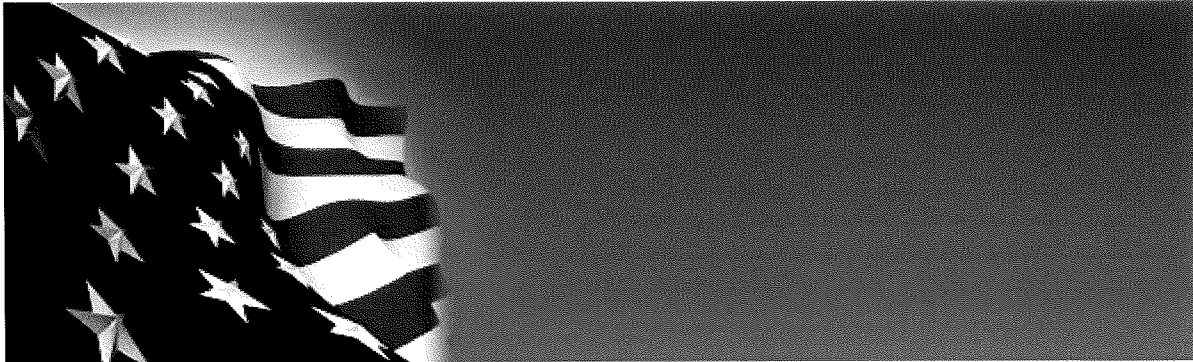


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**CYPEN & CYPEN
NEWSLETTER
SPECIAL SUPPLEMENT
for
MAY 11, 2015**

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Stephen H. Cypen, Esq., Editor

Never Forget September 11, 2001

and

Always Remember May 2, 2011

**ILLINOIS SUPREME COURT RULES
PENSION REFORM LAW UNCONSTITUTIONAL**

At issue on appeal was constitutionality of Public Act 98-599, which amended the Illinois Pension Code by reducing retirement annuity benefits for individuals who first became members of four of Illinois's five state-funded pension systems prior to January 1, 2011. Members of the retirement systems affected by Public Act 98-599 and groups representing those members brought five separate actions, challenging validity of the new law on the grounds that it violated numerous provisions of the Illinois Constitution of 1970, including article XIII, section 5 (popularly known as the pension protection clause.) All five actions were consolidated in the circuit court. On motions for partial summary judgment, judgment on the pleadings, and to strike an affirmative defense, the circuit court found plaintiffs'

challenge to be meritorious, declared Public Act 98-599 to be unconstitutional in its entirety as a violation of the pension protection clause, and permanently enjoined its enforcement. In so doing, the circuit court rejected defendants' contention that the Act could be upheld, notwithstanding violation of the pension protection clause, based on the state's reserved sovereign powers. Because the circuit court's judgment invalidated a statute of the State of Illinois, appeal lay directly to the Supreme Court. The Supreme Court affirmed. Illinois has established five state-funded retirement systems for public employees: the General Assembly Retirement System; the State Employees' Retirement System of Illinois; the State Universities Retirement System; the Teachers' Retirement System of the State of Illinois; and the Judges Retirement System of Illinois. These systems provide traditional defined benefit plans under which members can earn specific benefits based on their years of service, income and age. All are subject to the pension protection clause of the state constitution, which provides: "membership in any pension or retirement system of the state, any unit of local government or school district, or any agency or instrumentality thereof shall be an enforceable contractual relationship, the benefits of which shall not be diminished or impaired." Among benefits which members of the five state-funded retirement systems are entitled to receive are retirement annuities. The amount of a member's retirement annuity and how soon a member is eligible to begin receiving annuity payments depends on when the member first began making contributions into one of the retirement systems. Members who first contributed prior to January 1, 2011, receive what are known as "Tier 1" annuity payments. Members first contributing on or after January 1, 2011, receive a lower level of benefits designated as "Tier 2." Public Act 98-599, the legislation challenged in the case, is directed primarily at Tier 1 annuities, and is limited in its application to benefits earned under the GRS, SERS, SURS and TRS systems. (Annuities paid to judges under the JRS system were intentionally excluded from the law, and are not affected by it.) Tier 1 retirement annuity benefits and eligibility requirements differ somewhat between the various systems. Because they all operate in approximately the same way, however, just SERS was used to illustrate their basic features. Members of SERS are eligible to retire at age 60 if they have at least eight years of credited service. They may retire with full benefits at any age if their age plus years of service credit equal 85. They are also eligible to retire if they

