific educational qualifications for pension board members and barring from membership individuals whose presence on the board poses a conflict of interest to the pension fund. States implement these reforms with the aim of improving pension solvency through better pension board investment decisions. Additionally, barring conflicted individuals from service on public pension boards can work to limit the opportunities for corruption.

- ***New Hampshire.*** New Hampshire began requiring that its new or reappointed trustees have finance or business management experience. Chapter 300, Laws of 2008 (HB 1645).
- ***Kentucky.*** Kentucky now requires that two of its governor's three pension trustee appointments possess at least ten years of investment experience. Act 127, Laws of 2010 (HB 146).
- ***Idaho.*** Idaho rules require that a majority (three out of five) of the members of its pension board not be members of the State's pension fund.⁶³

⁶¹ *Id.*

⁶² *The Trillion Dollar Gap* at 38.

⁶³ *Id.*

- **Utah.** Utah only allows two members of its seven-member board to participate in the pension fund. The other members are the state treasurer and four disinterested financial professionals.⁶⁴
- **Oregon.** Oregon also reorganized its board, changing from a board of 12 members who were mostly pension fund participants to a board of five consisting of board members unconnected to the fund.⁶⁵
- **South Carolina.** Prior to 2005, South Carolina’s pension was administered by the state treasurer with the advice of a board that had minimal authority. Now the fund is administered by a commission consisting of four investment professionals in addition to the treasurer.⁶⁶
- **New Mexico.** New Mexico permits pension participants to serve on its retirement board but the State now requires each participant board member to disclose the amount of his or her pension benefit. Chapter 60, Laws of 2010 (HB 231).

10. Taxing Pension Payments

In Illinois, retirees receiving income from defined benefit pension plans and 401(k) plans do not pay income tax on those proceeds. In light of recent budgetary troubles, some legislators have proposed taxing retirement income in order to address the recent budget shortfall.⁶⁷

D. TRANSITION TO A NEW A NEW PUBLIC SECTOR RETIREMENT PARADIGM

1. Review of Other Retirement Plan Options

The Illinois public pension system is exclusively a defined benefit system where public workers, upon retirement, receive a stream of payments until death. While providing workers with the certainty and financial security that are the hallmarks of such a system, as discussed above, the system is increasingly coming under financial strain. In recent years, private sector employers have transitioned away from a defined benefit retirement model to a defined contribution model. Some ideas for moving workers away from a defined benefit retirement system include the following.

⁶⁴ *Id.*

⁶⁵ *Id.*

⁶⁶ *Id.* at 39.

⁶⁷ Monique Garcia & Rick Pearson, *Illinois Senate President wants to look at taxing retirement income*, Chi. Trib., March 7, 2011.

a. Portable Defined Contribution Plans

Defined contribution plans have recently gained popularity in the private sector; such arrangements are also becoming part of public sector retirement plans. These plans allow employees to defer pre-tax dollars into an account where those proceeds grow tax-free over the course of an employee's career. In some cases, the employer matches the employee's contribution up to a certain percentage and imposes a schedule for vesting of those employer contributions. Employees benefit from defined contribution arrangements because they are both portable and 100% solvent. Structurally, defined contribution plans shift the risk from the employer to the employee to adequately set aside and invest money for his or her retirement. This can work to an employee's detriment, as the employee bears the risk of fully funding his or her pension. Participants who fail to adequately set aside sufficient funds or properly invest those funds over the course of their careers, or who retire during a period of poor market performance risk reaching retirement age with insufficient savings.

b. Cash Balance Plans and Hybrid Plans

Cash balance plans contain features of both defined benefit and defined contribution plans. Unlike other defined benefit plans, cash balance plans show an employee's accrued benefit as an account balance. At retirement, cash balance participants can elect to receive retirement payments based on the amount in the account, or to receive a lump sum payment. In the private sector, many employers froze traditional defined benefit plans and converted them to cash balance plans as the cash balance funding formula proved less costly. There are other forms of hybrid plans that contain features of both defined benefit and defined contribution plans. These plans include defined benefit plans with additional defined contribution options, defined contribution plans that permit an employee to annuitize his or her balance upon retirement, and pension equity plans that allow participants to withdraw the cash value of their defined benefits much like a defined contribution plan.

2. Proposals to Transition Illinois to a New System

The Civic Committee has endorsed transitioning to a defined contribution plan. While the Civic Committee endorses extending the 2010 pension reforms to current employees, it is also on record as supporting a new defined contribution system for State workers in its minority report to the Illinois Pension Modernization Task Force.⁶⁸

On the other hand, the Commission to Strengthen Chicago's Pension Funds did not explicitly reject a defined contribution system. The Commission did, however, underscore the importance of maintaining a defined benefit system. Specifically, the Commission worried that removing future employee contributions from the system would render the system insolvent for current employees and retirees.⁶⁹ Labor organizations, such as the

⁶⁸ State of Illinois, Report of the Pension Modernization Task Force, (Nov. 9, 2009), at 62.

⁶⁹ Commission to Strengthen Chicago's Pension Funds, Volume 1, Report and Recommendations, (City of Chicago) April 30, 2010, at 8.

American Federation of State, County and Municipal Employees, have not supported reforms which transition employees out of the defined benefit system.⁷⁰

3. Reform Proposals and Examples From Other States

For defined benefit arrangements in the public sector, states bear the risk when plans become underfunded. Alaska and Michigan have opted to shift the entire risk to their employees, and several states have attempted to mitigate the effects of the market by sharing some of the risk with retirees. While both of these reforms result in savings to the state, they may leave workers without adequate savings upon retirement. West Virginia switched back to a defined benefit plan for its employees for that reason.

a. Defined Contribution Plans

Switching from a defined benefit pension to a defined contribution pension can be a cost-effective way for states to mitigate the funding problems associated with traditional pension schemes. Defined contribution plans still, however, pose financial problems in terms of administration costs. According to the Center for State and Local Government Excellence, administration costs may be more than half a percent higher for defined contribution plans in comparison with defined benefit plans.⁷¹ Additionally, although the switch to a defined contribution plan allows for long-term savings, states are frequently still responsible for the funding shortfalls for the accrued benefits of their current employees. In the short term, such a switch may not always prove to be an effective solution to the problem of current underfunding.

Defined contribution plans frequently permit participants to direct their own investments, an arrangement that poses risks to plan participants who fail to properly invest their accounts. Participants may, for example, fail to adequately diversify investments, or select investments that are not suitable for their age and risk profile. When an employee's entire pension benefit is based on the amount in the account at retirement (disbursed as either a lump sum or as a lifetime annuity), it is very important that the money in the account be invested wisely. Defined contribution plans are also largely unpopular with public sector employees. In states that allow employees to choose between a variety of plans, including a defined contribution plan, the majority of employees prefer defined benefit plans.⁷² Although the private sector has largely transitioned to a defined contribution model, such arrangements are still rare in the public sector. While some states have offered defined contribution options to participants in addition to traditional pension plans, Michigan and Alaska are unique in that both states closed their defined benefit plans to new employees and

⁷⁰ American Federation of State, County, and Municipal Employees, *Defined Benefit vs. Defined Contribution Debate*, available at <http://retired.locals.educationminnesota.org/~media/retired/Defined%20Benefit-Defined%20Contributions%20Articles/AFSCMEDBvs%20DCDebate.ashx>.

⁷¹ *Issue Brief: Why Have Some States Introduced Defined Contribution Plans?*, Center for State and Local Government Excellence, 4 (Jan. 2008), available at <http://www.slge.org/vertical/Sites/%7BA260E1DF-5AEE-459D-84C4-876EFE1E4032%7D/uploads/%7B57D27C29-7E72-4300-9FC6-D47B67D8BB48%7D.PDF>.

⁷² *Id.* at 5, table 1.

offered a defined contribution plan as the exclusive retirement plan option to newly hired employees.

The following states have begun to offer employees defined contribution plans, either as a supplement to or in place of a defined benefit plan.

- **Alaska.** Alaska closed its defined benefit plan in 2005 and created a defined contribution plan for all new employees; non-vested employees under the old system were allowed to switch to the new defined contribution plan. Alaska Statutes, Chapter 14.15, (SB 141, First Special Session of 2005). The general plan requires an 8% employee contribution and a 5% employer contribution. In 2009 there was considerable discussion in Alaska of switching back to a defined benefit plan; however, Alaska continues to maintain its defined contribution plan.⁷³
- **Michigan.** Until recently, Michigan offered a defined contribution plan for all new employees hired after 1997. As discussed below, Michigan provided its teachers with a hybrid plan as of 2010. Under the defined contribution plan that is required for all other employees, employees may contribute up to 12% of payroll to the plan. The State makes a matching contribution of up to 7% of an employee's salary; 4% of this match is automatic. Public Act 487 of 1996 (House Bill 6229), Michigan Compiled Laws, Chapter 38, sections 1 – 69.⁷⁴
- **West Virginia.** West Virginia operated a defined contribution plan for its teachers from 1991 through 2005. That plan was merged back into a defined benefit plan in 2006 and, after much litigation, members of the defined contribution plan were able to transfer their enrollment to the defined benefit plan.⁷⁵
- **Minnesota.** Minnesota operates a defined contribution plan for its physicians, elected local governmental officials, city managers, and governmental volunteer ambulance service personnel. Upon retirement, members receive a lump sum payment. Employee and employer contribution rates vary according to employment classification, but contributions are usually between 5% and 7%, with some portion matched by the employer.⁷⁶

⁷³ More information is available at: <http://doa.alaska.gov/drb/programs/programs.html>.

