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MEMORANDUM

To: James Bachman
Executive Director, Illinois Retired Teachers Association

From: Gino L. DiVito, John M. Fitzgerald, and Katherine M. O'Brien

Re: Constitutional Issues Concerning Legislative Pension Reform Proposals

Date: February 26, 2013

ISSUE PRESENTED

Do pension reform proposals such as those reflected in SB0001 (98th General Assembly) violate the Pension Protection Clause of the Illinois Constitution (article XIII, section 5)?

EXECUTIVE SUMMARY

SB0001 and similar pension reform legislation violates the Pension Protection Clause of the Illinois Constitution. Moreover, a constitutional challenge to SB0001 or similar legislation would be particularly strong if it were filed by retired Illinois teachers who have vested rights to continued health benefits pursuant to collective bargaining agreements.

Our analysis below discusses the provisions of SB0001 and the constitutional deficiencies in that bill that most directly concern members of the Illinois Retired Teachers Association. Accordingly, this memorandum is not intended to be an exhaustive analysis of every constitutional deficiency in SB0001 or similar legislation, and we have not analyzed constitutional challenges to SB0001 or similar legislation that could be advanced by currently serving public employees.

ANALYSIS

A. The Vested Pension Rights of Retired Public Employees are Especially Well-Protected by the Pension Protection Clause and Cannot Be Unilaterally Diminished by the State.

At the outset, it is helpful to review the text of the Pension Protection Clause and to provide a brief overview of the cases interpreting it. We also underscore the especially well-protected position that retired public employees occupy under the Pension Protection Clause.

The Pension Protection Clause of 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." Ill. Const., art. XIII, § 5. The Pension Protection Clause was intended to "guarantee that people will have the rights that were in force at the time they entered into the agreement to become an employee, and . . . if the benefits are $100 a month in 1971, they should be not less than $100 a month in 1990." See Record of Proceedings, Sixth Illinois Constitutional Convention, Daily Journals, Verbatim Transcript of July 21, 1970, at 2931-32 (remarks of Pension Protection Clause's co-sponsor, Delegate Helen C. Kinney).

The Pension Protection Clause has been consistently interpreted to mean that "a Pension Code modification changing the basis upon which pension benefits are directly determined cannot be applied to diminish the benefits of those who became members of the system prior to the statute's effective date." *Kraus v. Board of Trustees of Police Pension Fund of Village of Niles*, 72 Ill. App. 3d 833, 850 (1979). In other words, a public employee's pension rights are "governed by the actual terms of the Pension Code at the time the employee becomes a member of the pension system." *Di Falco v. Board of Trustees of Firemen's Pension Fund of Wood Dale Fire Protection District No. 1*, 122 Ill.2d 22, 26 (1988); *McNamee v. State*, 173 Ill.2d 433, 439 (1996) (same); *People ex rel. Sklodowski v. State*, 182 Ill.2d 220, 229 (1998) (same); see also *Buddell v. Board of Trustees, State University Retirement System of Illinois*, 118 Ill.2d 99, 104-05 (1987) (finding "no doubt" that when the Pension Protection Clause took effect, "the rights conferred upon the plaintiff by the Pension Code became contractual in nature and cannot be altered, modified or released except in accordance with usual contract principles").

The law firm Sidley Austin LLP has suggested that, notwithstanding the clear terms of the Pension Protection Clause and the well-settled Illinois case law interpreting it, the pension rights of currently serving public employees could somehow be diminished prospectively. In support of this notion, Sidley Austin has suggested that continued employment is sufficient consideration to justify a detrimental modification of public employees' vested pension rights. We do not believe that this theory has any legal validity. See, *e.g.*, *Ross v. May Co.*, 377 Ill. App. 3d 387, 392 (2007) ("[M]ere continued employment, standing alone, does not constitute consideration supporting the unilateral modification of an existing employment contract.") (*citing Doyle v. Holy Cross Hospital*, 186 Ill.2d 104, 113-14 (1999)); see also *Haake v. Board of Education for Township High School Glenbard District 87*, 399 Ill. App. 3d 121, 139 (2010) ("The defendant has not identified any precedent in which simply continuing to work under

similar circumstances was held to constitute assent to a reduction of vested benefits."). Even assuming purely for the sake of argument that Sidley Austin's proposal had any legal validity – which we expressly do not concede – such a proposal obviously could not be applied to diminish the vested pension rights of retirees, who have finished their careers and whose pension rights are *fully* vested in every imaginable sense of the term. In that sense, retired public employees are especially well-protected by the Pension Protection Clause, and even the most novel theories of those who would attempt to circumvent the Pension Protection Clause cannot validly be applied to diminish retirees' vested pension rights.