are between the ages 55 and 60 and have at least 25 years of credited service, but their benefit will be reduced by half of 1% for each month they are under age 60. The amount of the retirement annuity benefit under SERS is calculated based on (1) the member's final average compensation, which is the average monthly compensation they received during their highest paid 48 consecutive months of service over the previous ten years, (2) their total credited service, and (3) a multiplier, which changes depending on (a) whether or not the member is also covered by Social Security or (b) qualifies for an alternative retirement annuity. For members who do have Social Security and are not subject to the alternative retirement annuity rules, the multiplier is 1.67% per year of credited service. Accordingly, a member of SERS who is eligible to retire, who has also paid into Social Security, and who has final average compensation of \$1800 per month and 30 years of credited service will receive a retirement annuity of \$901.80 per month. SERS members may earn a retirement annuity of up to 75% of their final average compensation, although for members covered by Social Security, it would take nearly 45 years of state service to do so. These annuity payments are subject to 3% automatic annual increases beginning after the member's first full year of retirement, except that some members who retire before 60 and do not meet the rule of 85 will not receive the increases until they turn 60 and have been retired at least one full year. The annual annuity adjustments are built in to the pension benefit and are not tied to the cost of living. As a result, the real value of annuities may either increase or erode depending on economic conditions, notwithstanding the adjustments. Funding to pay benefits under each of Illinois's five state-funded systems is derived from three basic sources: contributions by the state through appropriation by the general assembly; contributions by or on behalf of members based on their salaries; and income, interest and dividends derived from retirement fund deposits and investments. Contributions to the systems by or on behalf of members of the systems have not been problematic. There is no dispute that employees have paid their full share as required by law at all times relevant to the litigation. That circumstance has not been the case with respect to the contributions owed by the general assembly. For as long as there have been public pension systems in Illinois, there has been tension between the government's responsibility for funding those systems, on the one hand, and costs of supporting governmental programs and providing

governmental services, on the other. In the resulting political give and take, public pensions have chronically suffered. As long ago as 1917, a report commissioned by the general assembly characterized the condition of state and municipal pension systems as one of insolvency, and moving toward a crisis because of financial provisions that were entirely adequate for paying the stipulated pensions when due. Concern over ongoing funding deficiencies and the attendant threat to the security of retirees in public pension systems eventually led directly to adoption of article XIII, section 5, the pension protection clause, when the new constitution was adopted in 1970. The solution proposed by the drafters and was also approved by the people of Illinois was to protect the benefits of membership in public pension systems, not by dictating specific funding levels, but by safeguarding the benefits themselves. The purpose of the clause and its dual features have never been in dispute. As the Supreme Court noted in a 1998 case, the clause served to eliminate any uncertainty as to whether state and local governments were obligated to pay pension benefits to the employees, and its plain language not only makes participation in a public pension plan an enforceable contractual relationship, but also demands that the benefits of that relationship shall not be diminished or impaired. The politically sensitive area of how the benefits would be financed was a matter left to the other branches of government to work out. That article XIII, section 5, created an enforceable obligation on the state to pay the benefits and prohibited the benefits from subsequently being reduced was and is unquestioned. The hope that prohibiting the state from diminishing retirement benefits would induce the general assembly to meet its funding obligations did not occur. Until 1982, the state funded its pensions using an approach which the United States Securities and Exchange Commission characterized as bearing no relation to actuarial calculation. In 1989, the general assembly enacted a new funding plan to take effect in 1990, but it failed as well. Starting in 1995, yet another funding plan was implemented by the general assembly. This one called for the legislature to contribute sufficient funds each year to ensure that its contributions, along with the contributions by or on behalf of members and other income, would meet the cost of maintaining and administering the respective retirement systems on a 90% funded basis in accordance with actuarial recommendations by the end of the 2045 fiscal year. That plan, however, contained inherent shortcomings that were aggravated

