

## THE PUBLIC PENSION REFORM PROBLEM

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*Unfunded public pensions liabilities have become a ticking time bomb in many states. The inability of these states to enact meaningful pension reform threatens the future of millions of public workers and retirees, and jeopardizes the ability of states to invest in necessary social services. However, pension reform is not only politically toxic but can also face successful legal challenges. Illinois faces a particularly dire crisis with unfunded pension liabilities reaching alarming levels. In this Note, the author analyzes the legal implications of meaningful public pension reform. By using the recently enacted public pension reform in Rhode Island (RIRSA) as a case study, the author examines the nature of public pension protections in Illinois and recommends a model that balances fairness with urgency to promote a type of reform that can satisfy Illinois's particular legal constraints.*

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## I. Introduction

As of April 2012, the majority of U.S. states have underfunded pensions with some estimates totaling up to \$4.4 trillion in unfunded liabilities.<sup>1</sup> As states realize that in the very near future their pension funds will run dry, many are calling for pension reform to alleviate some of their financial difficulties.<sup>2</sup> Without pension reform, many states will not be able to maintain basic public services without significantly increasing taxes.<sup>3</sup> This puts state and local politicians in a difficult position, caught between taxpayers, unions, and fiscal health.

In Illinois, only 57 percent of the public pension plan is funded, with unfunded pension liabilities totaling \$85.4 billion.<sup>4</sup> In August 2012, to confront the impending crises, the governor called a special session for the legislature with the purpose of reforming state pensions. Legislators, however, were not able to agree on the proper method of reform.<sup>5</sup> The number of competing interests resulted in gridlock.<sup>6</sup> After the failed special session, Illinois Governor Pat Quinn has been urging citizens and politicians to pass pension reforms as soon as possible, claiming that an "overhaul" is needed to ensure the state's ability to live up to its promises without devastating the state budget.<sup>7</sup> Other state leaders have made similar claims and many different solutions have been proposed; however, the state has been unable to pass pension reform.<sup>8</sup>

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1. Thomas J. Healey et al., *Underfunded Public Pensions in the United States* 3 (Harvard Kennedy School, Mossavar-Rahmani Center, Working Paper No. 2012-08, 2012).

2. *Id.* at 8.

3. *Id.* at 15.

4. *Id.* at 3. Some estimates have a lower funded ratio and a higher number for unfunded liabilities that is closer to \$100 billion. See Paul Merrion, *Illinois Hits a Sorry Milestone*, CRAIN'S CHI. BUS. (Mar. 25, 2013), available at <http://www.chicagobusiness.com/article/20130323/ISSUE01/303239976/>.

5. James B. Kelleher, *Illinois Fails to Act on Public Pensions in Special Session*, CHI. TRIB. (Aug. 17, 2012), [http://articles.chicagotribune.com/2012-08-17/news/sns-rt-us-illinois-pensionsbre87g0cy-20120817\\_1\\_pension-costs-pension-system-democratic-governor-pat-quinn](http://articles.chicagotribune.com/2012-08-17/news/sns-rt-us-illinois-pensionsbre87g0cy-20120817_1_pension-costs-pension-system-democratic-governor-pat-quinn).

6. *Id.*

7. *Illinois Governor Wants Pension Reform by Jan. 9*, BLOOMBERG BUS. WK. (Nov. 9, 2012), <http://www.businessweek.com/ap/2012-11-09/illinois-governor-wants-pension-reform-by-jan-dot-9>.

8. *Illinois Lawmakers Will Miss At Least One More Paycheck Amid Pension Inaction*, HUFFINGTON POST (Aug. 6, 2013), [http://www.huffingtonpost.com/2013/08/06/illinois-lawmakers-paychecks\\_n\\_3714547.html](http://www.huffingtonpost.com/2013/08/06/illinois-lawmakers-paychecks_n_3714547.html).

The complexity and severity of the pension crises in Illinois puts the state in a unique position to serve as an example for other states that are experiencing pension crises. In Illinois, strict legal requirements and intense political pressures forces legislators to be very careful and creative in developing ways to reduce the state's liabilities while upholding the contractual rights of public employees. Pension reform is a difficult task. In fact, constitutional changes may be necessary in Illinois and in other states.

There are differing opinions over what caused the Illinois pension fund to be underfunded.<sup>9</sup> Some blame the power of unions who pushed for increased benefits, while others blame the state for not following through on its actuarial required contribution (ARC).<sup>10</sup> All agree that the dot com bust in the early 2000s as well as the 2008 stock market crash made pension reform urgent.<sup>11</sup> Regardless of how this situation arose, past bad choices must be remedied and prompt reform must be implemented.<sup>12</sup>

While there is great disagreement about how to go about pension reform, reforming public pensions is necessary to keep states financially stable and to prevent passing on unbearable debt obligations to future generations. There are many suggestions for how pensions should be reformed including using career averages for benefit compensation, raising the age of eligibility requirements, raising employee contributions, combining pensions with Social Security contributions, decreasing the Cost of Living Adjustment (COLA), and separating pension sponsors from the legislature.<sup>13</sup> Faced with the need for pension reform and the goal of state fiscal solvency, states are beginning to take action.

The types of reforms states implement can have significant legal consequences. These consequences can often be overlooked in the

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9. See Ray Long, *Lawmakers Leave Springfield without Approving Pension Reform*, CHI. TRIB., Aug. 17, 2012, [http://articles.chicagotribune.com/2012-08-17/news/chi-illinois-pension-reform-remains-tied-up-in-springfield-20120817\\_1\\_pension-reform-pension-system-shift-teacher-pension-costs](http://articles.chicagotribune.com/2012-08-17/news/chi-illinois-pension-reform-remains-tied-up-in-springfield-20120817_1_pension-reform-pension-system-shift-teacher-pension-costs).

10. *Id.*

11. See generally ALICIA H. MUNNELL, *STATE AND LOCAL PENSIONS WHAT NOW?* 2 (2012) (explaining that the stock market crash highlighted the weaknesses in pension plans).

12. See generally *id.* (explaining that state public employee pensions are underfunded because of bad contribution decisions).

13. See Jeffrey Brown, *Three Hard Lessons from Illinois Public Pension Reform*, FORBES (May 30, 2012 9:40 ), <http://www.forbes.com/sites/jeffreybrown/2012/05/30/three-hard-lessons-from-illinois-public-pension-reform/>. See also Healey, *supra* note 1, at 3.

frenzy to push reform through. Furthermore, the legal status of public pensions varies by state. Many states treat pensions as a contract, and follow applicable federal contract law when changing or amending plans.<sup>14</sup> Some states have gone further and not only treat pensions as a contractual obligation, but also have added clauses to their state's constitution requiring the protection of pension benefits, guaranteeing that the state cannot decrease benefits for current employees.<sup>15</sup> A few states treat pensions as property, and consequently property law governs whether the state can decrease employee benefits.<sup>16</sup> A couple of states treat state employee pensions as a gratuity that can be changed or amended at any time.<sup>17</sup>

Beyond concerns over the states' exorbitant financial liabilities, the pension crisis is a major problem because millions of elder Americans depend on their pensions to fund their retirement. If cuts are implemented, public employees will not receive the retirement benefits that they had relied upon.<sup>18</sup> As of 2009, more than 23 million people were members of public pension programs.<sup>19</sup> About 13 million were active members, over 7.5 million were retired, and about 2.5 million were inactive with vested benefits.<sup>20</sup> As states change the amount of benefits that these people were planning on receiving, millions of Americans will find that they did not save enough to maintain their standard of living upon retirement.<sup>21</sup> To further complicate the problem, many people who work for state or local government agencies are not covered by Social Security.<sup>22</sup> This includes those who work in

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14. Alabama, California, Georgia, Kansas, Massachusetts, Nebraska, Nevada, New Hampshire, North Dakota, Oregon, Pennsylvania, Tennessee, Vermont, Washington, West Virginia, Colorado, Idaho, Maryland, Mississippi, New Jersey, Rhode Island, South Carolina, Arkansas, Delaware, Florida, Iowa, Kentucky, Missouri, Montana, North Carolina, Oklahoma, South Dakota, Utah, and Virginia all treat public pensions as contracts. See MUNNELL, *supra* note 11, at 220.

15. Alaska, Illinois, New York, Arizona, Hawaii, Louisiana, and Michigan all have added clauses to their constitutions protecting pension benefits. See MUNNELL, *supra* note 11, at 220.

16. MUNNELL, *supra* note 11, at 220.

17. *Id.*

18. For an example of how pension reforms reduce retiree benefits see *Executive Summary*, THE RHODE ISLAND GENERALLY ASSEMBLY RETIREMENT SECURITY LEGISLATION, <http://www.pensionreformri.com/resources/ReportwithGRSAppendix.pdf> (last visited Apr. 7, 2014) [hereinafter *Executive Summary*].

19. *Plan Provisions*, PUBLIC PLANS DATABASE, <http://pubplans.bc.edu/pls/apex/f?p=1988:14:0::NO:RP,14::> (last visited Apr. 7, 2013).

20. *Id.*

21. MUNNELL, *supra* note 11, at 229.

22. *Retirement Planner: State and Local Government Retirement*, SOC. SEC. ADMIN., <http://www.ssa.gov/retire2/stateandlocal.htm> (last visited Apr. 7, 2014).

school systems, colleges, or universities.<sup>23</sup> Currently, public employees in Alaska, California, Colorado, Illinois, Louisiana, Maine, Massachusetts, Missouri, Nevada, Ohio, and Texas, as well as some local governments in Georgia, Kentucky, and Rhode Island do not pay into Social Security.<sup>24</sup> Therefore, these public employees do not have the cushion of Social Security to fall back on when they retire. As states scramble to prevent the collapse of their pension programs and protect their overall financial health and credit,<sup>25</sup> they should not be shortsighted and overcut pension benefits. If they do, the nation will find itself with an impoverished elder population.

This Note will discuss Rhode Island's pension reform legislation and how other states can use its model as an example in making their own pension reforms. Each state has a different excuse for the underfunded public employee pension plans, and, from a legal standpoint, each state treats pension plans differently. However, evaluating Rhode Island's pension reform and legal challenges can provide insight into how Illinois, and other states' pension reforms, will be challenged and how they will fare in court. Part II of this Note will provide background for common pension models and how these pension funds came to be underfunded. Part III focuses specifically on the pension funding issues in Rhode Island and Illinois and the pension reform in those states. Part III will also discuss the legal challenges in Rhode Island, as well as other potential legal issues. Part IV will provide a rubric for what pension reforms are likely to be upheld in court and should be implemented over other proposed reforms that may face successful legal challenges.