B. Legislation that Unilaterally Modifies the Pension Rights of Retired Public Employees, Such as Part A of SB0001, is Unconstitutional as Applied to Retired Teachers.

The analysis below considers certain provisions of SB0001 that particularly concern retired teachers and that raise especially serious constitutional concerns. We emphasize that provisions such as those below are unconstitutional regardless of whether they appear in SB0001 or in other legislation. The analysis below focuses on SB0001 because we believe it is a representative example of pension reform legislation that the General Assembly is currently considering.

SB0001 is divided into two parts: Part A and Part B. Part A is "intended by the General Assembly as a stand-alone reform of" the Pension Code. See 98th Ill. Gen. Assem., Senate Bill 0001, 2013 Sess., 40 ILCS 5/1-103.5 (new). Part B "contains alternative provisions that take effect only if and when a corresponding portion of Part A is determined to be unconstitutional or otherwise invalid or unenforceable." *Id.*

Part A of SB0001 diminishes the vested pension rights of retired public employees in violation of the Pension Protection Clause. Of particular relevance to retired teachers, Part A would amend the Pension Code's provision for automatic annual increases in the retirement annuities paid by the Teachers' Retirement System of the State of Illinois (TRS) as follows:

- A Tier I retiree's automatic increase in retirement annuity occurring on or after the Act's effective date "shall be the lesser of (i) $750 or (ii) 3% of the total annuity payable at the time of the increase, including previous increases granted." See SB0001, Part A, amendments to 40 ILCS 5/16-133.1, new subsection (a-1).

- TRS "shall not grant any new or additional automatic increase in retirement annuity to a Tier I retiree" between the Act's effective date and January 1, 2017. *Id.* § 133.1(a-2).

- TRS "shall not grant any new or additional automatic increase in retirement annuity to a Tier I retiree who has not yet attained the age of 67 . . . ." *Id.*

- If a Tier I retiree has already received an annual increase "but does not yet meet the new eligibility requirements of this subsection, the annual increases already received shall continue in force, but no additional annual increase shall be granted until the Tier I retiree meets the new eligibility requirements." *Id.*

These amendments would fundamentally alter the provisions in the Pension Code that determine the amount by which retired teachers' retirement annuities are automatically increased every year. These amendments therefore violate the Pension Protection Clause of the Illinois Constitution.

The Illinois Supreme Court "has consistently invalidated amendments to the Pension Code where the result is to diminish benefits." *McNamee*, 173 Ill.2d at 445; see also *Felt v. Board of Trustees of Judges Retirement System*, 107 Ill.2d 158, 162-63 (1985) (invalidating a previous amendment to the Pension Code that "changed the salary base used to compute the annuity" paid to retired judges because the "change in the basis of computation clearly effects a reduction or impairment in the retirement benefits of the plaintiff members of State retirement systems in violation of the constitutional assurance of section 5 of article XIII" – *i.e.*, the Pension Protection Clause). It makes no difference that retirees who previously received automatic annual increases before reaching the age of 67 would be allowed to keep those previously received increases. Under the case law interpreting the Pension Protection Clause, the new age limit, the new limit on the amount of automatic annual increases, and the moratorium on automatic annual increases until 2017 are constitutionally prohibited diminishments to retirees' vested pension rights. Public employees' rights to have their pension benefits calculated in a particular way vests once they join a State retirement system. See, *e.g.*, *Di Falco*, 122 Ill.2d at 26 (Under the Pension Protection Clause, pension rights are "governed by the actual terms of the Pension Code at the time the employee becomes a member of the pension system"). Once a public employee has joined a State retirement system, there can be no detrimental change to his or her pension formula. The provisions of Part A discussed above would therefore violate the Pension Protection Clause.