by a phased in “ramp period” and decisions by the legislature to lower its contributions in 2006 and 2007. As a result, the plan failed to control the state’s growing pension burden. To the contrary, the SEC recently pointed out that the statutory funding plan’s contribution schedule increased the unfunded liability, underfunded the state’s pension obligations, and deferred pension funding. The resulting underfunding of the pension systems enabled the state to shift the burden associated with its pension costs to the future and, as a result, created significant financial stress and risks for the state. That the funding plan would operate in this way did not catch the state off guard. In entering a cease and desist order against the state in connection with misrepresentations made by the state with respect to bonds sold to help cover pension expenses, the SEC noted that the state understood the adverse implications of its strategy for the state funded pension systems and for the financial health of the state. According to the SEC the amount of the increase in the state’s unfunded liability over the period between 1996 and 2010 was \$57 billion. The SEC order found that the state’s insufficient contributions under the statutory funding plan were the primary driver of this increase, outweighing other causal factors, such as market performance and changes in benefits. By the end of June, 2013, the five state funded retirement systems contained a total of only 41.1% of the funding necessary to meet their accrued liabilities based on the market value of fund assets. (The funding rate was thus nearly unchanged from the 41.8% funding rate prior to ratification of the 1970 Constitution and its pension protection clause.) By contrast, as of December 30, 2013, the Illinois Municipal Retirement Fund, another major public pension plan that operates in the same market environment as the five state funded systems, but which is managed separately and not funded by the state, had an aggregate funding rate of 96.7% based on the market value of its assets. As the continued deficiencies in the legislature’s pension funding efforts became apparent to financial markets, federal regulators and the public, the state was also experiencing significant difficulties in meeting its other obligations. To address these budgetary pressures, the state implemented a variety of measures, including delaying payments to creditors and vendors who do business with the state, reducing or eliminating a variety of governmental programs, enacting a temporary tax increase (which was recently allowed to expire), and significantly lowering benefits for anyone first contributing to state pension

systems after January 1, 2011 (Tier 2). After numerous failed attempts to reach consensus among stakeholders, the general assembly also enacted what became Public Act 98-599, the legislation challenged in the case. Introduced as Senate Bill 1 and passed during the legislature's fall, 2013, veto session, Public Act 98-599 was described as an attempt to address the state's large debts and deficits, plummeting credit ratings, and imperiled discretionary spending programs that are essential to the people of Illinois and to help shore up the long term fiscal stability of both the state and its retirement systems. The mechanism chosen under the Act to accomplish those purposes was restructuring state funded retirement systems. The law does not pertain to all five of the state systems, however. As noted earlier JRS was deliberately excluded. Public Act 98-599 contains numerous provisions. Among these are a new payment schedule to replace the one in effect since 1995; a mechanism authorizing pension boards to initiate mandamus proceedings in our court if the State fails to make required contributions to their respective systems; and special directives with respect to certain payments to the pension systems, when payments are to be made and in what amounts. The Act provides a limited number of Tier 1 plan participants with the opportunity, at a future date, to participate in a defined contribution plan. It affords a nominal reduction in the percentage of salaries of Tier 1 plan participants are required to contribute toward the employee share of annuity costs. Going forward, it bars persons hired by certain nongovernmental organizations from participating in the public pension system and prohibits new hires from using accumulated sick or vacation time to boost their pension benefits. Public Act 98-599 also eliminates the duty of employers to engage in collective bargaining or interest arbitration over matters affected by the changes, the impact of changes, and the implementation of changes made to SERS, SURS and TRS systems by the new law. The centerpiece of Public Act 98-599, however, is a comprehensive set of provisions designed to reduce annuity benefits for members of GRS, SERS, SURS and TRS entitled to Tier 1 benefits, that is, members who belonged to those systems prior to January 1, 2011. The new law utilizes five different mechanisms for achieving this goal. First, it delays, by up to five years, when members under the age of 46 are eligible to begin receiving their retirement annuities. Second, with certain exceptions and qualifications, it caps the maximum salary that may be considered when calculating the amount of a member's

