INTERNATIONAL MUNICIPAL LAWYERS ASSOCIATION

2011 ANNUAL CONFERENCE
CHICAGO, IL

WORK SESSION 1:
THE WHITE ELEPHANT IN THE ROOM – PUBLIC PENSIONS AND MUNICIPAL FINANCE PRIMER

SCENES FROM A NIGHTMARE: HOW STATES AND MUNICIPALITIES ARE DEALING WITH THE CRISIS IN PUBLIC PENSIONS

DAVID A. JOHNSON
FRANCZEK RADELET
300 South Wacker Drive
Suite 3400
Chicago, IL 60606
(312) 786-6177

©2011 International Municipal Lawyers Association. This is an informational and educational report distributed by the International Municipal Lawyers Association during its 2011 Annual Conference, held September 11-14, 2011 in Chicago, Illinois. IMLA assumes no responsibility for the policies or positions presented in the report or for the presentation of its contents.

Scope and Scale of the Problem

In February of 2010 the Pew Center on the States issued a report entitled "The Trillion Dollar Gap." The title refers to its finding that "at the end of fiscal year 2008, there was a $1 trillion gap between the $2.35 trillion states and participating localities had set aside to pay for employees' retirement benefits and the $3.35 trillion price tag of those promises."[1] Staggering as it is, the $1 trillion figure may be on the low side. Robert Novy-Marx and Joshua Rauh have estimated the unfunded liability as closer to $3 trillion.[2] Novy-Marx and Rauh thoughtfully provide a table in which they calculate municipal liabilities in terms of unfunded liability per capita. One of the columns in the table expresses the unfunded liability for each municipality on a per household basis: "In aggregate, each municipal household in the fifty cities and counties in our study owes $14,165 to current and retired employees of local pension systems."[3] That is the *aggregate* number; *individual* municipal and county per household calculations range from $3,201 (San Antonio) to $8,233 (Orange County) to $30,901 (Boston) to – and leading the pack – $41,966 (Chicago).[4]

Has it always been this way? Two conclusions seem apparent. First, not all state and local pension systems are alike or are under-funded to the same degree; there still is a fairly broad range of health (or disease, if you prefer) in the public sector pension systems. Second, however, is the pace with which the pension crisis has hit. The 2001 and 2008 recessions did much to uncover underlying structural flaws and weaknesses in the pension systems. But it wasn't that long ago that the outlook was, if anything, fairly rosy. As the Pew Center observes in its report:

> In 2000, slightly more than half the states had fully funded pension systems. By 2006, that number had shrunk to six states. By 2008, only four – Florida, New York, Washington and Wisconsin – could make that claim.[5]

The 2008 recession had an obvious and severe impact on public pension systems. In calendar year 2008, public sector pension plans experienced a median 25 per cent decline in their investments.[6] The Pew Center identified four basic causes of the funding crisis: volatility of pension plan investments, states falling behind in their payments, ill-considered benefit increases, and "other structural issues." Investment issues implicate concerns such as whether investment expectations, typically around 8 per cent, are

---

1 The Pew Center on the States, "*The Trillion Dollar Gap: Underfunded State Retirement Systems and the Roads to Reform*," (Feb. 2010), http://pewcenteronthestates.org/trends_detail.aspx?id=58297 (hereinafter *Trillion Dollar Gap*)

2 Joshua Rauh and Robert Novy-Marx, "*The Crisis in Local Government Pensions in the United States*", National Bureau of Economic Research, Oct. 2010, at 48.

3 *Id*., at 64.

4 *Id*., at 65.

5 *Trillion Dollar Gap* at 3.

6 Keith Brainard, "*Public Fund Survey Summary of Findings for FY 2008*," Nat'l Ass'n of State Ret. Adm'r, Oct. 2009, at 2. www.publicfundsurvey.org/publicfundsurvey/index.htm.