⁷⁴ More information is available at: <http://www.michigan.gov/ors/>.

⁷⁵ Judy Ward, *State Plan Sponsor of the Year: A Lesson in Funding*, Plan Sponsor, 48-49 (Mar. 2009), available at <http://www.plansponsor.com/MagazineArticle.aspx?id=4294990027>.

⁷⁶ More information is available at http://www.mnpera.org/index.asp?Type=B_BASIC&SEC={8219D0EF-DA92-4EB9-B225-A9B5B8A2965C}.

b. Defined Contribution Option

Several other states currently allow employees to select a defined contribution plan as their primary plan.⁷⁷

- **Colorado.** Until recently, Colorado provided new employees with two defined contribution plan options in addition to a defined benefit option. One of the defined contribution plans was eliminated by legislation on July 1, 2009. Under the plan, employees are required to make an 8% contribution; employer contribution rates are statutorily set and vary by both job classification and by the employee's initial date of employment.⁷⁸
- **Florida.** Florida switched to a new retirement system in 2000. This system allows employees to choose between a defined benefit plan and a defined contribution plan. The defined contribution plan provides a 9% employer contribution; employees do not contribute to the plan. The defined contribution option vests after one year, whereas employees electing the defined benefit are subject to a six year vesting schedule.⁷⁹
- **Montana.** Since 2002, Montana has had an optional defined contribution plan. All employees are initially members of a defined benefit plan and are given 12 months to decide whether to switch to the defined contribution plan; once employees make the election, their choice is irrevocable. Members of the defined contribution plan contribute 7.17% and the State contributes 7.37% of employee income to the plan. Members of Montana's defined benefit plan accrue benefits at a rate of 1.785% each year. The defined benefit plan requires employees to contribute 6.9% of annual income while Montana contributes 7.17% of employee compensation to the fund. The defined benefit plan also provides a 1.5% guaranteed annual COLA for employees hired after July 1, 2007 (the COLA for employees hired before that was 3%).⁸⁰

⁷⁷ For additional information on defined contribution pension plans, see Ronald Snell, *State Defined Contribution and Hybrid Pension Plans*, National Conference of State Legislatures (June 2010) <http://www.ncsl.org/LinkClick.aspx?fileticket=yGsmFhwoq7E%3d&tabid=18511>; *Primary Defined Contribution Plans Data Set*, Center for State and Local Government Excellence (Aug. 2008), available at http://www.slge.org/index.asp?Type=B_BASIC&SEC=%7B6B5D32FD-C99D-41F7-9691-4F1B1D11452B%7D&DE=%7B2FC4DEA5-E113-4C0E-822F-359297BF92C2%7D (click on Data, Notes, and Codebook); *Issue Brief: Why Have Some States Introduced Defined Contribution Plans?*, Center for State and Local Government Excellence, 4 (Jan. 2008), <http://www.slge.org/vertical/Sites/%7BA260E1DF-5AEE-459D-84C4-876EFE1E4032%7D/uploads/%7B57D27C29-7E72-4300-9FC6-D47B67D8BB48%7D.PDF>; and Committee on Retirement and Benefits Administration, *Essential Design Elements of Defined Contribution Plans as the Primary Retirement Plan*, Government Finance Officers Association (Feb. 22, 2008), <http://www.gfoa.org/downloads/DCPlansFINAL.pdf>.

⁷⁸ More information is available at: <http://www.copera.org/pera/active/dc.htm>.

⁷⁹ More information is available at <http://www.myfrs.com>.

⁸⁰ More information is available at: <http://mpera.mt.gov/>.

- **North Dakota.** In 1999, North Dakota created an optional defined contribution plan for all “non-classified” employees. Employees are required to contribute 4%, but this contribution may be paid by the employer at the employer’s discretion. Additionally, employers are required to contribute 4.12% of an employee’s salary, regardless of whether they pick up the employee’s contribution.⁸¹
- **Ohio.** Ohio has created an optional defined contribution plan for many employees. The State offers the choice of a traditional defined benefit plan, a defined contribution plan, or a hybrid plan (discussed below). New employees have 180 days to make an election. Employer contributions change annually and were 8.73% for 2010. Employee contributions also change annually but were 9.9% for the past three years.⁸²
- **South Carolina.** South Carolina also provides an optional defined contribution plan. New employees have 30 days to elect whether to participate. There is a 6.5% required employee contribution but employers are statutorily required to pick that up. Additionally, the defined contribution plan requires employer contributions of 9.24%, 5% of which is devoted to individual employee accounts; the additional contribution covers accrued liability in the retirement system generally.⁸³
- **Utah.** Last year Utah closed its defined benefit plan and now allows new employees to elect either a defined contribution plan or a hybrid plan. The State’s contribution to both plans is 10% which constitutes a decrease of 4.22%. Senate Bill 63 of 2010. Employees do not need to contribute to the plan, but they may. Employee contributions vest immediately while employer contributions vest after four years.⁸⁴

c. Hybrid Plans

Some states looking to avoid the potentially high cost of defined benefit plans while still providing their employees with some protections against investment risk have adopted various hybrid plans. Instead of providing full defined benefit pensions, these systems provide a smaller defined benefit while also creating a supplemental defined contribution plan. Although the employee bears all of the risk for the defined contribution plan as stated above, the state will still be providing (and funding) a partial pension. This reduces the cost to the employer, but also avoids some of the problems faced by employees in providing for their own retirement. Several states have adopted some variation of a “hybrid plan” for their

⁸¹ More information is available at: <http://www.nd.gov/ndpers/forms-and-publications/publications/dc-plan-handbook.pdf>.

⁸² More information is available at: <https://www.opers.org/members/plan-select/info/descriptions.shtml>.

⁸³ More information is available at: <http://www.retirement.sc.gov/oursystems/default.htm>.

⁸⁴ More information is available at: <http://www.urs.org>.

employees.⁸⁵ For example, the following states have implemented some form of a hybrid plan:

- **Michigan.** In 2010 Michigan began requiring that all new education employees enroll in a hybrid plan instead of the State's defined contribution plan. Act 75 of 2010 (SB 1227). Employees automatically contribute 2% of their salary and the State matches these contributions at a rate of 1%. Employees accrue pension benefits at a rate of 1.5% per year.⁸⁶
- **Florida.** In 2000, Florida switched to a new retirement system, allowing current employees to choose between a defined benefit plan, a defined contribution plan, or a hybrid plan. Approximately 95% of current employees stayed with the defined benefit plan.⁸⁷ The hybrid plan option was only available during the transitional period.
- **Georgia.** Georgia has a unique plan where participants accrue benefits at a rate of 1% per year along with a defined contribution plan that members may participate in on a voluntary basis. If members stay in the defined contribution plan, the plan requires a mandatory 1% employee contribution which the employer will match. The employer will also match any additional contributions to the defined contribution plan at 50% up to 3% of employee salary deferrals. Act 757 of 2008 (Senate Bill 328).⁸⁸
- **Indiana.** Indiana requires its public sector employees to participate in the State's hybrid plan. Participants accrue benefits under the pension component of the plan at a rate of 1.1% each year. The defined contribution portion requires a 3% employee contribution and allows employers to elect to make employee contributions. Of note, the Teacher's Retirement Fund has an investment option that provides a guaranteed return, recalculated on an annual basis.⁸⁹
- **Ohio.** Ohio allows employees to choose among a defined benefit plan, a defined contribution plan, or a hybrid plan. Participants accrue pension benefits in the

⁸⁵ For additional information on hybrid pension plans, see Ronald Snell, *State Defined Contribution and Hybrid Pension Plans*, National Conference of State Legislatures (June 2010), <http://www.ncsl.org/LinkClick.aspx?fileticket=yGsmFhwoq7E%3d&tabid=18511>; *Key Elements of State Hybrid Retirement Plans*, National Association of State Retirement Administrators (Nov. 2010), <http://www.nasra.org/resources/Hybrid%20Grid.pdf>; *Hybrid and Defined Contribution Plans as the Primary or Optional State Retirement Benefit*, National Association of State Retirement Administrators (Feb. 2011), <http://www.nasra.org/resources/hybriddc.pdf>; and *What Are Hybrid Retirement Plans? A Quick Reference Guide*, Center for State and Local Government Excellence (Jan. 2011), <http://www.slge.org/vertical/Sites/%7BA260E1DF-5AEE-459D-84C4-876EFE1E4032%7D/uploads/%7BFC7FAD34-A28A-4443-9865-0D611C25C13E%7D.PDF>.

⁸⁶ More information is available at: <https://stateofmi.ingplans.com/eportal/welcome.do>.

⁸⁷ See *infra* *Hybrid and Defined Contribution Plans as the Primary or Optional State Retirement Benefit*.

⁸⁸ More information is available at: http://www.ers.ga.gov/plans/ers/gseps/formspubs/GSEPS_PlanOverview_FINAL4.pdf.