Proponents of SB0001 are likely to argue that Part A is permissible on the theory that retired public employees as a group are given consideration for their imagined "agreement" to this detrimental change, in the sense that their retirement system is now given a statutory right to sue to enforce funding levels. See SB0001, Part A, 40 ILCS 5/16-158.2 (new). This argument fails for the simple reason that, in reality, there is no bargained-for exchange to which retired public employees have voluntarily agreed. SB0001 instead constitutes a unilateral attempt to modify public employees' employment agreements with the State, even with respect to those employees *who have already retired.* See *Ross*, 377 Ill. App. 3d at 391-92 (finding that new benefits which employer unilaterally extended to employee were not sufficient consideration for modification of employment agreement, because "there was no bargained-for exchange, and no promises were made where [the employee] agreed to relinquish his contractual rights in exchange for the new benefits"). While "there is nothing to prohibit an employee from agreeing, for consideration, to accept a reduction in benefits" (*Kraus*, 72 Ill. App. 3d at 849), consideration "must be bargained for" (*American Airlines, Inc. v. Department of Revenue*, 58 Ill.2d 251, 257 (1974)). A unilateral reduction of pension rights is unconstitutional, even if coupled with an equally unilateral benefit that the General Assembly imagines retired and active public employees might theoretically find desirable. Accordingly, SB0001 and other legislation that similarly seeks to unilaterally modify the pension rights of retired public employees would fail constitutional scrutiny.

C. Legislation that Imposes upon Retired Public Employees an "Election" Between their Pension Rights and their Health Care Coverage, Such as Part B of SB0001, Is Unconstitutional, and Many Retired Teachers Could Raise an Especially Strong Challenge to Its Constitutionality.

Part B of SB0001 would take effect only upon a declaration that key provisions in Part A are "unconstitutional or otherwise invalid." See SB0001, Part B, 40 ILCS 5/1-103.5 (new). The existence of Part B, therefore, demonstrates that the proponents of SB0001 have serious doubts as to whether Part A is constitutional. While more complex than Part A, Part B stands on equally shaky ground, and it too would likely be found to violate the Pension Protection Clause of the Illinois Constitution, as would other legislation with substantially similar provisions.

Part B contains the following provisions that are of particular significance to retired teachers:

- Each Tier I retiree is required to make an election between the following options: (1) to agree to new provisions governing the amount of and eligibility for automatic annual increases in his or her retirement annuity; or (2) to not agree to those new provisions. See SB0001, Part B, 40 ILCS 5/16-122.9 (new), subsection (a-5).

- These are the new provisions governing the amount of and eligibility for automatic annual increases in the retirement annuity:

  > (1) The amount of each automatic annual increase henceforth will be "3% or one-half of the annual unadjusted percentage increase, if any, in the Consumer Price Index-U for the 12 months ending with the preceding September, whichever is less, of the originally granted retirement annuity;" and
  >
  > (2) The "monthly retirement annuity shall first be subject to annual increases on the January 1 occurring on or next after either the attainment of age 67 or the January 1 occurring on or next after the fifth anniversary of the annuity start date, whichever occurs earlier."

  See SB0001, Part B, 40 ILCS 5/16-133.1 (a-1), (a-2), 40 ILCS 5/16-136.1 (b-1), (b-2).

- A Tier I retiree who elects to agree to these new provisions is deemed to be an "eligible Tier I retiree." See SB0001, Part B, 5 ILCS 375/6.16 (new), subsection (a).

- An "eligible" Tier I retiree is given a "vested and enforceable contractual right to participate in a program of health benefits while he or she qualifies as an annuitant or retired employee." *Id.* § 6.16(b).

- An "eligible" Tier I retiree still may, however, have to "make contributions toward the cost of coverage" under that program. *Id.* § 6.16(c).

- The right to participate in this program is deemed to be "adequate and legal consideration" for the "eligible" Tier I retiree's election to agree to the reduction in pension benefits. *Id.* § 6.16(b).

- But this right to participate in a program of health benefits – while purportedly "vested and enforceable" – is expressly not "a pension benefit under Article XIII, Section 5 of the Illinois Constitution" or the Illinois Pension Code. *Id.* §§ 6.16(b), 6.16(d).

- SB0001 does not identify the specific benefits that would be given to "eligible" Tier I retirees who participate in the program of health benefits.

- A Tier I retiree who elects *not* to agree to the reduction in pension benefits is *not* "entitled to participate in the program of health benefits as an annuitant or retired employee receiving a retirement annuity . . . ." *Id.* § 6.16(e).