inflated, given the nature of investment portfolios characteristic of public pension funds. These funds typically invest significant portions of their assets in short-term and high quality fixed income instruments, which, while prudent, usually return far less than 8 per cent.[7] States and municipalities "fall behind" in their payments for any number of reasons, for example such as "contribution holidays" when the pension system appears to be more than adequately funded, or the setting of employer and employee contributions at an arbitrary level, (usually by legislation; occasionally through collective bargaining) based on considerations unrelated to actuarial realities. In the absence of actuarial standards or a requirement that a new or enhanced benefit be accompanied by a demonstration that there is an adequate funding mechanism for it – something which most states have not historically required – many pension systems have witnessed generous benefit enhancements which have subsequently proved to be unaffordable.[8] "Other structural issues" include early retirement programs,[9] which tend to disrupt actuarial assumptions; "cost of living adjustments" (COLAs) which exceed the actual increase in the cost of living; an insufficiently disciplined approach to defining an employee's "final salary" for annuity computation purposes, allowing the employee to "spike" the final salary by means of a fat wage increase in the final year of employment; and the inclusion of overtime earnings within the definition of "final salary." In addition, the combination of longer life spans, the incipient retirement of the baby boomers and the shrinking of public work forces have resulted in a worsening of the ratio between the number of current employees contributing to the pension fund compared to the number of retired employees receiving pension benefits. One report shows that in 2001 there were 2.45 current workers for each retiree, but by 2008 that number had dropped to 2.02.[10]

It is sobering just how quickly and dramatically a pension system can slide into the red zone. In April of 2010 the Commission to Strengthen Chicago's Pension Funds, convened by Mayor Daley in 2008, issued its Final Report examining the causes of the pension crisis affecting the four Funds to which City employees belong.[11] As recently as

---

[7] *See* City of Chicago, Commission to Strengthen Chicago's Pension Funds, at 24 (Apr. 30, 2010) (hereinafter *Chicago Commission* Report), http://www.cityofchicago.org/city/en/depts./obm/provdrs/perf_mang/news/2010/apr/commission_to_strengthenchicagopensionfundsreleasesreportonfisc.html.

[8] There is, of course, a political reality to this. Public employee unions typically exert no small amount of influence in state legislatures, and have frequently been able to bypass formal collective bargaining with the municipal employer and "sweeten" pension benefits for their members legislatively, as opposed to the give-and-take characterizing traditional collective bargaining. But it is also true that from time to time a municipal employer and a union will agree to jointly sponsor a pension enhancement either as part of or as an alternative to direct employee compensation under a collective bargaining agreement. This issue is explored further *infra*.

[9] Heavily criticized in pension commission reports for being actuarially unsound and even irresponsible, early retirement programs usually deliver significant and immediate savings for municipal employers, through a combination of reducing the size of the work force and of replacing highly paid long-time employees with lower-paid new hires. As such, they are extraordinarily tempting to a municipality confronting fiscal pressures of a more immediate nature than the pension funding crisis is perceived as being.

[10] Jonathan Laing, "The $2 Trillion Hole," Barrons, March 15, 2010.

[11] City of Chicago employees are members of four Pension Funds, each created under the Pension Code of the State of Illinois: Policemen's Annuity and Benefit Fund – Cities over 500,000, 40 ILCS 5/5-101-5-238; Firemen's Annuity and Benefit Fund – Cities over 500,000, 40 ILCS 5/6-101-6-229; Municipal

2000, the aggregate funded ratio for the four Funds was eighty-three percent.[12] The Laborers' Fund was over 120% in 1998. The Municipal Employees' Fund was over ninety percent at that time.[13] But by the end of 2009, even assuming an average annual rate of return on investments of eight percent, each of the four Funds was predicted to run out of money by 2030, barring any structural changes in contributions or benefits.[14]

Chicago was not the only public employer to commission a report on its pension system. In 2009 the Rhode Island Senate created a commission "to conduct a comprehensive review and study of different aspects of municipal pensions." On February 15, 2011, the Commission issued its Final Report. In Rhode Island, municipal pension benefits are provided through either the State-run Municipal Employees Retirement System (MERS) or through locally-administered plans. This latter category includes thirty-six pension plans in twenty-four communities. State employees and teachers participate in the State-administered Employees' Retirement System of Rhode Island (ERSRI). Municipalities participating in MERS have no administrative responsibilities with respect to them, but are required to meet their ARC payments or lose State aid payments. Municipalities with non-MERS plans are solely responsible for administering and funding the plan. At the time of the Commission hearings, the MERS plans had a funding ratio of 92.8 per cent. Non-MERS plans, in contrast, had a funded ratio of 42.8 per cent. The State Auditor General reported that twenty-three of the thirty-six locally-administered (non-MERS) plans were considered "at risk" due to low funded ratios or declining contributions. Central Falls is one of the municipalities outside MERS. The Auditor General reported a funding ratio of 8.10% for the Central Falls Police and Fire plan (prior to July 1, 1972) as of July 2008.[15] A separate (non-MERS) plan existed for Central Falls Police and Fire post-July 1972. It had a marginally better funding ratio in 2008 (30.2%) but in 2009 Central Falls made 0% of the required ARC payment for that plan. The 8.10% funding ratio existed notwithstanding the fact that Central Falls was making its required ARC payments to that plan between 2005 and 2009. By 2009, the ARC payments to non-MERS plans ate up fifty-seven percent of Central Falls total property tax levy.[16]