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23. *Id.*

24. *Social Security Offsets Frequently Asked Questions*, NAT'L EDUC. ASS'N <http://www.nea.org/home/16819.htm> (last visited Apr. 7, 2014).

25. Ray Long & Monique Garcia, *Illinois Credit Rating Worst in the Nation After Downgrade*, CHI. TRIB. (Jan. 26, 2013), available at [http://articles.chicagotribune.com/2013-01-26/news/ct-met-illinois-bond-rating-20130126\\_1\\_action-on-pension-reform-robin-prunty-downgrade](http://articles.chicagotribune.com/2013-01-26/news/ct-met-illinois-bond-rating-20130126_1_action-on-pension-reform-robin-prunty-downgrade).

## II. Background

### A. Defined Benefit Pension Programs

The majority of state public pension plans are defined benefit programs.<sup>26</sup> In a defined benefit pension program, the employer pays the employee a benefit amount at retirement based on a specific formula.<sup>27</sup> “The formula is usually one of three general types: a flat-benefit formula, a career average formula, or a final pay formula.”<sup>28</sup> Funds for the benefit come from employee contributions that are paid out of each paycheck and employer contributions to the actuarial required contribution (ARC).<sup>29</sup> A plan sponsor then invests the money and increases the fund’s assets.<sup>30</sup> When an employee reaches the number of years that qualifies them for retirement under the plan or the retirement age, the employee is able to retire and receives a monthly payment from the pension fund that is based on a percentage of his or her salary and the number of years worked.<sup>31</sup>

In a defined benefit program, the risk of fund asset losses is placed on the employer.<sup>32</sup> Regardless of how much money is in the fund, the employer must pay the employee the benefits that are outlined in the pension agreement.<sup>33</sup> This makes defined benefit programs a very secure form of deferred compensation for public employees, but causes problems for the employer—in this case the state—when the plan is largely underfunded.<sup>34</sup> “This issue is of major concern for governments that currently provide DB (defined benefit) retirement plans for their employees, as it is becoming increasingly clear that their plans are short of funds.”<sup>35</sup> Since the benefits must still be paid, the state must come up with a way to increase the funded ratio of their pension programs.

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26. EMP. BENEFIT RESEARCH INST., FUNDAMENTALS OF EMPLOYEE BENEFIT PROGRAMS 370 (5TH ED. 1997) [HEREINAFTER FUNDAMENTALS].

27. Healey, *supra* note 1, at 6.

28. FUNDAMENTALS, *supra* note 26, at 56.

29. Healey, *supra* note 1, at 19.

30. FUNDAMENTALS, *supra* note 26, at 374.

31. *Id.* at 56.

32. Healey, *supra* note 1, at 7.

33. *See generally* FUNDAMENTALS, *supra* note 26, at 56.

34. Healey, *supra* note 1, at 19.

35. *Id.* at 7.

## B. Defined Contribution Pension Programs

The other main pension program is a defined contribution program. Most private pension plans are defined contribution plans.<sup>36</sup> In a defined contribution program “the employer makes a provision for contributions to an account established for each participating employee. The final retirement benefit reflects the total of employer contributions, employee contributions, and investment gains or losses.”<sup>37</sup> Employees pay contributions from each paycheck to an individual investment fund that allows them to choose what to invest on.<sup>38</sup> Their employer also contributes to the fund at a percentage that is determined according to their plan when the employee is hired. Employer contribution is often a percentage of the employee’s salary or a percentage of the company’s profits.<sup>39</sup> When the employee reaches the age of retirement, the value of their pension plan is the value of their investment fund.

Defined contribution plans put the risk of asset loss on the individual employee.<sup>40</sup> If their investment fund loses all of its money, when the employee retires he or she will not receive these plan benefits. While employees have more control over what their fund invests in, they bear the risk for market losses. Potentially, an employee could have very little money for retirement despite consistently contributing a percentage of their salary throughout their career. Depending on the market, this could leave a large number of retirees who have no income other than Social Security to live on.

## C. Public Pension Programs v. Private Pension Programs

Private pension plans are governed by the Employee Retirement Income Security Act of 1974 (ERISA).<sup>41</sup> ERISA was passed because the federal government was aware of the importance of pension programs in providing retirement funds for retirees to maintain their

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36. MUNNELL, *supra* note 11, at 186.

37. FUNDAMENTALS, *supra* note 26, at 57.

38. Healey, *supra* note 1, at 7.

39. FUNDAMENTALS, *supra* note 26, at 57.

40. Healey, *supra* note 1, at 7.

41. 29 U.S.C. § 1001 (2012).

standard of living.<sup>42</sup> A report on private pension plans determined these plans were essential and that federal government oversight was needed to ensure that private plans were secure and operated with the goal of maximizing benefits for plan participants.<sup>43</sup> “Congress determined that participants generally received insufficient information about their benefit plans and that there was inadequate protection of their rights.”<sup>44</sup> To solve this problem, Congress enacted reporting, funding, and fiscal responsibility standards through ERISA.<sup>45</sup> ERISA requires private pension plans to be more transparent by including information regarding the funded status of the plan, the number of participants in the plan, and the plan’s investments and liabilities.<sup>46</sup>

ERISA also established fiduciary duties for plan sponsors.<sup>47</sup>

“Plans had to be operated for the exclusive benefit of participants and beneficiaries.”<sup>48</sup> Plan sponsors are held to strict fiduciary standards for investment competence under the “prudent man rule.”<sup>49</sup> ERISA provides that “[f]iduciaries must act 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 and with like aims.”<sup>50</sup> This fiduciary standard provides a guarantee to private pension plan participants that their investments in the fund will be managed with the goal of maximizing profits.

In addition to the “prudent man rule,” ERISA provides further protection for plan participants by establishing minimum funding requirements.<sup>51</sup> In defined benefit pension programs, the employees and the employer make contributions to the fund. While employees typically contribute a percentage of each paycheck, employers contribute to the fund on a different schedule.<sup>52</sup> In order for pension funds to be fully funded and withstand dips in the stock market, em-

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42. *Id.* See generally FUNDAMENTALS, *supra* note 26, at 35 (explaining why ERISA was enacted).

43. 29 U.S.C. § 1001 (2012).

44. FUNDAMENTALS, *supra* note 26, at 35.

45. 29 U.S.C. § 1201–1204 (2012).

46. FUNDAMENTALS, *supra* note 26, at 36.

47. *Id.* at 40.

48. *Id.*

49. 29 U.S.C. § 1104(a) (2012).

50. 29 U.S.C. § 1104(a)(1)(B) (2012).

51. FUNDAMENTALS, *supra* note 26, at 45.

52. See generally 29 U.S.C. § 1083 (2012) (detailing the employer contribution schedule).

ployers are obligated to make their scheduled contributions.<sup>53</sup> ERISA puts in place strict requirements for single employer defined benefit plans. They must “make at least minimum contributions equal to the normal cost of the plan plus amounts necessary to amortize in equal installments any unfunded past service liabilities, any experienced gains or losses, any waived funding deficiencies, any changes in actuarial assumptions, and other items.”<sup>54</sup> ERISA also requires that these contributions be made regularly, on a quarterly basis.<sup>55</sup> If the employer does not make their scheduled contributions, then they are responsible for additional taxes on the unpaid amount.<sup>56</sup> The rules are a little more relaxed for multi-employer plans, however, they are still subject to a scheduled contribution requirement.<sup>57</sup>

When a plan is underfunded, ERISA may require accelerated contributions to make sure that the employer does not fall too far behind on contributions and cause a large increase in unfunded liabilities.<sup>58</sup> Thus, the federal government requires that private pension sponsors fund their plans in a timely manner. After ERISA, the government passed more minimum funding requirements for these plans in the Internal Revenue Code of 1986 and the Pension Protection Act of 2006.<sup>59</sup> Under these funding requirements, federal law “essentially require[s] that any deficit . . . be paid off over a seven-year period.”<sup>60</sup> While it appears to make financial sense to require pension fund sponsors to fund their plans, there is no equivalent requirement for public employee pension funds.<sup>61</sup>

ERISA provides further protection for private pension plan participants by requiring these plans to pay insurance to the Pension Benefit Guarantee Corporation (PBGC), a federal agency.<sup>62</sup> The plans must pay premiums to the PBGC and if the plan runs out of money and goes bankrupt, the PBGC will pay out benefits that were accrued by employees.<sup>63</sup> Insurance for private pension plans only protects the

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53. See generally MUNNELL, *supra* note 11, at 76 (noting that not all state pension plans are in crisis, and the states that are were not fiscally responsible).

54. FUNDAMENTALS, *supra* note 26, at 46.

55. 29 U.S.C. § 1083(j)(3) (2012).

56. FUNDAMENTALS, *supra* note 26, at 46.

57. *Id.* at 47.

58. 29 U.S.C. § 1083(j)(3) (2012).

59. Healey, *supra* note 1, at 20.

60. *Id.*

61. *Id.*

62. *Id.*

63. FUNDAMENTALS, *supra* note 26, at 48; Healey, *supra* note 1, at 20.

benefits that are already accrued, the PBGC does not cover non-accrued future benefits.<sup>64</sup>

State and local public employee pension plans are not subject to ERISA.<sup>65</sup> Although some suggested that public pension plans should be subject to ERISA, federalism concerns weakened this possibility.<sup>66</sup> Moreover, at the time ERISA was passed, “additional time was considered necessary to determine the need for federal regulation of these plans.”<sup>67</sup> After *The Pension Task Force Report on Public Employee Retirement Systems*<sup>68</sup> was issued in 1978, while there were some concerns over the disclosure and fiduciary standards of public plans, the fact that public plan terminations and insolvencies were rare limited the need for federal oversight.<sup>69</sup> There were also many state and local government advocates who “maintained that most public employees were covered under large state systems that were generally well-managed and that, where problems had existed, the states had made great strides in improving plan practices.”<sup>70</sup> Ultimately, public pension programs were not included in ERISA.<sup>71</sup>

By 1982, Congress proposed federal regulation over state and local pension plans. The Public Pension Plan Reporting and Accountability Act of 1982 (PEPPRA) called for public pension plans to disclose and report benefit liability and investment information, and follow established standards of conduct and responsibility for plan fiduciaries.<sup>72</sup> The Act also extended favorable tax treatment to the benefits of participants, granted public employee benefit plans an “unconditional exemption” from federal income taxes, and provided for remedies and access to federal courts.<sup>73</sup> Legislators proposed the Act because they were aware that a large number of citizens relied on

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64. MUNNELL, *supra* note 11, at 222 (noting that ERISA PBGC insurance only protects past benefits, not future benefits).