⁸⁹ More information is available at: www.in.gov/perf and www.in.gov/trf.

hybrid plan at a rate of 1% each year. This benefit accrual rate increases to 1.5% after 30 years of service. There is a 10% employee contribution to the defined contribution portion of the plan; employer contributions are partially used to fund accrued benefits in the defined benefit plan along with retiree health benefits. Of note, the vast majority of employees have elected traditional defined benefit plans.⁹⁰

- **Oregon.** Oregon has required participation in its hybrid plan for all employees hired after August 2003. Participants accrue benefits at a rate of 1.5% each year in an employer funded defined benefit plan. There is a 6% employee contribution to the defined contribution component of the plan, but employers may elect to make that contribution on their employee's behalf.⁹¹
- **Utah.** Utah now allows new employees to elect either a defined contribution plan or a hybrid plan. The employer contribution to both plans is 10%. To be clear, the employer contribution is only 10% under either option; in the hybrid plan, the total employer contribution is split between the defined benefit and defined contribution aspects of the plan. The default option is the hybrid plan.⁹²
- **Washington.** Washington allows employees to select a hybrid plan where public sector employees accrue defined benefit pension benefits at a rate of 1% each year. The defined contribution portion of the plan allows for employees to defer between 5% and 15% of their salary. The State does not provide employees with a matching contribution.⁹³

d. Cash Balance Plans

Rather than implementing a defined contribution plan, some states have offered employees a cash balance plan. This unique form of defined benefit plan shares traits of both defined benefit and defined contribution plans. Cash balance arrangements do not rely on a benefit accrual formula; instead, participant pension benefits are calculated based on the balance in a participant's hypothetical account. Employees and the employer make contributions to a general fund which is invested by the state and employee "accounts" are credited with the investment returns in proportion to those contributions.

⁹⁰ See *infra* Hybrid and Defined Contribution Plans as the Primary or Optional State Retirement Benefit. More information is available at: www.opers.org and www.strsoh.org.

⁹¹ More information is available at: http://oregon.gov/PERS/MEM/section/forms/OPSRP_retire.shtml.

⁹² The Government Finance Officers Association refers to cash balance plans as "hybrid" plans. In 2008 they issued a statement of best practices regarding hybrid plans: Committee on Retirement and Benefits Administration, *Essential Design Elements of Hybrid Retirement Plans*, Government Finance Officers Association (Feb. 22, 2008), <http://www.gfoa.org/downloads/HybridPlansFINAL.pdf>. Another very informative resource is a study by the Government Accountability Office done in 2005 at the request of members of congress: *Private Pensions: Information on Cash Balance Pension Plans*, GAO (Oct. 2005), available at <http://www.gao.gov/new.items/d0642.pdf>.

⁹³ More information is available at: <http://www.icmarc.org/xp/plan3/>.

- **Nebraska.** Nebraska was the first state to implement a cash balance plan. Specifically, in 2002, Nebraska eliminated its defined contribution plan in response to research indicating that defined contribution plans were leaving employees ill-prepared for retirement.⁹⁴ Nebraska Statutes, §§84-1301 through 84-1333. Under the new cash balance plan, employees contribute 4.5% of their salary and the State contributes 7.5% of each employee's salary. The Nebraska cash balance plan guarantees a safe 5% annual return on investments and provides discretionary, extra dividends when the fund investments outperform this benchmark.⁹⁵ Nebraska's cash balance plan mitigates some of the investment risk associated with traditional defined contribution plans, but also saves the State the much higher costs associated with a traditional defined benefit plan. By removing the defined benefit formula, the State is not responsible for dramatic shortfalls in the expected return on investments. Although much of the risk in a cash balance arrangement is still technically with the employer, the potential impact of this risk is substantially decreased.

e. **Private Sector Transition Away from a Defined Benefit Model**

In the private sector, defined benefit arrangements are becoming increasingly rare. For example, in 1975, defined benefit plans constituted one-third of all plans and enrolled two-thirds of all new plan participants.⁹⁶ Defined benefit plans also accounted for two-thirds of plan assets and contributions.⁹⁷ By 1998, defined benefit plans constituted only one-twelfth of all private sector retirement plans, contained less than half of retirement plan assets, and received under a fifth of contributions.⁹⁸ Additionally, defined benefit plans enrolled under a third of all new plan participants.⁹⁹ By 2004, 63% of workers had only a defined contribution plan, while 20% of workers had only a defined benefit plan.¹⁰⁰

There are four principal reasons for the shift from defined benefit plans to defined contribution plans:

⁹⁴ *The Trillion Dollar Gap* at 40.

⁹⁵ The study that lead the state to adopt the cash balance plan is available at http://www.nlc.state.ne.us/docs/pilot/pubs/Nebraska_Benefit_Review_Study.pdf.

⁹⁶ See William G. Gale, Leslie E. Papke & Jack Vanderhei, *The Shifting Structure of Private Pensions, in The Evolving Pension System: Trends, Effects, and Proposals for Reform* 51, 55-62 (William G. Gale, John B. Shoven & Mark J. Warshawsky eds., 2005).

⁹⁷ *Id.*

⁹⁸ *Id.*

⁹⁹ *Id.*

¹⁰⁰ See Alicia H. Munnell & Annika Sundén, Ctr. for Retirement Research at Boston Coll., *401(k) Plans are Still Coming Up Short* 2 (Mar. 2006), http://crr.bc.edu/images/stories/Briefs/ib_43.pdf.

- Complex funding requirements for defined benefit plans have made them administratively costly for small employers.¹⁰¹ Defined benefit plans generally require greater administrative costs and use of consultants because they have much more complex funding requirements.¹⁰² Additionally, employers must insure defined benefit programs by paying premiums to the Pension Benefit Guaranty Corporation (“PBGC”). Defined contribution plans do not require a plan administrator to pay insurance premiums to the PBGC.¹⁰³
- Many large enterprises that previously sponsored defined benefit plans have faced deteriorating economic circumstances that have caused them to cut back on expensive benefit programs.¹⁰⁴ These economic circumstances, along with the increased funding requirements that congress imposed under the PPA have made it more difficult for employers to maintain and adequately fund traditional defined benefit pension arrangements. For example, United Airlines and General Motors have eliminated or drastically reduced their defined benefit programs in the last decade. United Airlines terminated its defined benefit program in bankruptcy.¹⁰⁵ General Motors severely curtailed its program years prior to entering bankruptcy.¹⁰⁶
- Defined benefit plan sponsors suffer a competitive disadvantage compared to firms that do not sponsor defined benefit plans.¹⁰⁷ This was the primary argument United Airlines made in bankruptcy. United specifically referenced competitive pressures from low-cost carriers like Southwest (which did not sponsor a defined benefit pension plan) as a reason for eliminating its pension plan.¹⁰⁸

¹⁰¹ William Handley Woolston, *Whose Money Is It Anyway? The Case for a Mortality Discount for Cash Balance Plan Early Termination Lump Sum Distributions*, 10 U. PA. J. BUS. & EMP. L. 383, 430 (2008).

¹⁰² Susan J. Stabile, *The Behavior of Defined Contribution Plan Participants*, 77 N.Y.U. L. REV. 71, 76-77 (2002) (discussing the advantages of defined contribution plans for employers).

¹⁰³ Chase A. Tweel, *Retirement Savings in the Face of Increasing Longevity: the Advantages of Deferring Retirement*, 14 N.C. Banking Inst. 103, 123 (2010).

¹⁰⁴ Samuel Estreicher & Laurence Gold, *The Shift From Defined Benefit Plans to Defined Contribution Plans*, 11 LEWIS & CLARK L. REV. 331, 331 (Summer 2007).

¹⁰⁵ *Editorial: United’s Pension Debacle*, N.Y. Times (May 12, 2005), available at <http://www.nytimes.com/2005/05/12/opinion/12thu1.html>.

¹⁰⁶ Micheline Maynard, *G.M. Freezes Pension Plan of Its Salaried Workers*, N.Y. Times (Mar. 8, 2006), available at <http://www.nytimes.com/2006/03/08/automobiles/08auto.html>.

¹⁰⁷ Samuel Estreicher & Laurence Gold, *The Shift From Defined Benefit Plans to Defined Contribution Plans*, 11 LEWIS & CLARK L. REV. 331, 331 (Summer 2007).

¹⁰⁸ Brief of Appellee United Airlines, Inc. at 5, *In re UAL Corp.*, 468 F.3d 444 (7th Cir. 2006) (No. 06-1222), 2006 WL 2300671; Editorial, *Airlines: Cut Costs or Perish*, Chi. Trib., Dec. 10, 2002, § 1, at 28.

- Defined benefit plan funding requirements are volatile and fluctuate with market conditions.¹⁰⁹ For example, a firm can have a benefit plan funded at 100% of actuarial requirements in year one, and in year two, the investments in the plan could fall precipitously.¹¹⁰

Furthermore, within the segment of existing defined benefit plans, a shift is taking place. Traditional defined benefit plans pay out a set amount of money for a fixed period of time, often for the remainder of the retiree's life. However, increasingly, employers have been freezing traditional defined benefit plans. In one survey, 62% of private plan sponsors froze at least one plan in the previous 10 years, while 28% froze all plans.¹¹¹ In these cases, the defined benefit program still exists, but future expected benefit accruals cease.