Employees', Officers', and Officials' Annuity and Benefit Fund – Cities over 500,000, 40 ILCS 5/8-101-8-253; and Laborers' and Retirement Board Employees' Annuity and Benefit Fund – Cities over 500,000, 40 ILCS 5/11-101-11-232.

12 *Chicago Commission Report* at 7.

13 *Id*., at 20.

14 *Id*., at 22. The Civic Federation of Chicago, in its February 14, 2011 report "*Financial Challenges for the New Mayor of Chicago*," noted that in 2000, the City's employer contributions to the four Funds actually exceeded the amount that would have been required utilizing the ARC (Annual Required Contribution) methodology. ARC is an amount equal to the sum of (1) the employer's 'normal cost' of retirement benefits earned by employees in the current year and (2) the amount needed to amortize any existing unfunded accrued liability over a period of not more than thirty years. But by 2009, the amount of contributions required under the ARC approach exceeded the amount of actual employer contributions by a sum of $566.5 million, or 17.9% of payroll. This report is available at www.civicfed.org.

15 State of Rhode Island, "*Senate Municipal Pensions Study Commission Final Report*," Feb. 15, 2011, at 8 (hereinafter "*Final Report")*.

16 *Id*., at 14-15.

The Response

The response has been a pronounced willingness to pursue legislative reform of the pension systems. The National Conference of State Legislatures maintains an excellent data base tracking legislative initiatives. In 2007 eleven states enacted a reform of some sort to their pension systems. By 2009 that number had increased to fifteen.[17] In 2010 the number further increased to twenty-one, and in 2011, twenty-five states enacted "significant retirement system changes."[18] The changes in 2011 fall into several distinct areas:

Employee contributions: Fifteen legislatures enacted increased employee contributions in 2011 (eleven states did so in 2010). Twelve of the fifteen implemented increased contributions for current employees. Eight of the fifteen states increasing employee contributions offset them by reducing, to one extent or another, employer contributions.

Eligibility for retirement benefits: Fourteen states increased age and service requirements for normal retirement. According to the NCSL, "the legislation generally applies only to people hired after the effective date of the legislation, but also in a few states to non-vested employees."

Calculation of retirement benefits: Five states lengthened the period over which final average salary is computed. Eight states made similar changes in 2010. All such changes applied only to individuals hired after the effective date of the legislation.

Post-retirement benefit increases (COLAs): Nine states altered their provisions in this area. In three of the states the modified provisions affect current benefit recipients. Others affect only those who will retire in the future, and in six of the nine states, the changes apply only to new hires.

Your Results May Vary: Selected 2011 Legal Challenges to Pension Reform

It is virtually impossible to draw any sweeping conclusions concerning the extent of a state or municipality's right to modify pension benefits to the detriment of employees and/or current recipients and survive the inevitable court challenge. Certainly there are some changes that are fairly easy to categorize. Reduced benefits/higher contributions for new employees, for example, are likely to survive virtually any challenge. At the other end of the spectrum, reducing the base pension benefit for current retirees, as distinct from a COLA or other adjustment to the base benefit, is going to be extremely difficult to

---

[17] National Conference of State Legislatures ("NCSL"), "*Pension and Retirement Plan Enactments in State Legislatures," (2000 through 2009).* www.ncsl.org/?tabid=13399.

[18] NCSL, "*Pensions and Retirement Plan Enactments in 2011 State Legislatures*," (June 30, 2011). www.ncsl.org/default.aspx?tabid=22763. Because some states that had enacted legislation in 2010 went back to the well in 2011, a total of 39 states enacted significant revisions. "Significant" is the NCSL's characterization.

defend. But for everything in between, which covers an extraordinary amount of ground, results are likely to be highly, even exclusively contingent upon nuanced principles of state law.[19] In other words, the identical "reform" undertaken in two adjacent states may result in inconsistent outcomes. With that caveat in mind, what follows is a tour through recent court decisions addressing pension changes in different states.