65. See Healey, *supra* note 1, at 20.

66. MUNNELL, *supra* note 11, at 16.

67. FUNDAMENTALS, *supra* note 26, at 370.

68. Staff of H. Comm. on Educ. and Lab., 95th Cong., Rep. on Public Employee Retirement Systems (Comm. Print 1978).

69. Fundamentals, *supra* note 26, at 370. See also Comm. on Educ. and Lab., Public Employee Pension Plan Reporting and Accountability Act of 1982 (H.R. 4929), H.R. Rep. No. 97-528, §2(a) (1982).

70. MUNNELL, *supra* note 11, at 16.

71. Fundamentals, *supra* note 26, at 370.

72. See generally Comm. on Educ. and Lab., Public Employee Pension Plan Reporting and Accountability Act of 1982 (H.R. 4929), H.R. Rep. No. 97-528 at §2(a) (1982).

73. *Id.*

public pension programs for their well-being upon retirement, and they were concerned by the practices that were being followed by public pension plans' sponsors.<sup>74</sup> Legislators also recognized the potential conflict of interest that state politicians faced that could prevent them from satisfying scheduled contributions.<sup>75</sup> State politicians may feel political pressure to finance other state services instead of contributing to the pension fund.<sup>76</sup> According to the Act, "[m]any jurisdictions do not systematically fund retirement benefits occurring to their employees . . ."<sup>77</sup> The Act further explains, "[f]inancial burdens of local governments have already resulted in the diversion of public employee pension benefit plan assets from such plans in order to relieve the plan sponsors from other financial obligations unrelated to the purposes for which such plans were established."<sup>78</sup>

While the Act accurately predicted that unfunded state pension liabilities would be a financial burden for states in the future, Congress ultimately failed to enact PEPPRA into law.<sup>79</sup> Congress instead trusted that states would not fall short of their fiduciary duties and left public pension plan oversight to the states.<sup>80</sup>

Even though PEPPRA was not enacted, it brought more attention to the status of public employee pension plans. This attention led to some changes to encourage better disclosure and reporting standards for these plans.<sup>81</sup> One of these measures was the creation of the Governmental Accounting Standards Board (GASB). The GASB "was established specifically to set standards of accounting and reporting for state and local governments."<sup>82</sup>

At the time ERISA and PEPPRA were being legislated, there was strong advocacy from state groups calling for state control over public pensions.<sup>83</sup> Many argued that there was no need for the federal government to require state employee pension plans to make their scheduled contributions, as private plans are required to do under ERISA,

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74. *Id.*

75. *Id.*

76. MUNNELL, *supra* note 11, at 16.

77. *Id.*

78. *Id.*

79. *Id.* at 17.

80. *Id.*

81. *Id.*

82. *Id.* at 16.

83. *Id.*

because the state cannot go bankrupt and therefore plan benefits are guaranteed.<sup>84</sup> In retrospect, the claim that public pension benefits are guaranteed seems ironic because, as a result of states not being required to make their scheduled contributions, many did not make those contributions. This led to the current situation where states face the prospect of large unfunded pension liabilities. Many states cannot pay the benefits that they promised and are looking for a way out. In reality, those benefits were not actually guaranteed.

#### D. How Did We Get Here?

According to the Pew Center on the States, “[m]any experts say that a healthy pension system should be at least 80 percent funded.” In 2010, 34 states were less than 80 percent funded, and four states were under 55 percent funded.<sup>85</sup> While many state public pension plans are having financial difficulty, some states are worse off than others.<sup>86</sup> Many factors contributed to the current level of underfunding. These include: missed state contributions, loss in the value of plan assets, inaccurate valuing and reporting methods, cost of living adjustments that exceeded the rate of inflation, and short-sighted benefit increases.

##### 1. MISSED STATE CONTRIBUTIONS

State pensions, unlike private pension programs which are subject to ERISA, are not required to pay their actuarially required contributions (ARCs).<sup>87</sup> An ARC consists of “the present value of any newly accrued benefits and a portion of a plan’s underfunded liability.”<sup>88</sup> Some states have taken advantage of the fact that there is no overseeing agency that requires them to make their scheduled contributions.<sup>89</sup> In 2010, states only contributed 78% percent of the recommended amount to their state-run retirement funds.<sup>90</sup> This statistic,

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84. “Connecticut, Illinois, Kentucky and Rhode Island were all under 55 percent funded in 2010.” Issue Brief, *The Widening Gap Update*, THE PEW CTR. ON THE STATES 2 (June 2012), [http://www.pewstates.org/uploadedFiles/PCS\\_Assets/2012/Pew\\_Pensions\\_Update.pdf](http://www.pewstates.org/uploadedFiles/PCS_Assets/2012/Pew_Pensions_Update.pdf) [hereinafter *The Widening Gap*].

85. *Id.*

86. MUNNELL, *supra* note 11, at 76. See also *The Widening Gap*, *supra* note 84, at 2.

87. Healey, *supra* note 1, at 19.

88. *Id.*

89. States such as Illinois, Kentucky and New Jersey have not been making their full ARC payments. *The Widening Gap*, *supra* note 84, at 6.

90. *Id.*

however, includes some states that have been making full ARC payments and other states that have made no contributions. In that same year, 17 states did not make any contributions at all to their ARC.<sup>91</sup> Although GASB sets standards for how the ARC should be calculated, it is ultimately up to the states to decide how much they are going to contribute.<sup>92</sup> Some states have ignored the GASB standards and have not contributed the recommended amount to their pension funds.<sup>93</sup>

There are a number of reasons why states have chosen not to make their full ARC contributions. Some states have statutes that put caps on the amount of the state budget that can go toward the ARC. As a result, if the ARC goes up due to market losses or an increase in retirees, the state may be limited in their ability to satisfy their ARC.<sup>94</sup> Some states have also faced immediate financial needs that have taken priority over paying their ARC contribution.<sup>95</sup> Elected officials must choose what public services to fund with the state budget, including providing education, health services, and state infrastructure.<sup>96</sup> They may decide that it is more important to keep schools open now than to set aside money for retirement benefits in the future.

Other states have simply been “bad actors.”<sup>97</sup> They allowed benefit increases without increasing funding sources and mismanaged their budget.<sup>98</sup> As Munnell explains, “[i]n short, the funded status of state and local plans today primarily reflects the sponsor’s past and present attitude toward managing its pension and non-pension finances.”<sup>99</sup> According to a report by the Pew Center on the States, those states that made their annual contributions have plans that are significantly better funded than states that have not made their annual contributions.<sup>100</sup> This research indicates that paying their ARC in full is the best way for states to manage their pension liabilities.<sup>101</sup>

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91. *Id.*

92. Healey, *supra* note 1, at 19.

93. See generally MUNNELL, *supra* note 11, at 79–80.

94. *Id.* at 80–81.

95. *The Widening Gap*, *supra* note 84, at 4.

96. *Id.*

97. MUNNELL, *supra* note 11, at 87.

98. *The Widening Gap*, *supra* note 84, at 4. See also MUNNELL, *supra* note 11, at 100.

99. MUNNELL, *supra* note 11, at 100.

100. *The Widening Gap*, *supra* note 84, at 6.

101. *Id.*

## 2. LOSS IN THE VALUE OF PLAN ASSETS

To pay retiree benefits, all public employee pension plans depend on investments in the stock market.<sup>102</sup> Employers and employees contribute funds that are invested by a plan sponsor to increase the plan's assets and help pay for retirees' benefits.<sup>103</sup> Plans generally expect funds to increase at a rate of 8 percent, but in 2010, plans experienced a loss of 25 percent.<sup>104</sup> Pensions that had high percentages of their funds invested in the stock market experienced a significant decrease in fund assets. At the same time that public employee pension plans lost a large portion of their assets, states were unable to make greater contributions because the recession led to decreased state tax revenues.<sup>105</sup> The loss in assets combined with missed state contributions—past and present—has brought to light that some plans will run out of funds to cover liabilities in the near future unless there is pension reform.<sup>106</sup>

## 3. INACCURATE VALUING AND REPORTING METHODS

Pension benefits accrue each year that an employee works for the government.<sup>107</sup> The benefits are not distributed out at the time they are earned, but rather they are paid when the employee retires.<sup>108</sup> Therefore, in order to ensure that the plan has enough funds to pay for the benefits that each employee earns each year, employers must set aside funds that they believe will be sufficient to cover future costs.<sup>109</sup> To do this, plans must decide the method by which they value benefit liabilities.

In the private sector, when plans are valuing benefits accrued that year, they tend to take into account potential future salary increases and the effect that the increases will have on the benefits that are earned that year.<sup>110</sup> Therefore, employers set aside a higher value

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102. *Id.* at 4. "About \$6 of every \$10 in the [pension] funds comes from earnings on investments." *Id.* at 6.

103. *Id.*

104. *Id.* at 4.

105. MUNNELL, *supra* note 11, at 4, 107.

106. *Id.*

107. Healey, *supra* note 1, at 19.

108. FUNDAMENTALS, *supra* note 26, at 56.

109. See generally *id.* at 72. See also MUNNELL, *supra* note 11, at 54–55 ("The goal is to have the employer pay an amount each year that will 'smooth' the costs so that the employer will set aside money in the present that will be enough to pay for future benefit payouts.")

110. MUNNELL, *supra* note 11, at 52.

for the benefits that an employee earns assuming that the actual cost that they pay out to the employee in the future will be based on a percentage of the employee's higher ending salary.<sup>111</sup> Public pension plans, on the other hand, tend to value the benefits earned by each employee annually based on their current salary level, and they make contributions based on that amount.<sup>112</sup> As the salary of a worker increases, the amount that the employer contributes for that employee increases.<sup>113</sup> Consequently, the amount of money that an employer sets aside for that employee each year increases with time.<sup>114</sup> Under these methods, private sector plans are setting aside what the actual costs of benefits will be for the benefits accrued each year, expecting salary increases in the future, and public plans stagger the cost of benefits, ultimately paying a higher amount towards the end of an employee's career.<sup>115</sup> The net effect is that private sector pension plans are setting aside more money for benefits as they are accrued.<sup>116</sup>

After the plan determines how much the annual cost of benefits accrued each year will be, it must decide what discount rate to use. Discount rates determine how much money it needs to contribute that year to pay for the benefits when the employee retires.<sup>117</sup> The discount rate should reflect the expected return on investments made by the plan sponsor.<sup>118</sup> The traditional discount rate is eight percent, assuming that the plan's investments will increase in value at least by eight percent.<sup>119</sup> However, in the midst of an economic recession an eight percent increase might be too ambitious and inaccurate.<sup>120</sup> Some economists recommend that plans instead use a lower discount rate that is more in tune with current economic growth.<sup>121</sup> If a discount

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111. *Id.* See generally Robert Novay-Marx & Joshua D. Rauh, Public Pension Promises: How Big Are They and What Are They Worth?, 1 J. FIN. (2011).