Furthermore, within the category of defined benefit plans, many employers converted their traditional pension plans into cash balance plans.¹¹² In fact, between 1998 and 2008, 52% of plan sponsors converted plans covering their non-unionized worker populations from a traditional defined benefit plan to a cash balance plan and 21% of sponsors converted plans covering their unionized workforce. In a cash balance plan, the employer – occasionally with contributions from the employee – pays money into a fund. The employee has no say over the allocation of the money in the fund, but such employee is guaranteed a set annual rate of return. Furthermore, like a traditional defined benefit plan, the employer may actuarially underfund. When the employee retires, he is entitled to the entire amount in the fund. Thus, like a defined contribution plan, the employer is not responsible for guaranteeing continued payments of a fixed amount to the employee after retirement. Like a defined benefit plan, a set benefit is promised at retirement and the employer bears the investment risk until the employee retires.

III. LEGAL ISSUES AFFECTING POTENTIAL REFORM PROPOSALS

Underpinning the debates on Illinois pension reform are certain legal issues arising under the Pension Protection Clause and the Illinois court opinions that have interpreted and applied its provisions. In this section, we identify and discuss some constitutional and other legal issues that have arisen or likely will arise as Illinois considers the various pension reform proposals.

¹⁰⁹ Gordon T. Butler, *American Paternalism and the One Fund Solution*, 9 Wyo. L. Rev. 485, 509 (2009); Henry H. Drummonds, *The Aging of the Boomers and the Coming Crisis in America's Changing Retirement and Elder Care Systems*, 11 LEWIS & CLARK L. REV. 267, 296 (2007).

¹¹⁰ Jeremy Caplan, *Pension Funds Weakened by Stock-Market Decline*, Time.com (Oct. 31, 2008), available at <http://www.time.com/time/business/article/0,8599,1855076,00.html>.

¹¹¹ *Defined Benefit Pensions*, *supra* note 54, at 30.

¹¹² *Id.*

A. THE PENSION PROTECTION CLAUSE IN THE ILLINOIS CONSTITUTION

The 1970 Illinois Constitution was ratified on December 15, 1970, and became effective on July 1, 1971. Article XIII, Section 5 of the Constitution, known as the “Pension Protection Clause,” states:

Membership in any pension or retirement system of the State, any unit of local government or school district, or any agency or instrumentality thereof, shall be an enforceable contractual relationship, the benefits of which shall not be diminished or impaired.

Ill. Const. art. XIII, § 5 (1970).

The Pension Protection Clause classifies a public pension plan as an enforceable contract between an employee and the state or local government. Prior to the enactment of this clause, Illinois categorized pension plans as either mandatory or optional. If an employee was required to participate in a pension plan, then any rights created thereby were gratuitous and could be revoked at will. *See Bergin v. Board of Trustees of the Teachers’ Ret. Sys.*, 31 Ill. 2d 566, 574 (1964). Any amendment could retroactively affect pension rights so long as the pension participant had not yet retired or passed away. *Keegan v. Board of Trustees*, 412 Ill. 430, 435 (1952). Prior to 1971, if participation in a public pension plan was compulsory, then the legislature was free to alter the allocation of pension benefits from time to time to best serve the welfare of the state. *Id.* at 436.

If, however, the employee’s participation in the pension plan was optional, the pension was an enforceable contract. In *Bardens v. Board of Trustees of the Judges Retirement System*, 22 Ill. 2d 56, 60 (1961), the Illinois Supreme Court invalidated an amendment to the Judges Retirement System Act that changed how judges’ pension benefits were calculated with the result that the benefits were decreased. Because the plaintiff’s participation in the plan was optional, the court found the plaintiff had a contract right to a pension calculated under the statute that existed when he began his employment. *Id.* at 60-61.

The Pension Protection Clause was not drafted by a constitutional committee but rather was introduced during the debate on the Constitution in response to concerns voiced by public employees who were members of mandatory pension plans. These employees were concerned about the status of their rights and had been advocating for such a clause. Elmer Gertz, the Chairman of the Bill of Rights Committee at the 1970 Constitutional Convention, had received “hundreds, if not thousands” of letters from government employees requesting a clause protecting their pension benefits.¹¹³ These employees wrote to Mr. Gertz, expressing concern that they would be left destitute given the lack of funds in the State pension system. Likewise, Delegate Green received a letter from the Executive Director of

¹¹³ *See* Elmer Gertz, *The Making of the Illinois Constitution of 1970*, 5 J. MARSHALL J. OF PRAC. & PROC. 215, 233 (Spring 1972).

the State Universities Retirement System a few weeks before the clause was proposed. The Executive Director explained that, given that mandatory pensions were mere gratuities and that the State has continuously failed to adequately fund the pension system, “public employees [were] beginning to lose faith in the ability of the State... to meet benefit payments....”¹¹⁴

With public employees clearly nervous about the status of their mandatory pension plans, the adoption of the Pension Protection Clause thus eliminated this distinction, making public pension plans enforceable contracts under which state and local governments are required to pay pension benefits to their employees. *See People ex rel. Sklodowski v. State*, 182 Ill. 2d 220, 228-29 (1998).

In addition to mandating that participation in a public pension plan is a contractual relationship, the Pension Protection Clause also requires that the benefits of this relationship not be diminished or impaired. While one delegate to the 1970 Constitutional Convention was concerned that pension plans that are not fully funded would “impair” benefits, the Illinois Supreme Court has explicitly stated that the Pension Protection Clause does not grant a right to a particular level of funding. *People ex rel. Illinois Federation of Teachers v. Lindberg*, 60 Ill. 2d 266 (1975); *McNamee v. State*, 173 Ill. 2d 433 (1996); *People ex rel. Sklodowski v. State*, 182 Ill. 2d 220, 232 (1998) (holding there is no vested contractual right to statutory funding levels); *see also Houlihan v. City of Chicago*, 306 Ill. App. 3d 589 (1st Dist. 1999). Regarding diminishment, the clause prohibits State and local governments from abolishing or reducing pension benefits. *Felt v. Board of Trustees*, 107 Ill. 2d 158, 162 (1985). The prohibition, however, does not mandate a cost of living adjustment. 4 Record of Proceedings, Sixth Illinois Constitutional Convention, Verbatim Transcript of July 21, 1970, at 2931.¹¹⁵

B. WHETHER REDUCING BENEFITS FOR CURRENT EMPLOYEES IS CONSTITUTIONAL

Whether the Illinois legislature can constitutionally reduce the prospective pension benefits of current employees is an extremely important issue given Illinois’s current budget deficit. We summarize below the arguments and legal authority advanced by those who believe reducing benefits is legal and those who contend any such reduction would violate the Pension Protection Clause.

1. Authority Holding That Reducing Benefits Is Constitutional

The Pension Protection Clause went into effect on July 1, 1971. Only a few years after that, the Illinois Supreme Court ruled on a legal challenge arising under the recently-enacted Clause. In *Peters v. City of Springfield*, 57 Ill. 2d 142 (1974), Mr. Peters, a 60-year-

¹¹⁴ Memorandum from Edward S. Gibala, Executive Director, State Universities Retirement System, to Henry Green, Delegate, 1970 Illinois Constitutional Convention (July 2, 1970).

¹¹⁵ The verbatim transcripts of the Record of Proceedings for the Sixth Illinois Constitutional Convention, Vol. 4 can be found at <http://www.idaillinois.org/cdm4/document.php?CISOROOT=/isl2&CISOPTR=7417&REC=15>.

old Springfield fireman, sued to enjoin the enforcement of a Springfield ordinance reducing the mandatory retirement age of Springfield policemen and firemen from 63 to 60 as unconstitutional under the Pension Protection Clause. *Id.* at 144. The firemen’s pension fund statute stated that the monthly pension would be increased by 1% for each additional year that the fireman worked over 20 years. *Id.* at 150. Because Mr. Peters had worked over 20 years, he qualified for this 1% increase for each additional year. As a result, the Springfield ordinance would force Mr. Peters to retire three years earlier than he previously anticipated, causing him to lose an additional 3% increase. Mr. Peters thus argued that the ordinance diminished and impaired his pension rights as they existed at the time he began his employment in Springfield. *Id.* at 144.

The Illinois Supreme Court noted that the firemen’s pension fund formula is based on salary and length of service; thus, “any change in these variables will affect the amount of the pension.” *Id.* at 151. Holding the city ordinance constitutional, the Illinois Supreme Court determined that the purpose of the Pension Protection Clause:

[W]as to insure that pension rights of public employees which had been earned should not be “diminished or impaired” but that it was not intended, and did not serve, to prevent the defendant City from reducing the maximum retirement age, even though the reduction might affect the pensions which plaintiffs would ultimately have received.

Id. at 152. As a result, the City of Springfield could constitutionally reduce the retirement age, even though current employees’ maximum potential pension benefits would be subsequently reduced.

A few years after the Illinois Supreme Court decided *Peters*, Illinois Attorney General William Scott issued an opinion determining that new Illinois legislation, which went into effect on January 1, 1978 and changed the way state employees’ compensation is calculated for pension purposes, was constitutional under the Pension Protection Clause. Atty. Gen. Op. No. S-1407, 1979 Ill. Atty. Gen. (Jan. 10, 1979). Both before and after the new legislation was enacted, an employee’s pension was based on her final average compensation over her last four years of employment. The new legislation, however, provided that “the average compensation for the last 12 months of the 48-month period shall not exceed the final average compensation by more than 25%.” *Id.* at 4. Thus, if the employee’s final year salary exceeds the four-year average by more than 25%, “not all of the fourth year’s pay can be considered for pension purposes.” *Id.*

In determining that the new legislation was constitutional, Attorney General Scott quoted the language from *Peters* that pension benefits of public employees “which had been earned” shall not be diminished and concluded that “[t]here is no earned right to increase one’s pension by being appointed to a higher paid position in the last of the four measuring years.” *Id.* at 8. Attorney General Scott further stated that “the 25 percent restriction may be applied only to earnings received after January 1, 1978. However, I do not agree that this

means that the 25 percent limitation could only be applied if the total 48-month period consisted of earnings received after January 1, 1978.” *Id.* at 9.