Colorado

On February 23, 2010, Governor Ritter signed into law Senate Bill 10-001. Addressing the "severe underfunding" of the Public Employees' Retirement Association of Colorado ("PERA"), this legislation modified employee/employer contributions, placed a cap on cost of living increases for retirees, created new contributions for working retirees and increased the age and service requirements for certain groups of employees before they are eligible to retire to receive retirement benefits. Plaintiffs challenged the provisions in the legislation modifying cost of living adjustments. *Justus et. al. v. State of Colorado, et al.*, No. 2010CV1589, slip op. at 2 (Denver County Dist. Ct., June 29, 2011). The class of plaintiffs in this case consisted of individuals currently receiving cost of living adjustments (COLAs). Depending on the sub-class to which a specific Plaintiff belonged, the COLAs were modified from an annual increase of 3.25% or 3.5% to an annual increase to be calculated under a different formula and capped at 2%. Plaintiffs sought a judicial declaration finding that these modifications violated the Contract clause of the Colorado Constitution, and the Contract, Takings, and Substantive Due Process Clauses of the United States Constitution.

The Plaintiffs argued that what the court characterized as "a base pension and a specific COLA" are both protected by the Contract Clause in both the Colorado and United States Constitution. The State Defendants acknowledged that a "base pension" is constitutionally protected, but that it is distinguishable from a cost of living adjustment.

On June 29, 2011, Judge Robert Hyatt granted the Defendants' motion for summary judgment, holding that the plaintiffs "unarguably have a contractual right to their PERA pension itself, [but] they do not have a contractual right to the specific COLA formula in place at their respective retirement, for life without change." (Emphasis in original).[20] The court based this holding on the fact that over the previous forty years the General Assembly had repeatedly modified the COLA formula for existing retirees: changing from non-compounded to compounded, adjusting the amount of the percentage cap, sometimes linking it to an increase in inflation and sometimes not: "In short, based

---

[19] "The law governing the rights of members of public employee retirement plans varies greatly from state to state, and has not been the subject of federal regulation or harmonization." *Parker v. Wakelin,* 123 F.3d 1, 6 (1st Cir. 1997). There is a dizzying array of approaches to pensions among the states: *Compare, e.g., Larsen v. Senate of the Commonwealth of Pennsylvania,* 154 F.3d 82 (3d Cir. 1998) (vesting in Pennsylvania occurs when a person completes service required to be eligible to receive benefits under terms of retirement plan), and *Baker v. Oklahoma Firefighters Pension & Retirement System*, 718 P.2d 348, 353 (Okla. 1986) (explaining pension rights vest upon completion of minimum service necessary for retirement), with *Mascio v. Public Employees Retirement System of Ohio*, 160 F.3d 310, 313 (6th Cir. 1998) (retirement benefits of Ohio public employees vest at time of actual retirement and receipt of benefits).

[20] *Justus*, slip op. at 4.

on numerous and steady changes in the PERA COLA formula for retirees, Plaintiffs could not have had a reasonable expectation that the COLA formula that happened to be in place at the date of their retirement would be unchangeable for the rest of their lives."[21] The court proceeded to distinguish between the COLA and the "base pension": "the General Assembly's most recent change to retiree COLA does not alter the fundamental mechanism for payment of pension benefits for PERA retirees. That has always been and remains to this day, a base benefit set at retirement."[22]

Minnesota

On the same day that the Colorado court dismissed the claims in *Justus v. State of Colorado*, a state court in Minnesota dismissed a lawsuit filed by retired employees there challenging state legislation enacted in 2009 and 2010 reducing the formula for post-retirement adjustments to pensions. In Minnesota, upon retirement an employee receives an annuity calculated based on a statutory formula depending on factors such as salary and credited years of work. But in addition to the annuity, retirees have received an "annual adjustment", also subject to a statutory formula. During the 1990s, this adjustment was a function both of inflation and investment performance in the fund reserved for payments to retirees (the "Post Fund", distinguished from the "Active Funds", consisting of contributions made by or on behalf of active employees in the several Plans available to them based on job classification). This approach yielded annual adjustments that exceeded inflation for several years, sometimes by double digits. But beginning in 2001 the Post Fund had begun to suffer significant investment losses. In 2006 the Legislature amended the statutory formula to impose an overall five percent cap on any future adjustments. In 2008 the Legislature further amended the formula, providing that if the funding ratio for the Post Fund dropped below 80%, that fund would be dissolved, its assets would be merged into the Active Funds and the annual adjustment capped at a flat 2.5%, for all plans. At the end of 2008 the Post Fund dipped below 80% and was dissolved. In 2010 the Legislature again amended the plans, capping the annual post-retirement adjustments at between two percent and one percent, depending upon the plan involved.