112. MUNNELL, *supra* note 11, at 52. See Novay-Marx, *supra* note 111, at 5.

113. See Novay-Marx, *supra* note 111, at 5. See also MUNNELL, *supra* note 11, at 52.

114. See Novay-Marx, *supra* note 111, at 5.

115. *Id.* at 5–6.

116. *Id.* at 5–6.

117. Novay-Marx, *supra* note 111, at 23.

118. *Id.*

119. *The Widening Gap*, *supra* note 84, at 4. See also Novay-Marx, *supra* note 111, at 23.

120. See Novay-Marx, *supra* note 111, at 23. See also *The Widening Gap*, *supra* note 84, at 4.

121. Novay-Marx, *supra* note 111, at 23.

rate of five percent is used, the funded ratio of public pension plans for 2010 plummets from 76 percent to 51 percent.<sup>122</sup>

The funded ratio of public pension plans is important because it is taken into account in determining the ARC for each plan.<sup>123</sup> If a higher discount rate is used, then the plan appears to be better-funded than if a lower discount rate is used.<sup>124</sup> Consequently, if a lower discount rate is used, the plan will appear to be underfunded and require a higher ARC to raise the funded ratio of the plan.<sup>125</sup> There is a lot of debate over what discount rate should be used. A lower rate could compel employers to make higher contributions which would lead to better-funded pension plans.<sup>126</sup> However, choosing one discount rate over another does not solve the pension liability problem. What discount rate is used matters little if states refuse to pay their full ARC, ignoring how underfunded their pension plans are.<sup>127</sup>

#### 4. COST OF LIVING ADJUSTMENT (COLA)

Many pension plans include a cost of living adjustment that is set out in their plan agreements to adjust benefits for inflation. This usually is a fixed rate around three percent.<sup>128</sup> However, if inflation does not increase by three percent, then the beneficiaries are over-compensated for inflation.<sup>129</sup> It is difficult to predict at the time of employment how much the benefits will need to be adjusted each year to account for inflation.<sup>130</sup>

An alternative to having a fixed COLA rate is using a fluctuating rate that tracks market conditions. The state of Delaware determines COLA in this manner. Delaware's public employee pension plan is consistently one of the better-funded state plans.<sup>131</sup> One of the measures that allows the state to maintain its funded status is that its COLA is determined on an ad hoc basis and is based on the needs of

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122. MUNNELL, *supra* note 11, at 61.

123. *Id.*

124. *Id.* at 68.

125. *Id.*

126. *See generally id.* at 62–65 (illustrating how using different ARC rates can either over or underfund pension plans).

127. *Id.* at 87.

128. *Plan Provisions*, PUBLIC PLANS DATABASE, <http://pubplans.bc.edu/pls/apex/f?p=1988:14:0::NO:RP,14::> (last visited Apr. 7, 2014).

129. Healey, *supra* note 1, at 27.

130. *Id.*

131. MUNNELL, *supra* note 11, at 116.

the state at that time.<sup>132</sup> Therefore, the state can determine each year how much participant benefits need to be adjusted, and can save money by not increasing benefit payments if an increase is not needed or if the state cannot afford the increase.<sup>133</sup>

#### 5. PRE-RECESSION BENEFIT INCREASES

Another often cited cause of the pension crises is the increase in pension benefits before the recession. Many states increased employee pension benefits because they did not anticipate the economic downturn. For example, “in 2001, 11 states expanded retirement benefits; others followed suit in subsequent years.”<sup>134</sup> State pension liabilities make up a significant portion of states’ budgets each year, but the ease with which states can pay out their benefits can vary from year to year.<sup>135</sup> Moreover, the nature of this system is that in some years, if the economy is doing well, these plans can appear well-funded or even to have a surplus.<sup>136</sup> However, legislators should have known that the apparent surplus was subject to changes in the market and should not have used it as an excuse to increase pension benefits.<sup>137</sup> Furthermore, as Alicia Munnell points out, from 2001 to 2010 “plans never came close to full funding, and therefore overfunding could never have been an excuse for raising benefits.”<sup>138</sup>

On the other hand, some believe that strong unions are responsible for the increase in state employee benefits when it was financially irresponsible.<sup>139</sup> As a response, some states have passed laws that restrict collective bargaining.<sup>140</sup> Not all agree, however, that increases in pension benefits were the result of strong unions. For example, a study by Alicia Munnell suggests unions may not have had a significant role in the increase at all.<sup>141</sup> Munnell notes that there is not a strong correlation between states that increased their pension benefits when the economy was doing well and states that have a larger percentage of unionized employees.<sup>142</sup>

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132. *Id.* at 117.

133. *See generally id.* at 116–17 (describing Delaware’s COLA scheme).

134. *The Widening Gap*, *supra* note 84, at 4.

135. *See id.* at 1.

136. MUNNELL, *supra* note 11, at 61.

137. *Id.*

138. *Id.*

139. *Id.* at 91.

140. *Id.*

141. *Id.* at 98–99.

142. *Id.* at 99.

## E. Legal Status of Public Pensions

### 1. Pension Plans as Contracts

The legal status of pension plans is determined by state law and, therefore, varies from state to state. The success of any public pension reform attempt is highly dependent on how pensions are legally treated in that state. Most states treat pension plans as a contract between the employee and the employer.<sup>143</sup> States that follow contract law for pensions include California, Rhode Island, and Missouri.<sup>144</sup> The federal Contract Clause of the U.S. Constitution, and similar state provisions legally protect these pensions. The federal Contract Clause provides that “[n]o State shall . . . pass any . . . Law impairing the Obligation of Contracts.”<sup>145</sup> To determine whether a state has unconstitutionally violated the Contract Clause, courts use a three-part test laid out in *U.S. Trust Co. of New York v. New Jersey*.<sup>146</sup>

In *U.S. Trust*, the plaintiff, U.S. Trust Co. of New York, brought an action against New Jersey claiming that the state’s repeal of a statutory covenant that limited the ability of the Port Authority of New York and New Jersey to subsidize rail passenger transportation from revenues and reserves violated the Contract Clause.<sup>147</sup> To evaluate whether New Jersey’s actions violated the Contract Clause the Supreme Court considered: (1) whether there was a contract; (2) whether the state’s action was an impairment of the terms of the contract; and, (3) whether the impairment was justified by an important public purpose, and the action taken in the public interest was reasonable and necessary.<sup>148</sup> In *U.S. Trust*, the Court held that New Jersey’s repeal of the covenant was not “reasonable and necessary” because there were other alternatives to accomplish its goals. New Jersey’s actions therefore violated the Contract Clause.<sup>149</sup>

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143. JENNIE HERRIOT-HATFIELD ET AL., EDUCATION SECTOR, A LEGAL GUIDE TO STATE PENSION REFORM 2 (2012), available at [http://www.educationsector.org/sites/default/files/publications/PensionLegalGuide\\_RELEASE.pdf](http://www.educationsector.org/sites/default/files/publications/PensionLegalGuide_RELEASE.pdf). See also MUNNELL, *supra* note 11, at 219.

144. MUNNELL, *supra* note 11, at 221.

145. U.S. CONST. art. I, § 10, cl. 1.

146. *U.S. Trust Co. of New York v. New Jersey*, 431 U.S. 1505 (1977).

147. *Id.* at 1509-10 (1977).

148. *Id.* at 1522-23; *Energy Reserves Grp., Inc. v. Kansas Power & Light Co.*, 459 U.S. 400 (1983).

149. *U.S. Trust Co. of New York*, 431 U.S. at 1505.

Even where a court decides that a state's actions do not satisfy the *U.S. Trust* test, the court's interpretation of the terms of the contract can affect the state's ability to implement reform. For example, as Munnell notes, "the ability to modify pensions in these states hinges on when the contract is deemed to exist."<sup>150</sup> Some courts have held that the contract begins when the employee begins work, while others have determined that the contract does not exist until the employee's benefits have vested.<sup>151</sup> Additionally, some courts have decided that while there are contractual rights to pensions, terms such as the COLA formula used to determine benefit increases are not protected.<sup>152</sup> As one Colorado court explained, "[f]or four decades the [cost-of-living-adjustment] formulas as applied to retirees have repeatedly changed and have never been frozen at the date of retirement."<sup>153</sup> Therefore, the degree to which certain benefits are shielded may vary.

Ultimately, viewing pensions as contracts makes it fairly difficult for states to enact pension reform. The date the contract begins can provide legislatures some leeway in making benefit changes. For example, if the state's courts determine that the contract does not exist until retirement, unaccrued pension benefits are not protected and the legislature is legally free to make changes to the benefits of current employees.<sup>154</sup> Nevertheless, although many states follow the pension-as-a-contract theory,<sup>155</sup> not all states afford pension benefits the same degree of protection.

## 2. STATE CONSTITUTIONAL PROTECTIONS

The states that will have the most difficulty passing pension reform bills are the states that have provisions protecting pension benefits included in their state's constitution. In these states, the legislature cannot reduce pension benefits without a constitutional amendment.<sup>156</sup> These "[s]tate [c]onstitutions prohibit altering (reduc-

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150. MUNNELL, *supra* note 11, at 221.

151. *Id.*

152. *Justus v. State*, No. 2010-CV-1589, at \*40 (D. Colo. June 29, 2011).

153. *Id.*

154. See generally MUNNELL, *supra* note 11, at 219 (explaining how states can change future benefits in states that follow contract law if courts interpret the contract to only protect accrued benefits).

155. *Id.* at 220–21.

156. *Id.* at 219.

ing or eliminating) state and local governmental contractual obligations to employees for pension benefits."<sup>157</sup> States that have constitutional protection provisions include Illinois, New York, and Alaska.<sup>158</sup> In Illinois and New York, constitutional protections place significant hurdles on pension reform because pension benefits become a "vested right" when the employee is hired.<sup>159</sup> Legislators can make changes to new employees' pension plans, but they cannot modify benefits—past, present, or future—for current employees.<sup>160</sup> Other states, such as Hawaii, Louisiana, and Michigan have constitutional provisions protecting pensions but only for benefits that have already accrued.<sup>161</sup>

While these state constitutions make it clear that the employee's pension plan is part of a contract with the state or local government, these states still have some options—other than constitutional amendments—to enact pension reform. While it is unobjectionable that the pension has contract protections, it is not always clear what benefits are included. For example, as some states have already done, states could argue that the COLA formula is not part of the benefits protected by the contract.<sup>162</sup> Additionally, if the state's actions satisfy the *U.S. Trust* test, those reforms will be upheld in court. Although some state courts have already determined when the pension benefits contract begins, states may be able to successfully argue that the contract only comes into being once the benefits have vested, or even later when the employee retires.