Those arguing that prospective reductions in benefits are constitutional have also relied on the language of the Pension Protection Clause itself, and on the contemporaneous understanding of its meaning, as derived from the transcripts of the 1970 Constitutional Convention debates.

During the debate, just prior to the roll-call vote on the Pension Protection Clause, one of its two principal sponsors, Mrs. Helen Kinney, stated in her summation:

We thought that it would be quite fair if a person undertook employment under a statute that provided for a contingency for lowering the benefits at some future time, that this was, indeed, the contract that he had accepted. All we are seeking to do is to guarantee that people will have the rights that were in force at the time they entered into the agreement to become an employee, and as Mr. Green has said, if the benefits are \$100 a month in 1971, they should be not less than \$100 a month in 1990.

4 Record of Proceedings, Sixth Illinois Constitutional Convention, Verbatim Transcript at July 21, 1970, 2931-32. The transcripts of the debates do not reflect that either the other principal co-sponsor, Mr. Henry Green, or any of the other delegates voiced disagreement with Mrs. Kinney’s statement. Both sides, however, contend that Delegate Kinney’s statements provide support for their position.

It is argued that the Pension Code allows for just such a contingency, in that it does not explicitly provide a vested right to benefit accrual under a specific formula. This is said to be supported by the general rule that statutes “do not create private contractual or vested rights, but merely declare a policy to be pursued until the legislature ordains otherwise.” *People ex rel. Sklodowski v. State*, 182 Ill.2d 220, 231 (1998) (citing *Fulmarolo v. Chicago Board of Education*, 142 Ill. 54, 104 (1990)). Since there is no express provision of the Pension Code that provides a vested right to accrue benefits under a given formula, prospective changes to the formula are allegedly in line with the Pension Protection Clause as it was originally understood by the Delegates to the 1970 Convention. Under this view, prospective changes in benefit accrual rates would not violate the Pension Protection Clause, and would therefore be constitutional.

Moreover, even if the Pension Protection Clause is read to protect benefits at a certain rate or level, those who maintain that a prospective reduction in benefits is constitutional argue it would not legally diminish or impair the benefits of membership in the pension systems. They contend that Constitutional rights presuppose the existence of a state government that provides education, public safety, and other essential services, and that these rights must yield when legislation advances compelling police power interests. This argument is based on language in *Felt v. Board of Trustees of the Judges Retirement System*, 107 Ill.2d 158, 165 (1985) (further discussed *infra* at Section III(B)(2)), where the Illinois Supreme Court held that the Contract Clause “does not immunize contractual obligations from every conceivable kind of impairment or from the effect of a reasonable exercise of the

police power.” Those arguing for the constitutionality of benefit reductions suggest that this logic should also apply to the current pension funding crisis because the General Assembly has “an undeniable interest and responsibility in ensuring the adequate funding of state pension systems.” *Id.* at 166.

Although the legislation at issue in *Felt* was found to be unconstitutional, proponents of this position maintain the present situation is different. The Court in *Felt* applied a balancing test, weighing the extent of the “impairment” against the state interest purportedly served by the legislation. There, the impairment to the affected judges was severe and the state’s interest was minor because the legislation would not have noticeably improved the State’s ability to contribute to the pension fund. Here, it is argued that legislation prospectively changing the benefit accrual formula could overcome the balancing test because a prospective benefit reduction would essentially eliminate a large portion of the unfunded pension liabilities. As a result, such a reduction would further the State’s interest in ensuring adequate funding of the pension system.

As to the other half of the balancing test, it is argued that prospective changes to benefits would not impair or diminish benefits, but would instead enhance them in that, currently, the State may not have enough funds to both pay out all of the pension benefits that have already accrued and to continue to provide other essential services. By prospectively reducing benefit accruals, it is asserted that the State will be able to satisfy its previously accrued pension obligations without reducing services. If the State were not able to pay pension benefits under the status quo, any action that enables the State to satisfy those already accrued claims could be seen as an enhancement of members’ pension benefits. This view inherently supports considering the severity of the funding crisis as part of the balancing test.

Lastly, even if members of the pensions systems are worse off (to the extent that they would receive a lower overall pension following a prospective reduction), it is argued that such an interference would be minor because previously earned benefits are clearly protected, and the effect of a prospective reduction in future benefits would be considerably less significant than the prospective salary reductions or layoffs that the State could otherwise potentially impose.

2. Authority Holding That Reducing Benefits Is Not Constitutional

Those who argue that a reduction in benefits for current employees would violate the Pension Protection Clause rely on, among other legal authority, certain key court cases. In the cases discussed below, Illinois courts have interpreted the Pension Protection Clause as prohibiting any diminishment to current employees’ pension benefits and held the relevant legislation reducing benefits to current employees to be unconstitutional. These courts have reasoned that public employees have a constitutional right to have their pensions calculated under the method existing when they first began working.

- *Kraus v. Board of Trustees*, 72 Ill. App. 3d 833 (1st Dist. 1979). In this case, Mr. Kraus began his career as a policeman in Niles, Illinois in 1956 but was placed on disability on October 1, 1967. At the time Mr. Kraus was placed on

disability, the Pension Code provided that when a disabled policeman reached retirement age and elected to retire, the policeman would be paid a regular pension equal to half of the salary attached to the rank he held for one year immediately prior to retirement. *Id.* at 835. In 1973, however, the Pension Code was amended to state that when a disabled policeman elected to retire, the policeman would be paid a regular pension equal to half of the salary attached to his rank on the police force at the date of his retirement on disability. *Id.* On July 7, 1976, Mr. Kraus became eligible and elected to retire. Since the salary attached to Mr. Kraus's rank was presumably higher in 1976 than in 1967, Mr. Kraus argued that his regular pension should be calculated under the older statute. *Id.* at 836.

In analyzing the constitutional issue before it, the Illinois Appellate Court reviewed the Illinois cases applying the Pension Protection Clause, including *Peters*, but did not find any of them to be determinative. The court did, however, follow the lead of the Illinois Supreme Court in *Peters* by examining the constitutional debates for guidance. Quoting Delegate Kinney's statement that the clause provides employees protection against "changing the terms of their rights after they have embarked on the employment—to lessen them," the court concluded that "[a]t the time plaintiff became an employee of the police force and a member of the pension system, the applicable section of the Pension Code [guaranteed the salary attached to his rank one year prior to retirement]." *Id.* at 844. Thus, the amended Pension Code was held unconstitutional as applied to Mr. Kraus. *See also Kuhlmann v. Board of Trustees*, 106 Ill. App. 3d 603 (1st Dist. 1982) (plaintiff was entitled to a pension based on the salary attached to his rank in 1980, even though he had been on a disability pension since 1968); *Peifer v. Board of Trustees*, 35 Ill. App. 3d 383 (1st Dist. 1976) (plaintiff's pension benefits were to be calculated under the statute in effect when he was put on disability).

- *Felt v. Board of Trustees*, 107 Ill. 2d 158 (1985). In *Felt*, when the three plaintiffs became judges and when the fourth plaintiff's deceased husband became a judge, retirement benefits for judges were based on the judge's salary on his last day of work. *Id.* at 161. However, under an amendment effective January 1, 1983, the base salary used to compute retirement benefits would be the average salary for the judge's final year of service. The three plaintiffs retired, and the widow's husband died, after January 1, 1983. *Id.* Each plaintiff applied for benefits based on the salary on the last day of work.

In determining whether this change was unconstitutional under the Pension Protection Clause, the Illinois Supreme Court pointed out that the amendment changed the salary base used to calculate retirement benefits. Because each of the plaintiffs had received a raise less than a year before they retired, the change diminished the plaintiffs' retirement benefits. *Id.* at 162. Additionally, noting that the constitutional convention delegates followed a New York Constitutional provision as a model for the Pension Protection Clause, the court gave weight to a Court of Appeals of New York opinion holding a statute that diminished pension

benefits was unconstitutional when it retroactively applied to employees who were members of the retirement system prior to the effective date of the statute. *Id.* at 163 (referring to *Kleinfeldt v. New York City Employees' Ret. Sys.*, 36 N.Y.2d 95 (1975)). While the defendant Board of Trustees argued that the reduction of pension benefits was within the state's police power, the Illinois Supreme Court found the argument unconvincing. Even though it stated at the outset that it was considering on appeal only whether the amendment was constitutional as applied to the plaintiffs, *id.* at 160, the Illinois Supreme Court held the amendment to be "unconstitutional as applied to these plaintiffs and to other judges in service on or before the effective date of the amendment." *Id.* at 168.

- *Buddell v. Board of Trustees*, 118 Ill. 2d 99 (1987). Dr. Buddell became employed by Southern Illinois University (SIU) in 1969. Prior to his employment, he was on active duty in the armed forces. Under the law in effect when Dr. Buddell became an SIU employee, he could purchase service credit for time spent in military service. *Id.* at 101. However, in 1974 this law was amended to limit credit for military service only to those who applied for such credit prior to September 1, 1974. When Dr. Buddell applied to purchase these credits in 1983, he was denied due to the amendment.