retirement annuity. Third, it jettisons the current provisions under which retirees receive flat 3% annual increases to their annuities and replaces them with a system under which annual annuity increases are determined according to a variable formula and are limited. Fourth, it completely eliminates at least one and up to five annual annuity increases depending on the age of the pension system member at the time of the Act's effective date. Finally, with respect to the TRS and SURS, the Act also alters how the base annuity amount is determined for purposes of what is known as the money purchase formula, something available to members of those two systems who began employment prior to July 1, 2005, as an alternative to the standard formula for calculating pensions. Because of this change, which involves use of a different interest rate, affected members of TRS and SURS will have smaller base pensions. After being approved by both houses of the general assembly, Senate Bill 1 was signed into law by then-Governor Quinn as Public Act 98-599 on December 5, 2013. Five separate lawsuits challenging the law were filed almost immediately. The complaints in all five consolidated actions focused their challenges on the core provisions of Public Act 98-599, those which would reduce the retirement annuities of individuals entitled to Tier 1 benefits by raising the age at which members under the age of 46 are eligible to begin receiving their retirement annuities, capping the maximum salary that may be considered when calculating the amount of a member's retirement annuity, abolishing the existing fixed 3% annual annuity increases, eliminating at least one and up to five annual annuity increases under the new formula, and altering how the base annuity amount is determined for purposes of the money purchase formula. Plaintiffs' challenges to the new law were predicated on the Illinois Constitution of 1970. The district court granted plaintiffs' joint motion for partial summary judgment to their claims to Public Act 98-599 was void and unenforceable under pension protection clause, allowed the various motions by plaintiffs' for judgment on the pleadings as to the states affirmative defense and denied the motion for summary judgment filed by the state. Because it believed that the constitutionally-infirm annuity reduction provisions were an important part of the overall legislative package, the lower court declared the Act to be unconstitutional in its entirety, and permanently enjoined its enforcement. In light of that result, the court concluded that there was no need to address the other issues raised in the case, including

plaintiffs' challenges based on other provisions of the Illinois Constitution. The Supreme Court found that three issues were presented for review: (1) does Public Act 98-599's reduction of retirement annuity benefits owed to members of the GRS, SERS, SURS and TRS retirement systems violate the pension protection clause set forth in article XIII, section 5, of the Illinois Constitution of 1970; (2) and if so, can the law's reduction of those benefits nevertheless be upheld as a proper exercise of the state's police power; and (3) if not, are the invalid provisions of Public Act 98-599 severable from the remainder of the statute? Those questions are all questions of law, thus requiring *de novo* review. The first issue is easily resolved. The pension protection clause clearly states membership in any pension or retirement system of the state shall be an enforceable contractual relationship, the benefits of which shall not be diminished or impaired. The second issue, that the annuity reduction provisions of Public Act 98-599 violate the pension protection clause's prohibition against the diminishment of the benefits of membership in a state funded retirement system is one that has now all but conceded. And the third and final issue presented by this appeal: are the invalid annuity reduction provisions of Public Act 98-599 severable from the remainder of the statute? There can be no serious question that, with invalidation of those provisions of Public Act 98-599 which reduce the retirement annuities Tier 1 members of the GRS, SERS, SURS and TRS are entitled to receive, the entire statute must fall. *In Re: Pension Reform Litigation vs. Quinn*, Docket No. 118585, (Illinois May 8, 2015).

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