### 3. PENSION BENEFITS AS PROPERTY

Some states consider pension benefits property. In these states, the degree of protection that pension benefits receive is governed by property law. Examples of states that view pension benefits as property are Maine, Wyoming, New Mexico, and Wisconsin.<sup>163</sup> The Fifth Amendment of the Constitution prohibits the government from depriving any person of property without due process of law, and the

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157. JAMES E. SPIOTTO, UNFUNDED PENSION OBLIGATIONS: IS CHAPTER 9 THE ULTIMATE REMEDY? IS THERE A BETTER RESOLUTION MECHANISM? THE CASE FOR A PUBLIC PENSION FUNDING AUTHORITY 29 (June 2010), available at [http://www.chicagofed.org/digital\\_assets/others/events/2010/charting\\_illinois\\_fiscal\\_future/spiotto.pdf](http://www.chicagofed.org/digital_assets/others/events/2010/charting_illinois_fiscal_future/spiotto.pdf).

158. MUNNELL, *supra* note 11, at 220.

159. HERRIOT-HATFIELD, *supra* note 143, at 2.

160. MUNNELL, *supra* note 11, at 222.

161. *Id.* at 219.

162. *Justus v. State*, No. 2010-CV-1589, at \*12 (D. Colo. June 29, 2011).

163. MUNNELL, *supra* note 11, at 220.

taking of “private property for public use, without just compensation.”<sup>164</sup> Property rights are constitutionally protected, but property rights are not absolute and are vulnerable to state action. When the state passes legislation that results in an individual’s loss in property value, the action may be considered a regulatory taking for which the government must provide just compensation.<sup>165</sup>

To evaluate whether a regulatory taking has taken place, the Supreme Court adopted an ad hoc three-factor test that balances: (1) “the economic impact of the regulation on the claimant;” (2) “the extent to which the regulation has interfered with distinct investment-backed expectations;” and, (3) “the character of the governmental action.”<sup>166</sup> After considering these factors, if the court decides that there was taking, the government must provide just compensation. If the state action is not a taking then no compensation is necessary. Generally, courts have been reluctant to view reductions in pension benefits as a regulatory taking.

For example, in *Pineman v. Fallon*, the Second Circuit decided that legislative action that resulted in lower pension values was “an adjustment to the benefits and burdens of economic life” and not a regulatory taking.<sup>167</sup> Consequently, states that treat pension plans and benefits as property may have less of a legal barrier if they want to modify public employee benefits.<sup>168</sup> As some have noted, if the state views pension plans as property, public employees have protected property right claims but their right is not absolute.<sup>169</sup>

#### 4. PUBLIC PENSIONS AS GRATUITY

When pensions were first created in the United States, most were seen as a gratuity for public employees to help them with retirement.<sup>170</sup> As a gratuity, pension benefits are not legally protected and state legislators could alter benefits in any way they see fit at any time. Only Texas and Indiana still consider certain public employee

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164. U.S. CONST. amend. V.

165. *Pennsylvania Coal Co. v. Mahon*, 260 U.S. 158, 159 (1922).

166. *Penn Cent. Transp. Co. v. City of New York*, 438 U.S. 104, 124 (1978).

167. *Pineman v. Fallon*, 842 F.2d 598 (2d Cir. 1988); MUNNELL, *supra* note 11, at 221.

168. MUNNELL, *supra* note 11, at 221.

169. HERRIOT-HATFIELD, *supra* note 143.

170. MUNNELL, *supra* note 11, at 218–19.

pensions a gratuity.<sup>171</sup> In Texas, “the gratuity approach applies only to state-administered plans” and “[a]ccruals in many locally administered plans are protected under the Texas constitution.”<sup>172</sup> In these states, the consequences of changing or reducing pension benefits are mainly political.

Treating pension benefits as a gratuity provides no protection to state’s employee retirement funds. The result is that many people who spent their lives serving their state may be unable to care for themselves in their elder years.

### III. Case Studies

To better analyze the challenges of pension reform, the following section will discuss attempts at reform in Rhode Island and Illinois.

#### A. Rhode Island

In November 2011, Rhode Island passed a comprehensive pension reform bill that resulted in a complete overhaul of the state’s employee pension programs.<sup>173</sup> The Rhode Island Retirement Security Act of 2011 (RIRSA) is an attempt to make necessary changes in the pension plan to reduce the state’s unfunded liability while addressing concerns of employees who paid contributions and relied on the promise of specified benefits upon retirement. RIRSA is anticipated to lower Rhode Island’s unfunded liability from \$7 billion to about \$4 billion over the next 25 years.<sup>174</sup> It will accomplish this goal by: (1) increasing the age of retirement from sixty-five to sixty-seven;<sup>175</sup> (2) freezing COLA increases until the plan is eighty percent funded;<sup>176</sup> (3) creating a hybrid plan that has a defined benefit structure as well as a defined contribution structure;<sup>177</sup> and, (4) re-amortizing the unfunded pension liability.<sup>178</sup>

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171. Herriot-Hatfield, *supra* note 143.

172. MUNNELL, *supra* note 11, at 220.

173. Christopher D. Hu, *Reforming Public Pensions in Rhode Island*, 23 STAN. L. & POL’Y REV. 523, 523 (2012).

174. *Id.* at 524.

175. *Executive Summary*, *supra* note 18, at 12–13.

176. *Id.* at 4.

177. *Id.* at 5–6.

178. *Id.* at 9.

Rhode Island was substantially affected by the 2008 financial crisis.<sup>179</sup> In 2011, Rhode Island's unemployment rate was 10.6 percent, well above the national average.<sup>180</sup> Throughout the state, local governments were struggling to remain solvent. One town, Central Falls, declared bankruptcy and set a troubling example for the rest of the state.<sup>181</sup> The political climate was not conducive to telling state employees and retirees that the state had to cut their pension benefits. Organized labor has a strong presence in Rhode Island, and the unions loudly opposed pension reform.<sup>182</sup> Under these difficult circumstances, the state treasurer Gina Raimondo, urged residents that pension reform had to be implemented in order for there to be any money left to pay pension benefits at all.<sup>183</sup> In 2011, Raimondo issued the *Truth in Numbers* report, which acknowledged the sacrifice that public employees would have to make and stressed that all reforms would have to be fair for both public workers and taxpayers.<sup>184</sup> The report further explained why the public pension fund was underfunded, and why reform was urgent. While pension reform is still greatly opposed by many state employees, the bill gained enough traction with both Republicans and Democrats to be passed and then signed into law on November 18, 2011.<sup>185</sup>

At the time RIRSA was passed, Rhode Island had an unfunded liability of over \$7 billion with its retirement system only 48 percent funded.<sup>186</sup> Experts recommend that for a pension fund to be "healthy" it should be 80 percent funded.<sup>187</sup> The legislature recognized that changes to the pension plan were necessary or the pension fund would run out of money and no longer be able to pay retirees their benefits or provide other vital state services.<sup>188</sup> In the opening section of RIRSA, the legislature explains the gravity of the problem: "[t]he current condition of Rhode Island's critically underfunded pension

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179. Mary Williams Walsh, *The Little State with a Big Mess*, N.Y. TIMES (Oct. 22, 2011), available at <http://www.nytimes.com/2011/10/23/business/for-rhode-island-the-pension-crisis-is-now.html> (last visited Apr. 7, 2014).

180. *Id.*

181. *See id.*

182. *Id.*

183. *Id.*

184. GINA M. RAIMONDO, TRUTH IN NUMBERS: THE SECURITY AND SUSTAINABILITY OF RHODE ISLAND'S RETIREMENT SYSTEM 1 (2011), available at <http://www.treasury.ri.gov/documents/SPRI/TIN-WEB-06-1-11.pdf>.

185. Hu, *supra* note 173, at 523.

186. *Id.* at 524.

187. *The Widening Gap*, *supra* note 84, at 2.

188. 2011 R.I. Pub. Laws Ch. 11-408 § 1.

system, combined with the state's continuing financial instability and existing onerous tax burden, threatens the base pensions of current and future public workers, hampers the ability of the state to provide its citizens with vital services necessary for the public's health, safety and welfare, and places an unsustainable financial burden on all Rhode Island citizens and taxpayers."<sup>189</sup> In essence, the legislature had to act, even though reform was politically unpopular.

The Rhode Island legislature passed RIRSA in November 2011 and faced legal challenges soon thereafter.<sup>190</sup> Prior to RIRSA, between 2005 and 2010, Rhode Island had enacted smaller changes to reduce pension benefits.<sup>191</sup> These reforms also led to legal challenges and they shed light on how a court could decide the current challenges to RIRSA.

In *Rhode Island Council 94 v. Carcieri*, the Rhode Island Superior Court concluded that a unilateral contract between state employees and the state existed for employees who have served at least 10 years.<sup>192</sup> The court reasoned that since one of the objectives of public pensions is to induce persons to enter public employment, the existence of a pension agreement constitutes an offer.<sup>193</sup> The employees accept the offer by "faithful and diligent" employment for the number of years set out in the agreement.<sup>194</sup> Therefore, the court held that the plaintiffs "possess implied unilateral contract rights arising from the ERSRI (Employees' Retirement System of the State of Rhode Island)."<sup>195</sup> Importantly, the court also noted that "a COLA and a pension are one and the same."<sup>196</sup> While the court found that employees (who have worked for at least 10 years) have a contractual right to the COLA and pension benefits that they originally agreed to, the government was not prevented from altering pension benefits.<sup>197</sup> Therefore, finding that a contract exists is only the first step in the analysis of whether the legislature's change in benefits is constitutional.<sup>198</sup> The

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189. 2011 R.I. Pub. Laws Ch. 11-408 § 1(a)(3).

190. *Rhode Island Pub. Employees' Retiree Coal. v. Chafee*, 58 A.3d 915 (R.I. 2012).

191. RAIMONDO, *supra* note 184, at 4.

192. *Rhode Island Council 94 v. Carcieri*, 2011 WL 4198506 (R.I. Super.).