In *Swanson, et al. v State of Minnesota*, No. 62-CV-10-05285 (Dist. Ct. Ramsey County, June 29, 2011), the plaintiffs, current retirees, alleged that these changes violated the contracts and taking clauses of the United States and Minnesota Constitutions. The court first addressed whether the challenged legislation operated retroactively or prospectively. The plaintiffs argued they were entitled to post-retirement adjustment formula in place on the date of their retirement, and thus the challenged legislation was retroactive. The court distinguished the underlying right to or eligibility for a pension benefit from the manner in which the benefit is calculated:

---

[21] *Id.*, at 8.

[22] *Id.*, at 9. As discussed *infra* with respect to the controversy in Illinois over the ability to modify pension benefits and accruals for current participants, there are those who would question the rigid dichotomy between a "COLA" and a "base pension" as determined by the Colorado court. This is particularly so in light of the fact that from the court's discussion, it would seem that the multiple changes and modifications to COLAs for current retirees over the past forty years all seem to have been to the advantage of the retirees.

> The post-retirement adjustment process is an annual event that each year uses a formula to determine the amount of that year's adjustment. Minn. Stat. §11A.18, subd. 9 (2008). It is available to all members receiving an annuity, regardless of retirement date. The adjustment thus logically rests on a formula used **as of the date of the calculation**, not the date of retirement.
>
> The legislation operates prospectively since no retiree's basic retirement annuity has been reduced. No sums previously paid to any retiree were taken away. No retiree was divested of the adjustment generated by a previous formula and added to a basic retirement annuity. These undisputed facts are strong evidence that the challenged legislation operates prospectively, not retroactively.
>
> The Court concludes that the Legislature neither contracted to use, nor promised to use, the formula in effect on the date of retirement for future post-retirement adjustments to retirement annuities. (Emphasis in original).[23]

The court rejected the assertion that a contract or promise to use a particular statutory formula had been unconstitutionally impaired. Muddying the waters some, the court noted that "contract principles continue to have some relevance in the pension context."[24] Stressing the absence of evidence that the Legislature "intended to confer contract rights to a particular adjustment formula" and the inherent legislative power to "amend, revise, and if necessary repeal, pension statutes when doing so is consistent with maintaining those plans for the benefit of all members," the court refused to find the existence of a contractual right to a specific formula.[25] Further, the facts that retirees' monthly annuities had not been reduced and they continued to be eligible for an annual adjustment based on "a" statutory formula defeated any argument that any protected right had been impaired. Finally, the court held that the challenged legislation was a "reasonable and appropriate exercise of legislative authority and responsibility to maintain the Plans' fiscal stability for the benefit of all members." (*Id.*, at 23).

Illinois

Enjoying the dubious distinction of being in the "worst shape of any state"[26] with a funding level of fifty-four percent and an unfunded pension liability of more than $54 billion as of 2008, Illinois has been the scene of contentious pension reform debate. In spring of 2010 the Illinois General Assembly enacted "two-tier" reforms for non-police

---

23 *Swanson*, slip op. at 15-16.

24 *Id.*

25 In doing so, however, it distinguished a 1973 decision involving pensions for judges (*Sylvestre v. State*, 214 N.W.2d 658), on the basis that because the position of judge was created not by the legislature but by the State Constitution, there existed a possible constitutional basis for the judges' compensation that did not exist with respect to the legislatively-created pension rights for other public employees. (*Id.*, at 19).

26 *The Trillion Dollar Gap*, at 3.

and fire pension funds, applicable solely to employees hired after the effective date of the legislation. Primary features of the legislation were:

- ◊ normal retirement age raised to 67, with ten years of service
- ◊ no early retirement before age 62 with ten years of service; annuity reduced by one-half percent for each month under age 67 (i.e., six percentage points for each year)
- ◊ "final average salary" based on the high consecutive 96 months within the final 120 months
- ◊ "final average salary", for annuity purposes, not to exceed $106,800 (indexed to inflation)
- ◊ COLA may not take effect before age 67, and then are capped at lower of three percent (non-compounded) or one-half of CPI-U