In response to his legal challenge, the Illinois Supreme Court emphasized that when Dr. Buddell began his employment, he had the right to purchase service credits. Subsequently, when the 1970 Constitution became effective, "the rights conferred upon the plaintiff by the Pension Code became contractual in nature and [could not] be altered, modified or released except in accordance with usual contract principles." *Id.* at 104-05. The Illinois Supreme Court determined that the right to purchase credits was written in the Pension Code and was not provided for in another statute incidentally related to the calculation of pension benefits, and held that the 1974 amendment was unconstitutional as applied to Dr. Buddell. *Id.* at 104.

- *Miller v. Ret. Board of Policemen's Annuity*, 329 Ill. App. 3d 589 (1st Dist. 2002). In this more recent case, the Illinois court for the First District determined the constitutionality of a legislative reduction of pension benefits. The facts of this case are quite complicated, as the law affecting Mr. Miller's pension was amended multiple times; what follows is a simplified factual summary. In 1983, as the result of a United States Supreme Court holding, the retirement age for Chicago police officers was increased from 63 to 70. In 1985, Mr. Miller, a Chicago policeman, turned 63 and continued working. However, at this time, the Illinois Pension Code fixed retirement benefits at age 63, with a subsequent annual 3% increase. From 1985 until 1988, Mr. Miller continued to work without receiving pension benefits, while the 3% annual increase was accruing. In 1988, Chicago lowered the retirement age back to 63. In March of 1988, Mr. Miller retired at the age of 66; at this point, he began receiving pension benefits with a value fixed at age 63 with the annual 3% increase that had accrued for 3 years. However, in 1989, an amendment was passed that was retroactive to Jan. 1, 1988.

This amendment fixed benefits at the age an individual actually retired instead of at 63. Under this amendment, Mr. Miller's pension benefits would be fixed at age 66 but with the accrued 3% increases deleted, which would have given Mr. Miller lower monthly benefits. *Id.* at 592-94.

Analogizing this case to *Kraus* and *Felt*, the Illinois Appellate Court determined that “[s]ince it is undisputed that the plaintiffs entered the system before 1971, their pensions became vested in 1971 and the law which existed at that time controls the interpretation of the agreement in this case.” *Id.* at 598. Thus, the retroactive 1989 amendment unconstitutionally diminished Mr. Miller's pension rights. The court also found *Peters* to be distinguishable, explaining that unlike in that case, this amendment did not create an incidental effect on pension calculation but directly changed a fixed variable.

3. Application of Contract Law

The Pension Protection Clause provides that membership in a public pension system is an enforceable contractual relationship. Thus, when the right to pension benefits vests is central to how contract law affects the pension relationship. The general rule regarding the modification of vested benefits is that, upon vesting, benefits become forever unalterable. *Haake v. Board of Education*, 399 Ill. App. 3d 121, 139 (2d Dist. 2010) (citing *Bland v. Fiatallis N. America, Inc.*, 401 F.3d 779, 784 (7th Cir. 2005)). The two exceptions to this general rule are when both parties consent to the modification, *Haake*, 399 Ill. App. 3d at 129, or when the impairment of the vested benefits occurs through a legitimate exercise of police power. *Bank of Illmo v. Simmons*, 142 Ill. App. 3d 741, 745 (5th Dist. 1986). Otherwise, the legislature may not interfere with vested rights. *Maiter v. Chicago Board of Education*, 82 Ill. 2d 373, 390 (1980); *see also Hogan v. Bleeker*, 29 Ill. 2d 181, 187 (1963).

a. Employees Are Entitled to Increased Pension Benefits Once Their Rights Under New Legislation Vest

Some legislation that has passed since the 1970 Illinois Constitution became effective has increased employees' benefits. The Illinois appellate courts for the first, second, third, and fifth districts have held that, if legislation increases an employee's benefits during her employment, the employee becomes entitled to those benefits once she provides consideration for the contract modification. *Taft v. Board of Trustees*, 133 Ill. App. 3d 566 (2d Dist. 1985); *Gualano v. City of Des Plaines*, 139 Ill. App. 3d 456 (1st Dist. 1985); *Carr v. Board of Trustees*, 158 Ill. App. 3d 7 (3d Dist. 1987); *Fenton v. Board of Trustees*, 203 Ill. App. 3d 714 (5th Dist. 1990); *Schroeder v. Morton Grove Police Pension*, 219 Ill. App. 3d 697 (1st Dist. 1991).

In each of these cases, the same legislative action affected each of the plaintiffs in the same way. When each of the plaintiffs began their employment, the Workers' Compensation Act provided for a reduction in pension benefits by any amounts received as workers' compensation. In 1974, the section mandating this reduction was repealed. Each of the plaintiffs, subsequent to this repeal, continued contributing to the pension fund. In 1977, the Pension Code was amended, requiring pension disability payments be reduced by the

amounts received pursuant to the Workers' Compensation Act. After this last amendment, each of the plaintiffs were injured at work, began receiving a disability pension, and then were awarded workers' compensation. When their disability pensions were reduced based on the workers' compensation award pursuant to the 1977 amendment, each of the plaintiffs filed suit.

In *Schroeder*, the most recent of the cases, the First District explicitly adopted the rationale of *Taft*, *Gualano*, *Carr*, and *Fenton*. The First District held that:

The "contractual relationship" between the State and the employee is formed and governed by the actual terms of the contract or pension at the time the employee initially contributes to the system. The law which exists at the time of the contract formation is deemed to be a part of the contract as though it was expressly referred to or incorporated into it. ...The *Taft* court held that plaintiff Taft's continued contributions to his pension fund after the repeal of the reduction provision of the Workers' Compensation Act increased his pension benefits and constituted the vesting of an additional right.

Schroeder, 219 Ill. App. 3d at 701 (internal citations omitted). Had the plaintiffs not contributed to the pension fund after the repeal, they would not have benefitted from it. Just as an employee is protected from a reduction in pension benefits, the employee "cannot take advantage of a beneficial pension change without providing consideration for the contractual modification." *Kuhlmann v. Board of Trustees*, 106 Ill. App. 3d 603, 608 (1st Dist. 1982).

In *Sellards v. Board of Trustees*, 133 Ill. App. 3d 415, 417 (1st Dist. 1985), on facts nearly identical to those in the above-cited cases, the First District held that the Illinois Constitution "does not provide that a person has a vested right in any beneficial changes in a pension system." However, the First District has since then explicitly rejected *Sellards*. *Gualano*, 139 Ill. App. 3d at 459; *Schroeder*, 219 Ill. App. 3d at 701.

b. Vested Rights Can Only Be Modified if Both Parties Consent

Membership in a public pension system is an enforceable contract relationship that may be modified in accordance with general contract principles. However, the vested rights may not be disturbed absent the consent of both parties. *Haake*, 399 Ill. App. 3d at 129. Thus, if each individual employee agrees to a modification of the terms under which their prospective pension benefits are calculated, the legislation may constitutionally apply to them.

Under well-established Illinois law, a contract may be modified so long as all parties agree and provide additional consideration. See *Buddell v. Board of Trustees*, 118 Ill. 2d 99, 104-05 (1987) (holding that pension rights conferred by the Pension Code cannot be modified except in accordance with usual contract principles). A contract cannot be

modified “without the knowledge and consent of the remaining party to the agreement.” *Ross v. May Co.*, 377 Ill. App. 3d 387, 391 (1st Dist. 2007) (internal citation and quotations omitted). As the appellate court in *Kraus* noted, “there is nothing to prohibit an employee from agreeing, for consideration, to accept a reduction in benefits.” 72 Ill. App. 3d at 849. As the Illinois Supreme Court has stated, “[c]onsideration consists of some detriment to the offeror, some benefit to the offeree, or some bargained-for exchange between them.” *Doyle v. Holy Cross Hosp.*, 186 Ill. 2d 104, 112 (1999). However, “our courts have determined that mere continued employment, standing alone, does not constitute consideration supporting the unilateral modification of an existing employment contract.” *Id.* at 392.

Nonetheless, “[t]he essential element of consideration is a bargained-for exchange of promises or performances that may consist of a promise, an act, a forbearance, or the creation, modification, or destruction of a legal relation.” *Ross*, 377 Ill. App. 3d at 391. Forbearance is adequate consideration only when such forbearance was expressly or impliedly requested by the other party. *First Nat’l Bank of Red Bud v. Chapman*, 51 Ill. App. 3d 738, 742 (5th Dist. 1977).