193. *Id.*

194. *Id.*

195. *Id.*

196. *Id.*

197. *Id.*

198. See *supra* discussion Part II; *Rhode Island Council 94 v. Carcieri*, 2011 WL 4198506 (R.I. Super.).

state's actions will only be unconstitutional if they "substantially impair" the contractual rights and if the reforms are unreasonable and unnecessary to carry out a legitimate public purpose."<sup>199</sup>

The Rhode Island legislature, conscious of the holding in *Rhode Island Council 94*, carefully tailored the language of RIRSA to fit the test that the court laid out. After explaining the magnitude of the pension crisis and how both beneficiaries of the state's pensions and taxpayers would benefit, the legislature stated that "[t]he Rhode Island Security Act of 2011 is reasonable and necessary to achieve and protect the compelling public interests listed herein . . . the achievement of those compelling public interests, on balance, far outweigh any impact that such enactment might have upon the expectations of active and retired members of the affected pension systems."<sup>200</sup>

Currently pending is a case filed by the Rhode Island Public Employees' Retiree Coalition against Rhode Island Governor Lincoln D. Chafee challenging provisions of RIRSA that retroactively reduce the vested pension benefits for employees who have already retired.<sup>201</sup> For RIRSA to be upheld it must satisfy the requirements set out in *U.S. Trust*. In Rhode Island, courts use an additional test laid out in *Energy Reserves Group, Inc. v. Kansas Power & Light* that clarifies what is required to satisfy the *U.S. Trust* test.<sup>202</sup> A court must determine: (1) whether the state law has substantially impaired a contractual relationship; (2) if the state law is a substantial impairment, whether there is a legitimate public purpose for the regulation; and, (3) whether the legitimate public purpose is sufficient to justify the impairment of the contractual rights.<sup>203</sup>

In *Rhode Island Council 94*, the court concluded that employees who have retired have contractual rights to their pensions, creating a contract between the state and its employees.<sup>204</sup> Under this standard, the court is likely to conclude that RIRSA's provisions freezing the COLA constitute a substantial interference with the employees' pension benefits because COLAs are considered "one and the same"<sup>205</sup> as

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199. *Id.*

200. R.I. Pub. Laws. 11-408 § 1.

201. *Rhode Island Pub. Employees' Retiree Coal. v. Chafee*, 58 A.3d 915 (R.I. 2012).

202. *U.S. Trust Co. of New York v. New Jersey*, 431 U.S. 1505, 1505 (1977).

203. *Id.* In Rhode Island, the court clarified the *U.S. Trust* test with a test laid out in *Energy Reserves Group, Inc. v. Kansas Power & Light Co.*, 459 U.S. 400, 410-12 (1983).

204. *Rhode Island Council 94 v. Carcieri*, 2011 WL 4198506 (R.I. Super.).

205. *Id.* at 24.

pensions. Freezing the COLA until the pension fund is 80 percent funded will completely take the COLA away, potentially indefinitely, removing any benefit that the employees would have received from the COLA. Nevertheless, the court will probably be persuaded that the legislature had an important public purpose in implementing pension reforms. The legislature was very careful to outline that it believed RIRSA to be reasonable and necessary to further the important state interests that it was enacted to uphold.<sup>206</sup>

The plaintiffs in *Rhode Island Public Employees' Retiree Coalition* argue that the means to reach the legitimate state interests were not reasonable and necessary.<sup>207</sup> For example, while the State does need to fix the pension crisis, it may have other means available, such as raising taxes and reevaluating its accounting methods.<sup>208</sup> To evaluate whether other methods are appropriate, the court will likely evaluate the gravity of the public pension problem in Rhode Island and the state's additional revenue options.<sup>209</sup> Considering the public interest, including the state employees expecting to receive their pension, everyone is better served by ensuring that the pension fund remains solvent.<sup>210</sup> Because RIRSA went into effect on July 1, 2012, if the law is struck down, the state would be required to retroactively pay back the COLA and other benefits to retirees.

## B. Illinois

In Illinois, pension benefits are considered contracts between the employees and the state. Additionally, these contracts are secured by the state constitution.<sup>211</sup> The Illinois constitution provides that "[m]embership 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."<sup>212</sup> Implement-

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206. 2011 R.I. Pub. Laws Ch. 11-408, § 1.

207. Complaint, *Rhode Island Pub. Employees' Retiree Coal. v. Chafee*, 58 A.3d 915 (R.I. 2012).

208. Hillary Russ, *Update 2-Rhode Island Pension Reform Faces Court Challenge*, REUTERS.COM, available at <http://www.reuters.com/article/2012/06/22/usa-labor-rhodeisland-idUSL2E8HM9NL20120622> (last visited Apr. 7, 2014).

209. Walsh, *supra* note 179 (explaining that Rhode Island's size and limited industry would make it more difficult to raise revenue than a state such as California).

210. RAIMONDO, *supra* note 184, at 13-14.

211. Ill. Const. art. 13, § 5.

212. *Id.*

ing broad changes in pension benefits would likely require a constitutional amendment.<sup>213</sup> The procedure for amending the Illinois constitution requires that the amendment: (1) be initiated in either house of the General Assembly; (2) be approved by a three-fifths vote in both houses; (3) be submitted to the electorate at the next general election that occurs at least 6 months after legislative approval; and, (4) be approved by either three-fifths of those voting on the question or a majority of those voting in the election.<sup>214</sup>

For over a year and a half, the Illinois legislature had been unsuccessful in passing pension reform.<sup>215</sup> Faced with the complicated challenge of reducing the state's financial liabilities while still protecting the pensions of state employees, Illinois politicians waived under political pressure. On December 3, 2013, the Illinois legislature finally passed pension reform and it was signed into law on December 5, 2013.<sup>216</sup> Before the bill's passage, the legislature considered a number of proposals. The debate centered on whether to make smaller cuts to benefits and give employees the choice over how their benefits would be cut, or to make broad reductions in benefits and, thereby greatly reduce financial liabilities.<sup>217</sup> The first proposal's legality relied on giving the employee a choice in how their benefits are reduced, thereby creating a new contract and avoiding unilateral state action. The second proposal would have had greater savings for the state, but relies on courts agreeing that the state has an important public purpose and that drastic reductions in pension benefits are both reasonable and necessary to solve the state's financial problems.

The first bill, introduced by Senate President John Cullerton, included two parts: Part A, which has greater reforms, and Part B, which is more modest and would phase in if Part A is found to be un-

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213. *Id.*

214. ILL. CONST. art. 14, § 2.

215. As of March 22, 2013, the Illinois legislature had not passed pension reform. At that time, the Senate passed a completely different bill than the bill the House passed. See Ray Long, *Sweeping Pension Reform Fails in Illinois Senate*, CHI. TRIB. (Mar. 20, 2013) [http://articles.chicagotribune.com/2013-03-20/news/chisweeping-pension-reform-fails-in-illinois-senate-20130320\\_1\\_pension-reform-pension-system-illinois-senate](http://articles.chicagotribune.com/2013-03-20/news/chisweeping-pension-reform-fails-in-illinois-senate-20130320_1_pension-reform-pension-system-illinois-senate). See also Joanne von Alroth, *Illinois Pension Reform: House Passes Major Cap on Public Pension Payments*, HUFFINGTON POST (Mar. 22, 2013), [http://www.huffingtonpost.com/2013/03/22/illinois-house-passes-cap\\_n\\_2928178.html](http://www.huffingtonpost.com/2013/03/22/illinois-house-passes-cap_n_2928178.html).

216. Act of Dec. 3, 2013, P.A. 98-599, 2013 Ill. Legis. Serv. (West).

217. See generally *Madigan v. Cullerton: Whose Pension Reform Bill Will Reign Supreme*, CAPITALFAX (Aug. 9, 2013), <http://capitolfax.com/wp-content/Pension-ReformMadigancullertonfull.jpg>.

constitutional.<sup>218</sup> Part A would have: (1) reduced pension benefits of current employees and retirees by replacing the three percent compounding COLA with a COLA that is no more than \$600 or \$750 depending on whether the beneficiary receives Social Security benefits; (2) halted a COLA until January 1, 2017; (3) required employees to contribute an additional two percent of their salary to the pension system; and, (4) capped pensions based on salaries below Social Security's wage base, currently \$113,000.<sup>219</sup>

Part B was a contractual approach that gave the employee a choice. The employee could either agree to a lower three percent simple COLA that is delayed five years and keep access to the Illinois's retiree health care program, or reject the offer, keep existing benefits, but lose access to the state's retiree health care program. Additionally, if the plan was rejected, future salary increases would not have been counted for pension purposes.<sup>220</sup> If this bill was enacted and upheld in court, it would have saved the state between 11 and 18 billion dollars.<sup>221</sup>

The second proposal, hereinafter referred to as the Unilateral State Action proposal, made greater pension cuts than Cullerton's plan.<sup>222</sup> Speaker of the House Michael Madigan, State Senator Daniel Biss, and State Representative Elaine Nekritz have all supported variations of this second proposal. The plan: (1) "[l]imit[s] automatic annual benefit increases to the lesser of (a) three percent of the pension benefit, compounded or (b) three percent of \$1,000 multiplied by the number of years of service;" (2) "[d]elay[s] annual benefit increases until age 67 or until the fifth year after retirement;" (3) "[p]hases in higher retirement ages for those under 45;" (4) "[c]ap[s] the maximum salary on which a pension is based at the same level as new employees;" (5) "[i]ncrease[s] employee contributions by 2 percentage points, phased in over two years;" (6) "[g]uarantee[s] that the State make its contributions by requiring the pension funds to seek redress in the

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218. S.B. 2404, 98th Gen. Assemb. (Ill. 2013).

219. S.B. 2404, 98th Gen. Assemb. (Ill. 2013). See also John. J. Cullerton, *Hon. John J. Cullerton, Senate President, State of Illinois*, CITY CLUB CHI. VIDEOS (Jan. 28, 2013), <http://cityclubvideo.wordpress.com/2013/01/28/john-j-cullerton-senate-president-state-of-illinois/>.

220. S.B. 2404; see also John. J. Cullerton, *supra* note 219 (video explaining the prepared legislation).

221. Tom Kacich, *Two Pension Bills Sent to the Illinois Senate Floor*, THE NEWS GAZETTE (Mar. 13, 2013), <http://www.news-gazette.com/news/local/2013-03-13/two-pensions-bills-sent-illinois-senate-floor.html>.

222. *Id.*

Supreme Court;" (7) "[e]liminate[s] the requirement in State law that pension changes be subject to collective bargaining;" and, (8) "[u]se[s] an actuarial method supported by the Government Accounting Standards Board to allocate annual benefit costs."<sup>223</sup>

Implementing any aspect of these pension reform proposals requires that they be upheld by Illinois courts. Since pension benefits are considered contractual rights in Illinois, the three-part test laid out in *U.S. Trust* applies.<sup>224</sup> Therefore, courts must determine: (1) whether there was a contract; (2) if the state law is an impairment of the terms of the contract; and, (3) whether the impairment is justified by an important public purpose. If these requirements are met, the legislation must still be reasonable and necessary to further the important public purpose.<sup>225</sup>

In Illinois, there is a constitutional provision that establishes that state's employee pension benefits are part of a contract with the state.<sup>226</sup> Part A of the Cullerton plan and the Unilateral State Action proposal would have substantially impaired the contractual relationship because they would have temporarily frozen COLA, permanently reduced COLA, and required higher employee contributions.<sup>227</sup> These terms amount to substantial impairment because employees would be contributing more to receive lower benefits than they were previously entitled to.<sup>228</sup>

The next issue is whether there is an important public purpose. Illinois currently has the worst funded pension fund in the country with some estimates of unfunded liabilities totaling \$96.8 billion.<sup>229</sup> This accounts for a very large percentage of the State's budget and according to Senate President John Cullerton, will result in immediate cuts to important public services.<sup>230</sup> With no foreseeable change in circumstances, the state continues to have an important interest in preventing the pension fund from reaching insolvency.