Although this represented the most comprehensive pension reform legislation Illinois had ever seen, the fact that its provisions apply only to new hires and not to current employees, let alone retirees, means that it exerts only an attenuated effect on the pension funding crisis. There will be no cash savings for at least ten years, and the full impact of benefit reductions probably will not be felt much earlier than 2040, although by that point the savings will be quite large. Further, the exemption of police and fire funds from the scope of this legislation meant that the two worst funded funds were unaddressed.[27]

Far from quelling the appetite for pension reform, this legislation shined a light on the steps that would be necessary to fully address the pension funds crisis. Specifically, there would be a need for some combination of increased funding and decreased expenses, whether in the form of increased employer/taxpayer contributions, increased employee contributions, limitations on COLA increases as well as raising the retirement age, with regard to current employees or possibly retirees.

Thus began the great lawyers' debate of 2010-11. Civic and business groups began a public campaign urging benefit reductions for and increased contributions from current employees. The prominent law firm of Sidley Austin LLP weighed in on their side, with widely distributed legal memoranda arguing that impacting current employees

[27] In December of 2010 Illinois addressed the police and fire funds, again with a two-tier approach. For new hires the minimum retirement age is raised from 50 to 55, the definition of "final average salary" is the same as that in the civilian funds, and COLA adjustments are prohibited before age 60 and are capped. However, the most controversial aspect of the legislation was application of actuarial funding principles to Chicago's contributions to the two funds. Previously Chicago's contributions were limited to a multiplier of the employee contributions. The new legislation requires Chicago to levy an amount of money (through the property tax) sufficient to satisfy actuarial calculations of the amount necessary to reach 90% funding by 2040, beginning in 2015. Initial calculations are that this will require an additional $409 million in contributions that year.

in this fashion did not violate Illinois law. Retired state court judge Gino DiVito and retired federal appellate court judge Abner Mikva weighed in on the other side, arguing that the Illinois Constitution flatly prohibits reducing benefits or increasing contributions for current employees.[28] Sidley countered with additional memoranda. Newspaper columnists tracked the legal debate, posting copies of the memoranda. Then in the spring of 2011 Eric Madiar, Chief Legal Counsel to Senate President John Cullerton, posted a 76 page article, with 630 footnotes, containing an exhaustive discussion of the process by which the one sentence provision in the Illinois Constitution came to be and its subsequent judicial history.[29] He argues:

> The Pension Clause not only makes a public employee's participation in a pension system an enforceable contractual relationship, but also constitutionally protects the pension benefit rights contained in the Pension Code when an employee joins a pension system, including employee contribution rates. The Clause also safeguards pension benefit enhancements that are later added during employment. Further, the Clause bars the General Assembly from adversely changing the benefit rights of current employees via unilateral action. And, the Clause ensures that pensions will be paid even if a pension system defaults or is on the verge of default. The Clause's plain language, the framers' original intent, and voters' understanding of the provision, as well as court decisions interpreting the Clause, show these conclusions to be correct and Sidley's analysis erroneous.[30]

If nothing else, the Illinois experience teaches how much more complicated the pension crisis can become when pension benefits and rights are specifically referenced in a constitutional provision. At least eight other states provide some degree of constitutional protection for public employee pensions.[31] Granted, not all states provide the same level of constitutional protection to employee pensions, but the presence of such a provision may serve to take the discussion outside the customary Contracts Clause analysis and result in a constricted degree of flexibility to respond in times of crisis.[32]

---

[28] Illinois' Constitution dates to 1970. Article XIII, §5 provides: "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."

[29] The website for the Illinois Senate Democrats has posted all of the legal memoranda debating (frequently with a bitter tone) the "pension issues." Combined, they are well more than an inch thick. The link is: http://www.illinoissenatedemocrats.com/index.php/component/content/article/108-public-information-brochures/1517-pension-debate

[30] Eric M. Madiar, "*Is Welching on Public Pension Promises an Option for Illinois? An Analysis of Article XIII, Section 5 of the Illinois Constitution*", at 76.

[31] Alaska, Arizona, Hawaii, Louisiana, Michigan, New Mexico, New York and Texas.