The analysis under contract law changes, however, if the right to pension benefits does not vest until the underlying work has been completed. If an existing law changes by amendment or repeal prior to the vesting of a right, then no cause to object arises. *Griffin v. City of N. Chicago*, 112 Ill. App. 3d 901, 906 (2d Dist. 1983). If the pension right is only protected once it has been “earned” under *Peters*, the legislature may freely alter the calculation of a current employee’s prospective pension benefits.

c. Interfering with Vested Rights Under the Police Power

While the legislature cannot interfere with vested rights, an exception is made when the state must safeguard the interests of its citizens; including safeguarding economic needs. *Bank of Illmo*, 142 Ill. App. 3d at 745. Whether a statute interfering with vested rights is constitutional “depends upon the reasonableness, necessity and importance of the public purpose served.” *Id.* “The severity of the impairment measures the height of the hurdle the state legislation must clear.” *Allied Structural Steel Co. v. Spannaus*, 438 U.S. 234, 245 (1978). However, the Illinois Supreme Court confronted this argument and rejected it in the context of an earlier legislative change to one of the State’s pension plans. In *Felt*, the Board of Trustees administering the Judges Retirement System argued that the statute providing for a new calculation of pension benefits was within the state’s police power. The Illinois Supreme Court rejected this argument. Finding that two plaintiffs’ annuities would be reduced by \$3,187.44 and that another plaintiff’s annuity would be diminished by \$5,842.80, the court held that such an impairment would have been substantial and thus not a reasonable exercise of police power. *Felt*, 107 Ill.2d at 166. While the reduction of benefits was prompted by the legislative concern that the judicial retirement system was underfunded, the court found no basis that this legislation would solve that problem. *Id.* at 166-67.

There is some dispute over how *Felt* would apply to the present pension funding situation. Legislation that would reduce prospective pension benefits of current employees is arguably distinct from *Felt*. First, alleviating the severe budget crisis in Illinois could be viewed as an extremely important public purpose. Second, unlike in *Felt*, legislation

reducing prospective pension benefits is related to and could be deemed to aid the Illinois debt problem. Ultimately, whether such legislation is a valid exercise of police power is a question of fact for the courts.

C. WHETHER THE ILLINOIS CONSTITUTION CAN BE AMENDED TO REDUCE BENEFITS TO CURRENT EMPLOYEES

Under Article XIV of the Illinois Constitution, the Constitution may be revised by either constitutional convention or through the General Assembly. However, any revision must otherwise comply with the existing provisions of both the Illinois and the United States Constitutions. While the Pension Protection Clause may be amended to clarify the extent of benefits protected, any revision of the clause must comply with both state and federal constitutions. If the clause were to be amended to state that only benefits for which work has already been completed are protected from diminishment, the new clause would still have to comply with the Illinois and federal Contract Clauses. Ill. Const. art. I, § 16; U.S. Const. art. I, §10; *see also Hardin v. Vill. of Mount Prospect*, 99 Ill. 2d 96, 103 (1983) (finding no reason why the “virtually identical language” in the Contract Clause of the Illinois Constitution should not be interpreted the same as the Contract Clause in the U.S. Constitution). Ultimately, the constitutionality of an amendment or repeal of the Pension Protection Clause would depend on the extent of protection granted by the clause prior to the amendment. If the right to pension benefits vests at the time an employee begins public employment, then an amendment of the Pension Protection Clause could only constitutionally apply to newly hired employees. On the other hand, if the right only vests when the underlying work has already been completed, then an amendment may constitutionally apply to the prospective benefits of current employees.

Under Article I, Section 16 of the Illinois Constitution and under Article I, Section 10 of the United States Constitution, no law impairing the obligation of contracts shall be passed. The court will consider four factors in determining whether a law violates the contract clause: whether a contractual obligation exists, whether government action has impaired that obligation, whether the impairment is substantial, and whether the government action serves an important public purpose. *Commonwealth Edison v. Ill. Commerce Comm’n*, 398 Ill. App. 3d 510, 529 (2d Dist. 2009). In contract impairment cases under both the federal and the Illinois Constitutions, the primary inquiry must be whether the relevant law substantially impaired a contractual relationship. *Allied Structural Steel Co. v. Spannaus*, 438 U.S. 234, 244 (1978); *Panzella v. River Trails School Dist. 26*, 313 Ill. App. 3d 527, 535 (1st Dist. 2000). Legislation adjusting the rights and responsibilities of contracting parties must be upon reasonable conditions and of a character appropriate to the public purpose justifying its adoption. *Energy Reserves Group, Inc. v. Kansas Power and Light Co.*, 459 U.S. 400, 412 (1983). In determining the importance of the public purpose advanced by the legislation, if the state is a party to the contract that has been impaired, then a court reviewing the constitutionality of the legislation should not defer to the legislative determination of reasonableness and necessity. *Id.* at 412-13.

A law that otherwise substantially impairs the obligation of a contract is constitutional if justified as a reasonable exercise of the police power. *Panzella*, 313 Ill. App. 3d at 535. The same police power analysis applied under the Pension Protection Clause applies under

the Contract Clause. While the legislature cannot interfere with vested rights, an exception is made when the state must safeguard the interests of its citizens; this authority does extend to safeguarding economic needs. *Bank of Illmo v. Simmons*, 142 Ill. App. 3d 741, 745 (5th Dist. 1986). Whether a statute interfering with vested rights is constitutional “depends upon the reasonableness, necessity and importance of the public purpose served.” *Id.* “The severity of the impairment measures the height of the hurdle the state legislation must clear.” *Allied Structural Steel Co. v. Spannaus*, 438 U.S. 234, 245 (1978). If an amendment to the Pension Protection Clause is deemed a reasonable exercise of police power, then the amendment will likely be held constitutional.

A statute cannot impair a contract that did not exist at the time the statute or amendment was passed. *R.W. Dunteman Co. v. C/G Enters., Inc.*, 181 Ill. 2d 153, 167-68 (1998). Thus, the Pension Protection Clause may be freely amended to change the protection given to rights of public employees who will be hired in the future. The General Assembly could cause the same result by passing new legislation reducing pension benefits for future employees, without the added step of amending the Constitution. However, the State would be locked into paying the level of benefits granted in the new statute; if the Constitution were amended, the General Assembly could then always reduce the prospective benefits of current employees.

Likewise, if the convenience of the state effects an amendment or repeal of a law before the rights under that law have vested, the individuals have no cause of action under the Contract Clause. *People ex rel. Eitel v. Lindheimer*, 371 Ill. 367, 373 (1939); *Shepard v. Pollution Control Bd.*, 272 Ill. App. 3d 764, 772 (2d Dist. 1995) (holding that there is no vested right in the mere continuance of a law or statute). To be within the protection of the Contract Clause, a right must have vested. In *Pittman v. Chicago Bd. of Educ.*, 860 F. Supp. 495, 506 (N.D. Ill. 1994), the plaintiffs alleged that the General Assembly’s elimination of tenure for Chicago Public School principals violated the Contract Clause of both the federal and the Illinois Constitutions. The court held that the statute granting tenure merely declared a legislative policy; the General Assembly did not intend to create contractual rights. Therefore, the elimination of tenure did not violate either the federal or Illinois Contract Clauses. *Id.* at 509. Thus, the ultimate effect that amending the Pension Protection Clause will have depends on when a public employee’s right to pension benefits vest. If the right vests when an employee embarks on employment, a constitutional amendment could only apply to public employees hired after the effective date of the amendment. Alternatively, if the rights do not vest until the underlying work has been completed, then the constitutional amendment could apply to current employees.

In addition to amending the Pension Protection Clause, Illinois legislators could also amend the Contract Clause of Article I, Section 16 of the Illinois Constitution, to clarify that pension benefits do not vest until the underlying work has been completed. However, as noted above, any Illinois Constitutional revision must also comply with the federal Constitution, including the federal Contract Clause. Under Article I, Section 10 of the U.S. Constitution, the states are prohibited from passing any law impairing the obligation of contracts.

Ultimately, the constitutionality of an amendment to the Pension Protection Clause and Illinois Contract Clause would depend on the extent of protection granted by those clauses prior to the revisions.

D. WHETHER THE PENSION PROTECTION CLAUSE REQUIRES A CERTAIN LEVEL OF FUNDING

Even if a current public employee's future pension benefits cannot constitutionally be reduced, such a constitutional right may not be fulfilled if a pension program is not adequately funded. This issue was addressed both at the 1970 Illinois constitutional convention and also in certain Illinois court cases. According to both of these authorities, the Pension Protection Clause does not require a certain level of funding for public pension funds.

1. The Illinois Supreme Court Has Consistently Held that the Pension Protection Clause Does Not Require a Certain Level or Method of Funding for Pension Programs

The first major funding-related issue that the Illinois Supreme Court addressed involved a gubernatorial veto that reduced the amount of money appropriated to various teachers' pension plans. In *People ex rel. Illinois Federation of Teachers, AFT, AFL-CIO v. Lindberg*, plaintiffs sought to compel the State to contribute a certain amount of money in order to alleviate the debt level of the pension plans. 326 N.E.2d 749 (1975). In seeking payment from the State, the plaintiffs also alleged that Governor Daniel Walker violated the Pension Protection Clause when he exercised his veto power to reduce the amount of money appropriated by the General Assembly to the various teachers' pension plans. Specifically, for fiscal year 1974, the Governor reduced a \$205,600,000 appropriation to \$96,000,000; a \$66,908,000 appropriation to \$20,190,000; and a \$57,707,000 appropriation to \$27,000,000. *Id.* at 750.

The Illinois Supreme Court rejected the argument that pension fund participants were entitled, pursuant to the Pension Protection Clause, to enforce a specific level of funding that had been appropriated for the pension plans. Consequently, the Court held that the Governor did not exceed his constitutional authority in exercising his veto to reduce payments to some of the State's pension funds. The Court further concluded that "the question of the *specific* fiscal appropriations necessary to meet these deficiencies is one which, *at this time*, should be directed to the legislature." *Id.* at 755 (emphasis added).