It may be harder for pension reform legislation to satisfy the requirement that it be reasonable and necessary to further the state's

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223. *House to Consider Speaker's Pension Reform Bill*, INST. FOR ILLINOIS' FISCAL SUSTAINABILITY (May 2, 2013, 3:43 PM), <http://www.civicfed.org/civic-federation/blog/house-consider-speaker's-pension-reform-bill>.

224. *U.S. Trust Co. of New York v. New Jersey*, 431 U.S. 1505, 1505 (1977).

225. *Id.*

226. ILL. CONST. art. XIII, § 5.

227. Long, *supra* note 215.

228. S.B. 2404, 98th Gen. Assemb. (Ill. 2013).

229. *Id.*

230. John Cullerton, *supra* note 219; *see also* MUNNELL, *supra* note 11, at 223.

interest of fiscal solvency. In Illinois, in order for a state action to be reasonable and necessary, it must target the cause of the problem that the state is trying to solve. In *Felt v. Board of Trustees of the Judges Retirement System*, the Illinois Supreme Court held that legislation changing the final calculation of retirement benefits for judges was an unconstitutional impairment of contract because there was no indication that underfunding of the pension fund was caused by an incentive for judges to retire upon salary increases and capture greater benefits than they contributed.<sup>231</sup>

The biggest reason the public pensions are severely underfunded is because the state has consistently failed to pay its ARC.<sup>232</sup> The employees who will be negatively affected by pension reform fulfilled their obligation and paid their contributions to the fund when they were due.<sup>233</sup> Thus, there is only an attenuated relationship between the cause of the problem and the remedy proposed. It will, therefore, be difficult for the state to show that the reason the pension fund is underfunded is because of the COLAs that were included in employee contracts with the state. The state's claim may be weakened by evidence that the state chose to fund other projects instead of contributing its ARC.<sup>234</sup>

Moreover, there are a few other options that the legislature proposed that may put less of a burden on the employees and still work towards a better-funded pension program. In *U.S. Trust*, the court invalidated the New Jersey repeal of a law that would negatively affect the state's creditors because there were other, less burdensome, alternatives for New Jersey to achieve its goal of promoting use of public transportation without impairing its contract.<sup>235</sup> While Illinois's financial problems continue to be grave, there may be other, less burdensome, methods to work towards fiscal solvency. For example, the state could implement a combination of raising taxes, cutting services, and reducing employee benefits less drastically. In order for a court to uphold the law, the state must show that the reforms

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231. *Felt v. Bd. of Trustees of the Judge's Ret. Sys.*, 107 Ill. 2d 158, 166 (1985).

232. Eric M. Madiar, *Is Welching on Public Pension Promises an Option for Illinois? An Analysis of Article XIII, Section 5 of the Illinois Constitution* (Soc. Sci. Rep. Network, Working Paper, May 7, 2013), available at [http://ssrn.com/5013/papers.cfm?abstract\\_id=1774163](http://ssrn.com/5013/papers.cfm?abstract_id=1774163).

233. *Id.*

234. ILL. GEN. ASSEMBLY, REPORT OF THE PENSION MODERNIZATION TASK FORCE 48, 68, 119, 121 (revised Mar. 30, 2010).

235. *U.S. Trust Co. of New York v. New Jersey*, 431 U.S. 1505, 1505 (1977).

enacted are necessary to solve the pension problem and that other alternatives would be inadequate.

Pension reform legislation in Illinois has the additional challenge of the pension clause in the Illinois constitution. The pension clause reads similarly to the U.S. Constitution's Fifth Amendment contract clause, in that it states that pension benefits are considered a contract that the state cannot "impair or diminish."<sup>236</sup> *U.S. Trust* and later cases have interpreted the contract clause to mean that although generally states cannot impair contracts, in exceptional circumstances, as determined by the three-factor test, impairment may be justified.<sup>237</sup> However, courts in Illinois have interpreted the pension clause very strictly.<sup>238</sup> While it is unclear if the pension clause serves as an absolute bar to lowering pension benefits, it is possible for courts to read it this way.<sup>239</sup> Because states can provide more protection for their citizens than the federal Constitution provides, through the Illinois pension clause and subsequent case law, Illinois may provide greater protection to pension contracts than the federal Constitution's contract clause.<sup>240</sup> Consequently, in Illinois, even if the *U.S. Trust* test is met, the state may still not be able to impair pension contracts.

Part B of the first proposed introduced by Cullerton was less likely to be invalidated under the *U.S. Trust* test and the pension clause in the Illinois constitution than a bill that authorized the state to unilaterally lower pension benefits, such as the Unilateral State Action proposal. To avoid issues over impairment of the employee's contract, Cullerton's proposal would bilaterally modify the contract, creating a new contract. The employees would have a choice to either lower their pension benefits and retain their state provided health insurance, or to maintain their benefits, but lose medical coverage and the ability for increases in salary to be used when calculating their pension benefits.<sup>241</sup>

While this proposal eliminated the issue of the state impairing the contract, other issues relating to contract law arise, including whether there is consideration on the part of the employees to create a

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236. See ILL. CONST. art. XIII, § 5.

237. *U.S. Trust Co. of New York*, 431 U.S. at 1505.

238. See, e.g., *Felt v. Bd. of Tr. of the Judges Ret. Sys.*, 481 N.E.2d 698, 698 (Ill. 1985); *Buddell v. Bd. of Tr., State Univ. Ret. Sys.*, 514 N.E.2d 184 (Ill. 1987).

239. See *Madiar*, *supra* note 232, at 26–27, 36–37, 41–42.

240. See, e.g., *Felt*, 481 N.E.2d at 698; *Buddell* 514 N.E.2d at 184.

241. See S.B. 2404, 98th Gen. Assemb. (Ill. 2013); see also John. J. Cullerton, *supra* note 219.

new valid contract. Under this proposal, the state would receive a benefit through the reduction in pension costs, however, employees would receive less than what they would already have received under the previous contract. Currently, medical coverage is provided to employees, but it is not guaranteed under the terms of the contract.<sup>242</sup>

So while the employees appear to not be receiving a new benefit, guaranteeing medical coverage in a new contract is likely to be considered adequate consideration by a court. Although Part B might have been legal, to current employees it may have seemed like an extremely unfair deal because the choice they were given was not a real choice. Employees would have had to choose between keeping the health coverage they relied on having in their old age or keeping the pension benefits that they relied on having for financial security in retirement. Essentially, employees would choose whether they would like to lack health coverage or greater financial stability in their elder years.

#### IV. Recommendation

##### A. Rhode Island as an Example

Rhode Island can be viewed as an example for other states considering pension reform. Rhode Island is particularly well-suited to serve as an example because, like most states, it considers pension benefits to be contracts between the employee and the State. Therefore, the law that constrained and dictated the reforms implemented in Rhode Island will be similar to the law that will dictate the reforms in most other states.<sup>243</sup> Further, because contract law is the most restrictive law interpreting pension rights,<sup>244</sup> reforms that can pass this muster will have little trouble being upheld in states that consider pension benefits as property or a gratuity.

Rhode Island's pension reform was ambitious, comprehensive, and directly confronted the pension problem. If RIRSA is upheld in court, other states could use it as a model for how to write effective pension reform legislation that will survive court scrutiny. RIRSA increased the retirement age; created a hybrid defined contribution-

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242. S.B. 2404.

243. MUNNELL, *supra* note 11, at 219.

244. Pensions as a contract is the most restrictive kind of legal protection pensions have, but it can be further restricted by state constitutional provisions.

defined benefit plan; re-amortized the unfunded pension liability, and froze COLA increases until the plan is 80 percent funded, and; when 80 percent funded, COLAs will be dependent on the plan meeting investment goals.<sup>245</sup> Once these methods are deemed legal, states can confidently use them in a combination that works best for their particular state.

While RIRSA may serve as a good example for the political and fiscal tools that legislators could use for pension reform, it does not completely resolve the issues of fairness, the employees' interest in a secure retirement, and the states' ability to attract good employees. Gina Raimondo's *Truth in Numbers Report* listed four goals for pension reform in Rhode Island. She wanted reform that: (1) "[a]ttracts quality employees;" (2) "[p]rovides a level of security for employees;" (3) "[p]reserves funding for public services;" and, (4) "[p]rotects taxpayers."<sup>246</sup> Raimondo stressed that all of these interests are important and that the ultimate goal of pension reform is to save the pension system so that it can provide security to those who depend on it for their retirement.<sup>247</sup> Raimondo explained that the pension program was severely underfunded because it was a poorly designed system that legislators did not responsibly contribute to, and not the fault of the members of the program "who did nothing wrong."<sup>248</sup> Yet, while the public employees were not being unjustifiably blamed for causing the problem, they were being asked to sacrifice the benefits they earned for the sake of a greater good.

It is important that legislators, and the public, keep in mind, as they call for reductions in pension benefits, that they are calling for lowering much needed income of current and future retirees. These retirees relied on the promise of pension benefits that the state made to them when they were planning for retirement. When COLAs are frozen for current retirees, retirees will receive less income for living and health care expenses than they originally planned for. Retirees who did not pay into Social Security do not receive those benefits and may not have another source of income. These individuals cannot go back in time and contribute more money to an independent investment account to make up for this loss. According to Kathleen Connell of the Rhode Island AARP, "because such a thing [pension cuts] was

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245. *Executive Summary*, supra note 18.