[32] In *Kraus v. Board of Trustees of the Police Pension Fund of the Village of Niles*, 72 Ill.App.3d 833, 847 (1st Dist. 1997), the court stressed that unlike the constitutional provisions in Alaska, Hawaii and Michigan, which protect only "accrued" benefits, the absence of that qualifier in the Illinois Constitution necessitated the conclusion that pension rights vest at the time the member enters the system, and cannot be

Some Options for Municipal Employers

Most municipal employers will have limited ability to dictate or even shape the course of state-wide legislation. To the extent they do, obviously the first course is to determine how restrictive state law is in modifying pension benefits for current members. But even apart from tackling pension benefits and entitlements head on, there are other measures potentially available to employers to alleviate the situation to at least some degree.

When bargaining for a new collective bargaining agreement, structure the compensation package in a manner to minimize increases in the amount of pensionable compensation. Employee compensation comes in all shapes and sizes – base wage increases, step increases, bonuses, uniform allowances, shift differentials, deferred compensation, payments into a VEBA, holiday pay, vacation pay, rank differentials, hazardous duty pay, merit pay, compensatory time, etc. – not all of which are pensionable. In general, not only is a dollar worth of compensation increase on a non-pensionable item less expensive, but it will result in less strain on the pension fund down the road.[33]

The bane of the existence of many municipal employers has been the ability of police and fire unions to resolve impasses in collective bargaining by invoking interest arbitration, a process in which a third party neutral decides the disputed terms. Interest arbitration has been regarded by many as a process unduly solicitous of continuation of the *status quo* and unresponsive to fiscal pressures confronting municipalities, resulting in the imposition of excessive wage settlements. Such settlements, in turn, exacerbate the pension funding situation, as the amount of the employee's annuity is directly tied to wage increases received during his tenure with the employer. For many years, municipalities in Illinois have sought to adjust the balance in favor of employers by amending state collective bargaining laws dealing with interest arbitration, but with little

---

reduced (or "impaired") by subsequent legislation. The *Kraus* court found persuasive a similar holding under the New York Constitution, *Kleinfeldt v. New York*, 36 N.Y.2d 95 (1975) (statute limiting amount of increased compensation for computing annuity may not be applied against member who entered system prior to effective date of the statute). The *Kraus* decision, in turn, was distinguished in the Maryland District Court decision addressing Baltimore's decision to eliminate a post-retirement "Variable Benefit" increase for police and firefighters in its municipal pension plan. The plaintiffs there relied on *Kraus* and a New York decision for the proposition that their entitlement to a specific formula vested when they entered the system, but were rejected by Judge Marvin Garbis: "A constitutional provision is quite distinct from a provision in the City's Code. This Court is not interpreting a Maryland constitutional provision. Rather, this Court is interpreting §42 of the Baltimore City Code, in light of Maryland common law and applicable federal law. Moreover, the cases cited are not Contract Clause claims, but state constitutional claims." *Cherry, et al. v. Mayor and City Council of Baltimore City*, No. MJG-10-1447, slip opinion at 15 (Dist. Ct. Md., March 16, 2011)

[33] The other side of the coin is that public employee unions, especially those with senior leadership, tend to fight hard to maximize pensionable compensation, viewing non-pensionable items as "junk cash." One example of this tension is *Holland v. City of Chicago*, 289 Ill.App.3d 682 (1st Dist. 1997), in which police and fire fighters alleged that their due process rights were violated by the City and the Police and Fire pension boards when such items as duty availability allowance, holiday pay and shift reduction allowance were not treated as "salary" for purposes of calculating pension benefits.

if any success. There are indications this is changing. Earlier this year Illinois enacted into law Senate Bill 7, providing for comprehensive educational reform. Tucked into the legislation is a provision modifying that section of the Illinois Educational Labor Relations Act, 115 ILCS 5/12, pertaining to resolution of bargaining impasses between educational employers and unions. Not only does it require fact-finding, but it restricts the ability of the fact-finding panel to recommend compensation increases beyond that which the employer can reasonably afford.[34] Five years ago legislation such as SB 7 would have been inconceivable. Unlike legislation affecting collective bargaining in Wisconsin and Ohio, SB 7 was enacted only after a process in which all stakeholders, including the unions, were at the table. There is no inherent reason why the provisions regarding fact-finding for educational employers cannot be transferred to municipal employers and resolution of bargaining impasses with public safety unions.