The Illinois Supreme Court similarly determined that the Pension Protection Clause does not require a certain funding schedule or particular method of funding be adopted by a particular pension system. At issue in *McNamee*, for example, was a legislative amendment to the Downstate Police article of the Pension Code which changed the beginning date of the 40-year amortization period from January 1, 1980 to July 1, 1993—a change of roughly thirteen years. *McNamee v. State*, 173 Ill. 2d 433 (1996). The amendment also changed the method for amortizing unfunded liabilities from a level-dollar amortization to an annual contribution based on a percentage of payroll. Plaintiffs argued that refinancing in such a manner would place pension funds in a more precarious financial position because it would

permit municipalities to make lower employer contributions to their respective police pension funds in the early years of the new amortization period than would have been required under the previous law. The Court held that while the Pension Protection Clause protects the rights to receive benefits, public employers are not constitutionally required to adhere to a particular pension funding schedule in order to meet their obligations under the Clause.

Finally, the Illinois Supreme Court explicitly acknowledged the politically thorny issue of pension funding, and emphasized again that the Pension Protection Clause was not intended to regulate such a “sensitive” issue. In *People ex rel. Sklodowski v. State*, plaintiffs sought to compel the State to appropriate the funds that were statutorily required to meet its funding obligations under the Illinois Pension Code. 695 N.E.2d 374. Specifically, plaintiffs alleged that the State was required to contribute certain incremental amounts of money each year that, when combined with employee contributions and investment returns, would meet the annual normal cost of each pension fund. The Court, however, rejected this argument and concluded that the Pension Protection Clause did not create a contractual right to enforce a level of state contributions mandated by the statute, and emphasized that the Pension Protection Clause was not a tool for dealing with the “politically sensitive area of pension financing.” *Id.* at 379.

The Court has thus distinguished the funding prerogatives of the State and its municipalities from what the Court considers legislative or administrative actions that diminish or impair pension benefits. In *McNamee*, for example, the Court stated that it “is with this understanding of the protection afforded by [the Pension Clause] that this court has consistently invalidated amendments to the Pension Code where the result is to diminish benefits.” *Id.* (citing *Felt v. Bd. of Trustees of the Judges Retirement Sys.*, 107 Ill. 2d 158, 481 N.E.2d 698 (1985); *Buddell v. Bd. of Trustees, State Univ. Retirement Sys.*, 118 Ill. 2d 99, 514 N.E.2d 184 (1987); *Kraus v. Bd. of Trustees of the Police Pension Fund*, 72 Ill. App. 3d 833, 390 N.E.2d 1281 (1971); and *Schroeder v. Morton Grove Police Pension Bd.*, 219 Ill. App. 3d 697, 579 N.E.2d 997 (1991)).

2. The Drafters of the Pension Protection Clause Did Not Intend to Require a Certain Level of Funding for a Pension System

Comments made by delegates at the constitutional convention, and in particular, those made by the sponsors of the Pension Protection Clause, have been used by the Illinois Supreme Court to ascertain the purpose and scope of the Clause. The Court generally has upheld the funding prerogatives of the State and its municipalities, particularly when dealing with benefits that are not yet due or when a pension fund is not on the brink of insolvency. The funding-related jurisprudence of the Court consistently emphasizes that the “clearly expressed intentions of the framers of the Illinois Constitution must control . . . The framers of our constitution simply did not intend that [the Pension Protection Clause] control the manner in which state and local governments fund their pension obligations.” *McNamee*, 672 N.E. at 1165.

Prior to the 1970 Illinois constitutional convention, the Executive Director of the State Universities Retirement System (“SURS”) sent Henry Green, one of the Pension

Protection Clause's principal sponsors, a letter in July 1970 noting "how the General Assembly passed legislation in 1967 providing state universities with appropriations that would at least cover the amount necessary to fully fund current service costs and the interest owed on past liabilities" but ultimately failed to appropriate the required funds in 1968 and 1969.¹¹⁶ Similarly, Mr. Harl H. Ray, chairman of the Employees Advisory Committee to SURS, argued that pension benefits deserved constitutional protection, in part, because "the State Legislature has failed to finance the pension obligations on a sound basis." Harl H. Ray, Vice Chairman of the Employees Advisory Committee to State Universities Retirement System, Letter to Delegates of the Illinois Constitutional Convention (June 26, 1970).

Despite concerns about the State's underfunded pension systems, the drafters of the Pension Protection Clause indicated during the Convention's proceedings that the Clause was not intended to require full funding of any pension system or require funding up to any given percentage or amount. Delegate Henry Green, a primary sponsor of the Pension Protection Clause who was also responsible for making the initial presentation of the pension proposal to the other Convention delegates, stated that the constitutional language was intended to "put the General Assembly on notice that these memberships are enforceable contracts and that they shall not be diminished or impaired." The Clause was not, however, intended to compel the State to fully fund its pension systems. *Id.*

Delegate Helen Kinney, another main sponsor of the Clause, similarly emphasized that the Clause was not intended to regulate funding. She argued that the purpose of the Clause was not "to require 100 per cent funding or 50 per cent or 30 per cent funding or to get into any of those problems." *McNamee*, 672 N.E. at 1164. Instead, Delegate Kinney emphasized that the purpose of the Clause was to ensure "that people who do accept employment will not find at a future time that they are not entitled to the benefits they thought they were when they accepted the employment." 4 Record of Proceedings, Sixth Illinois Constitutional Convention, Verbatim Transcript of July 21, 1970, at 2931. Specifically, "[b]enefits not being diminished really refers to this situation: If a police officer accepted employment under a provision where he was entitled to retire at two-thirds of his salary after twenty years of service, that could not be subsequently changed to say he was entitled to only one-third of his salary after thirty years of service, *or perhaps entitled to nothing.*" *Id.* at 2929 (emphasis added).

The efforts by Delegates Green and Kinney to clarify the scope of the Clause led other delegates to affirm their support for the proposed provision. Delegate Thomas Lyons, for example, stated "[w]e have now heard from the proponents who have represented that that is the limit of the scope of this amendment. It does not refer to upfunding, nor does it seek to establish some sort of an administrative elite to administer these various funds." *Id.*

¹¹⁶ Memorandum from Edward S. Gibala, *supra* note 110, at 1-4.

APPENDIX 1. GLOSSARY OF TERMS

Benefit Accrual Rate. Benefit accrual refers to the annual percentage of an employee's pension that the participant accrues on a periodic basis. In Illinois, public sector employees accrue pension benefits at a rate ranging from 1.67% to 2.5% each year. Upon retirement, the benefit accrual rate is multiplied by years of service. This number, when multiplied by the employee's final average compensation, is used to determine the employee's final pension benefit.

Cliff Vesting Schedule. A cliff vesting schedule is one where an employee's retirement or pension benefit vests all at once after a determined amount of time. Typically, a participant's right to an employer's contributions "vests" when he or she has an unlimited right to those contributions regardless of whether he or she still works for the employer. Vesting schedules are generally used by employers as a tool to retain workers.

COLA. COLA is a acronym for cost of living adjustment. Illinois pensions all provide for an annual cost of living adjustment for active retirees. Former rules provide for an automatic 3% COLA; the legislature has since reduced the COLA for employees hired after January 1, 2011.

Defined Benefit Pension. This type of pension provides workers with a stream of annuity payments over a certain period of time upon retirement from a plan sponsored by his or her employer. While disappearing in the private sector, defined benefit plans are common for public sector employees. Under this form of pension, the employer bears the risk of adequately funding the retirees' benefits.

Defined Contribution Plan. This arrangement permits an employee to contribute pre-tax earnings to an individual account to save for retirement. Frequently the employer will match a certain percentage of the employee's annual contribution. These plans shift the responsibility to the employee to set aside adequate savings and properly invest those savings to provide sufficient retirement income.

Early Retirement Age. Illinois public pensions provide for early retirement benefits where a participant, by forgoing a certain percentage of his or her full retirement annuity, may receive a stream of annuity payments in advance of his or her normal retirement age.

ERISA. An acronym for the Employee Retirement Income Security Act of 1974. This federal statute provides vesting, benefit accrual, and funding rules for private sector pensions and retirement plans.

Final Average Compensation. Part of a formula used to determine an employee's final pension annuity. In Illinois, final average compensation is expressed as an average of an employee's four or eight highest consecutive years of pay of that employee's final ten years of employment.

Funded Ratio. A funded ratio is an indicator of the health of a pension funds assets. It is a ratio of the pension's assets to its future liabilities. Under private sector rules, a pension is underfunded when its funded ratio falls below 80%.

Graded Vesting Schedule. A graded vesting schedule is one where an employee's benefit vests by a certain percentage each year until fully vested. Such an approach is used as a technique to retain workers.

Pension Ramp. Illinois passed legislation in 1995 colloquially referred to as the "pension ramp" or "funding ramp" that requires the State or city to provide additional contributions sufficient that an underfunded pension will reach a 90% funded ratio by a certain target date. Initially, these additional contributions are small, later increasing until reaching a level annual funding amount.

Vested Benefit. A participant's right to the employer contributions to his pension fund, regardless of whether the participant is working for the employer. In Illinois, an employee's pension rights usually vest after ten years of service, though some Illinois pension plans have shorter vesting schedules.

APPENDIX 2

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