246. RAIMONDO, supra note 184, at 4.

247. *Id.*

248. *Id.*

previously considered unthinkable, many retirees remained in denial” of pension reform and therefore were unprepared for the changes in their benefits.<sup>249</sup>

To involve elder Americans who would be affected by pension reform but were underrepresented in the debate over what should be done, the AARP began an awareness campaign.<sup>250</sup> In this campaign the AARP informed the public that “70 percent of the burden of pension reform was being placed on the backs of current retirees.”<sup>251</sup> Due to the AARP and concerned legislator’s actions, RIRSA included a provision for re-amortization of the liability in order to lessen some of the burden that would be placed on plan members and retirees. Through the re-amortization, the amount of time to fund the pension system is increased and the taxpayers will have to contribute more than they otherwise would have. Alicia Munnell identifies one of the key strengths of RIRSA to be its’ overall feeling of fairness because it recognizes the employees’ sacrifice and calls for everyone to feel the negative effects of reform through the restructuring of the liability.<sup>252</sup> Similarly, Kathleen Connell recognized a feeling of fairness by noting that the AARP believes Rhode Island’s pension reform could have been more equitable but commends that concessions were made on all sides and that legislators were willing to listen.<sup>253</sup> However, the AARP does not feel that retiree’s rights were sufficiently protected and views RIRSA as the beginning, and not the end of the solution to the pension problem.<sup>254</sup> In a statement clarifying the AARP’s position on RIRSA, Connell writes, “[w]e urge the General Assembly to ignore any insistence that the legislation represent a lifetime ‘fix’ of Rhode Island’s pension system and seek future opportunities to make good the promises of retirees that have been broken by the bills passage.”<sup>255</sup> Rhode Island’s efforts to engage with the public and legislators’ willingness to listen to all stakeholders can still be used as an example for other states. However, the consideration of the interests of the elderly, who are the most vulnerable to pension cuts, can be improved upon.

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249. Kathleen Connell, *Setting the Record Straight*, AARP.ORG (Dec. 8, 2011) <http://www.pensionalertri.org/kathleen-connell-setting-record-straight>.

250. *Id.*

251. *Id.*

252. MUNNELL, *supra* note 11, at 226.

253. Connell, *supra* note 249.

254. *Id.*

255. *Id.*

## B. What Should Illinois Do?

### 1. REDEFINE THE ISSUE OF PENSION REFORM

The severity of the situation in Illinois led some to declare that the pension system is “unfixable.”<sup>256</sup> However, comprehensive pension reform was necessary and inevitable in order for the state to become solvent. In December 2013 the Illinois legislature passed pension reform, reducing the benefits of state employees.<sup>257</sup> But, the debate over pension reform is far from over. Legal challenges to the December reform have already been made.<sup>258</sup> As Illinois continues to grapple with pension reform, it is important that the issue of fairness to employees remain central to the discussion.

Illinois should follow Rhode Island’s example of redefining the issue of underfunded pensions so that it is not a question of how can the state make its next pension payments, but rather a question of how the state can provide retirement security to state employees both current and retired. Like Rhode Island, Illinois should engage the public.<sup>259</sup> Pension reform is an issue that affects people on a very personal level and needs to be handled delicately. By portraying the pension problem as a python that is squeezing the state,<sup>260</sup> Governor Quinn indicated that the pension liability will severely cut into the state’s ability to provide other services. However, it also vilified the state pension system and those who are members of it. Rather, the public needs to understand that the state acted irresponsibly and used the pension system as a “credit card” for other state services.<sup>261</sup> Gina Raimondo was careful in her *Truth in Numbers* report to make it clear that it was the state that caused the problem. As a result of legislators

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256. *Illinois the ‘Unfixable,’* WALL ST. J. (Nov. 22, 2012), <http://online.wsj.com/article/SB10001424127887324556304578123052059258768.html> (reporting that the Commercial Club of Chicago deemed the pension problem unfixable in November 2012).

257. Act of Dec. 3, 2013, P.A. 98-599, 2013 Ill. Legis. Serv. (West); *see also* Joanne Von Alroth & Karen Pierog, *Illinois Lawmakers Pass Long-Awaited Pension Reform*, REUTERS (Dec. 3, 2013), <http://www.reuters.com/article/2013/12/04/us-usa-illinois-pensions-idUSBRE9B303T20131204> (explaining the pension reform that was enacted, including benefit reductions).

258. Kerry Lester, *Illinois Unions Sue Over Pension Reform Cuts*, HUFFINGTON POST (Jan. 29, 2014), [http://www.huffingtonpost.com/2014/01/29/illinois-unions-pension-reform\\_n\\_4686627.html](http://www.huffingtonpost.com/2014/01/29/illinois-unions-pension-reform_n_4686627.html).

259. MUNNELL, *supra* note 11, at 225–26.

260. THISISMYILLINOIS.COM, <http://thisismyillinois.com/> (last visited Aug. 9, 2013).

261. ILL. GEN. ASSEMBLY, *supra* note 234 at 48.

understanding the issue and listening to the people who would be affected, the process of reform seemed fair, even if people disagreed on the methods implemented. If the state of Illinois changes direction by redefining the issue and allows direct public participation in the discussion that appears fair, legislators will have more political support to make needed changes.

## 2. CONSTITUTIONAL AMENDMENT

Illinois's pension reform cannot be complete unless it includes measures that attack the primary cause of the problem—the state's unchecked ability to stop funding the pension system. Pension rights are contracts that are constitutionally guaranteed yet the Illinois constitution does not require the state to contribute to the pension fund to make that guarantee possible. This inconsistency cannot continue. It is unfair for the state to cut back pension benefits without concretely taking some responsibility for causing the problem. New York, which has an almost identical constitutional provision protecting pensions, also has a statute that requires the state to make regular contributions to the pension fund.<sup>262</sup> Illinois should have a similar requirement that obligates the state to make contributions. There should be a corollary measure to any pension reform passed for a constitutional amendment obligating the state to contribute responsibly to the pension fund.

Due to the nature of the state as provider of vital services, the amendment should not require that the full ARC be paid each year. Instead, the amendment should make it more difficult for the state to not pay its ARC by requiring a super majority vote every time the state decides to prioritize other services over ARC payments. Further, the amendment should require the state to identify an important public interest that is being funded instead of the pension system and include a plan for how the state will make up for the lack of contribution in the future. This amendment would provide security for employees by making it more likely that the plan will be funded and that pensioners will not be asked to sacrifice benefits again in the future. The amendment would also provide assurance to future employees that their pension benefits have some protection, facilitating the states' interest in recruiting quality employees.

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262. N.Y. Ret. & Soc. Sec. Law § 16 (McKinney).

### 3. LEGISLATION

The magnitude of the \$98 billion unfunded liability necessitates that some pension reform be made to save the pension system from collapse and to protect other state services. Legislators must be careful in structuring reforms to ensure that they will be upheld in court. Reform legislation faces a higher legal bar to pass in Illinois than in Rhode Island because of Illinois's constitutional protection. Therefore, some of the methods that Rhode Island implemented may be too drastic to be upheld in Illinois, where courts have interpreted the pension clause as very protective of pension rights. The pension reform proposals in Illinois make reductions in benefits relying on the assumption that courts will uphold the states' use of its police power to further the important public interest of fiscal solvency. However, Illinois courts have previously held that impairment of pension contracts is not "defensible as a reasonable exercise of the State's police powers"<sup>263</sup> when the benefit targeted is not the cause of the program being underfunded. Further, in *Felt*, the court also made it clear that Illinois's pension clause is more protective than other states' pension clauses and therefore the fact that other states with similar clauses have allowed pension reform is not indicative of pension reform's legality in Illinois.<sup>264</sup>

Additionally, the Illinois Supreme Court has explained that the meaning of the pension clause is to "give [public employees] a basic protection against abolishing their rights completely or changing the terms of their rights after they embarked upon employment."<sup>265</sup> In *Peters v. City of Springfield* and subsequent cases, the court indicated that the state could take actions that indirectly reduce pension benefits if the formula calculating pension benefits is unchanged.<sup>266</sup> This would mean that the state might be able to take indirect measures, such as increasing the retirement age, without impairing the contract. However, the Illinois proposals go beyond indirect reductions and are therefore susceptible to be found unconstitutional.

Further, in *Buddell v. Board of Trustees of the State University System*, the court explained that "[t]here can be no doubt . . . that upon

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263. *Felt v. Bd. Of Tr. of the Judges Ret. Sys.*, 107 Ill. 2d 152, 167 (1985).

264. *Id.* (citing *Kraus v. Bd. of Tr.*, 72 Ill. App. 3d 833, 347-48 (1979)).

265. *Id.* at 161-162.

266. *Peters v. City of Springfield*, 57 Ill. 2d 142, 151 (1974) (holding that the state can reduce the mandatory retirement age even though it indirectly lessens pension benefits).

the effective date of the [Pension Clause] the rights conferred [on the employee]. . . by the Pension Code became contractual in nature and cannot be altered, modified or released except in accordance with usual contract principles.<sup>267</sup> Thus, Illinois courts have been reluctant to find an important public interest that justifies impairing pension contract rights and have indicated that pension reductions can only be made through contract modification. If the current legislation is found to be unconstitutional, Illinois should pass new legislation similar to Part B of John Cullerton's first proposal that is based on contract modification. This proposal also reflects a willingness to compromise and work with public employees, who have a great interest in the legislation that is passed, because its terms are supported by We Are One Illinois, a labor coalition made up of unions that represent public employees.<sup>268</sup>

## V. Conclusion

Unfunded public pension liabilities continue to escalate in many states throughout the country.<sup>269</sup> As the pension deficit grows, the states' ability to pay pension benefits and continue other state services is threatened, making pension reform an immediate concern. Rhode Island's pension reform legislation, RIRSA, serves as a instructive example for methods that other states can implement to lower their underfunded pension liabilities and work towards fiscal solvency. However, when enacting reform, states must be responsive to the cause of the problem fair to the affected employees and retirees. Following Rhode Island's example, states must acknowledge responsibility for their negligent actions and engage the public to work towards a fair solution. As Kathleen Connell of the Rhode Island AARP suggested, pension reform legislation does not need to be the end of the discussion of the solution to the public pension problem.<sup>270</sup> Concrete reforms must be made to lower liabilities and to provide certainty to employees as they plan for retirement. However, the state should continue to make an effort to listen to the people who are effected by

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267. *Buddell v. Bd. of Tr., State Univ. Ret. Sys.*, 118 Ill. 2d 99, 104-05 (1987).

268. *How to Fix the Illinois Pension Problem, Fairly, Together, WE ARE ONE ILLINOIS* (June 13, 2013), <http://www.weareoneillinois.org/news/learn-more>.

269. *Plan Provisions*, PUBLIC PLANS DATABASE, <http://pubplans.bc.edu/pls/apex/f?p=1988:14:0::NO:RP,14::> (last visited Apr. 7, 2014).

270. Connell, *supra* note 249.

pension reform and to do what it can to make sure that public employees' futures are secure.

In Illinois, legislators can strengthen their position to reform the pension system by creating a fair process that redefines the issue as one of retirement security, takes responsibility for its actions by initiating a constitutional amendment that would require responsible pension funding, and passing legislation that will avoid blunt benefit cuts that treat people as mere "numbers in a mathematical formula."<sup>271</sup> If Illinois and other states take these actions, legislators will have more political support to make benefit cuts. Pension reform will reduce the liability of the state while assuaging fears of state employees and retirees that legislators will make a habit of cutting their benefits, maintaining the state's ability to attract qualified employees.

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271. *Id.*