Other possible avenues to explore include a more aggressive approach to getting injured or disabled employees off disability pension rolls by finding appropriate light or limited duty positions for them. The Rhode Island Commission Report, discussed above, went so far as to recommend investigation of the feasibility of extending workers compensation coverage to police officers and firefighters, as an alternative to disability pension.[35]

A Case Study: the Chicago Transit Authority

In 2006 the Pension Fund for CTA employees was in dire distress: it was only thirty percent funded, and was projected to go bankrupt by 2013. The approximately 10,000 employees participating in the Fund paid three percent into the Fund for their pension. The CTA paid six percent. The unfunded liability was approximately $2.1 billion. In addition, the Fund paid for retiree health care. Retiree health care consisted of 100% coverage, with retirees contributing approximately twenty percent of the cost of coverage.

Between 2006 and 2007 a complex, multi-pronged process tackled this crisis. Participants included the unions, including the head of the Chicago Federation of Labor; management, in the person of principals from both the CTA and the Regional Transportation Authority; legislative leaders, in the person of the Speaker of the Illinois House; and subject matter experts, such as actuaries, consultants and bond attorneys. The resolution was reflected in inter-dependent documents, consisting of legislation and an interest arbitration award which set the contribution rates for Pension and Retiree Health Care. On the Pension side, a new Pension Board, with a new governance structure, was established. Employee contributions immediately went from three percent to six percent. CTA contributions continued to be on a two to one ratio to employee contributions, resulting in a contribution rate for CTA of twelve percent. However, an additional term of

---

[34] Section 12(a-10)(4)(F) defines the "ability to pay" criterion in this fashion: "The employer's financial ability to fund the proposals based on existing available resources, provided that such ability is not predicated on an assumption that lines of credit or reserve funds are available or that the employer may or will receive or develop new sources of revenue or increase existing sources of revenue."

[35] *Final Report*, at 22.

the resolution was issuance of a Pension Obligation bond of approximately $1 billion to support the Fund.[36] The POB immediately brought the funding status of the Fund to seventy-five percent. Further, CTA debt service on the $1 billion is credited against its Employer contribution, to a maximum of six percent. New hires (after the effective date of the legislation) are subject to more stringent age and service requirements for both a reduced and a full retirement allowance. Contribution rates (for both employees and the CTA, retaining the two to one ratio concept) are subject to a statutory formula, overseen by the Illinois Auditor General, who conducts annual reviews. If at any time the funding ratio dips below sixty percent, either the Trustees or the Auditor General must require additional contributions.[37] The Auditor General is responsible for ensuring progress toward ninety percent funding by 2059, keeping the parties on track and foreclosing "funding holidays."

A Retiree Health Care Trust governs retiree health care. Active employees are now responsible for contributing a "payroll tax" equal to three percent of compensation. CTA is out of the business of funding retiree health care. Retiree contributions to the cost of coverage have gone from twenty percent in 2007 to approximately forty-five percent today. The benefit plan terms have changed. Where the retiree plan once paid 100%, regardless of whether the services were in or out of network, now the plan pays no more than ninety percent for in-network and seventy percent for out of network. In addition, a $528 million POB provided initial funding for the Trust. The Auditor General also reviews and audits the Trust, ensuring that it stays at 100% funding. In the event that funding for the Trust is insufficient, the Trustees may increase contribution levels or decrease benefit levels. If there is a surplus, the Trustees may decrease contribution levels or increase benefits.

Conclusion

At a time of unprecedented stress on public pensions, with most states and municipalities being buffeted by the same forces, it borders on the bizarre that resolution of common problems will be dependent on the vagaries of a patchwork of state and municipal laws. This presents an extraordinary challenge to municipal and legislative leaders. What is particularly troubling is that the solutions that would address the funding problems require a substantial commitment by municipalities, as employees simply are

---

[36] POBs are not without risk or controversy. As the authors of *The Trillion Dollar Gap* observe:

> Simply put, states need to muster convincing evidence that the timing is right. According to Girard Miller, a senior strategist for retirement plans and investments with the FPM Group, retirement bonds 'should only be issued during recessions or during the early stages of economic recovery, when stock prices are depressed.' Based on Miller's analysis, state governments that want to use retirement obligation bonds should be ready to issue them in the near future to ride out the eventual recovery.

Id., at 34.

[37] The CTA Fund was not immune to the recession, and the trigger was met. Employees now contribute 8.345% and the CTA's rate is 16.69%, except that credit for the debt service brings that number down to 10.35%.

not in a position to bear all of the responsibility. States and municipalities will have to shoulder this burden while confronting severe budget shortfalls, a scenario that historically has been cause for "kicking the can down the road." This will require imagination and a commitment on the part of all stakeholders to share in the pain.