- As further "adequate and legal consideration" for the election to agree to the reduction of pension benefits, Tier I retirees who made that election *and* who return to active service are given certain rights, including the right to participate in an optional cash balance plan, but those rights apparently are inapplicable to retirees who make that election but do not return to active service. See SB0001, Part B, 40 ILCS 5/16-122.9 (new), subsection (b).[1]

In short, while Part A of SB0001 unilaterally bestows an unrequested benefit upon public employees and retirees as a group and deems that benefit to be valid consideration for a unilateral modification of the employment agreement, Part B attempts to extract a pretense of agreement from *individual* public employees and retirees to the reduction of their vested pension rights. The consent envisioned in Part B, however, is just as fictitious and legally invalid as that envisioned in Part A.

Because Part B forces a retiree to choose between pension rights and health care coverage, it rests upon an assumption that the State has an unlimited right to exclude a public employee or retiree from participation in a health insurance program. In many cases, however, retired teachers have a vested contractual right to participate in a health plan by virtue of collective bargaining agreements between their unions and their school districts. As the Illinois Appellate Court has recognized, if a collective bargaining agreement between a teachers' union and a school district promises health benefits to teachers in retirement for a term that extends beyond the agreement's duration, the teachers who retired under that agreement have a vested right to the promised health benefits. *Haake v. Board of Education for Township High School Glenbard District 87*, 399 Ill. App. 3d 121, 132-34, 137-39 (2010).[2] In *Haake*, the Illinois

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[1] See also SB0001, Part B, 40 ILCS 5/16-133.6 (new) (Tier I retirees who elect to agree to the pension reduction may make a "one-time member contribution to the System" and thereby avoid the pension reduction to a certain extent, if they "retire[] on or after the beginning of the first State fiscal year to occur after the end of the election period . . . ."). This provision appears not to apply to Tier I retirees who are presently retired and do not return to active service.

[2] Because federal common law governs the interpretation of a collective bargaining agreement, the court in *Haake* applied federal common law to the substantive issues raised by the parties. *Haake*, 399 Ill. App. 3d at 127-28.

Appellate Court affirmed an award of summary judgment to the plaintiff retired teachers in their breach of contract action against a school district, finding that the retired teachers had a vested right to early retirement health benefits under previous collective bargaining agreements. *Id.* at 137, 142. Specifically, the appellate court held that those earlier agreements "express an unambiguous intent to provide retiree health insurance benefits until the retirees reached age 65 or became eligible for Medicare," and that this "language plainly set out the time during which the benefits would be paid, in terms separate and independent from the duration of the contracts themselves." *Id.* at 132. This right to retiree health insurance benefits "vested when the [school district] approved each [teacher's] participation in the early retirement plan," and therefore could not be modified or eliminated by a subsequent collective bargaining agreement. *Id.* at 137-39.

Similarly, and by way of example, the 2012-2016 Agreement between the Board of Education of District No. 200 and the Woodstock Council of Teachers, McHenry County Federation of Teachers, IFT/AFT, AFL-CIO, Local #1642 contains the following promise: "Teachers submitting their resignation on or before December 1 of the school year of retirement, to be effective no later than the end of the same school term, and who retire at age fifty-five (55), or older shall receive fully paid major medical insurance for individual coverage only in the TRIP plan (formerly TRS medical insurance) program until age sixty-five (65)" (Art. 21, § 5 (p. 63)). Under this agreement and others that promise retiree health benefits for a term that is independent of the agreement's duration, retired teachers are entitled to the health insurance benefits that were contractually promised to them. *Haake*, 399 Ill. App. 3d at 136-37; see also *Lawrence v. Board of Education of School District 189*, 152 Ill. App. 3d 187, 198-201 (1987) (concluding that the retirement benefit sought by plaintiff – merit pay for accumulated sick days – vested when plaintiff fulfilled his service condition, and therefore the merit pay, as a form of deferred compensation, constituted a vested right "incapable of retroactive modification"). In short, vested contractual rights to health benefits in retirement cannot be taken away as a penalty for refusing to surrender vested pension rights. Accordingly, retired teachers who have vested rights to health coverage under their collective bargaining agreements could raise particularly strong legal challenges to SB0001 or other legislation that would eliminate their health coverage as a consequence of their refusal to surrender their vested pension rights.

Moreover, an "agreement" extracted from a retiree on the threat of losing his or her health coverage would hardly be the sort of voluntary undertaking that is necessary for a valid contractual modification. As the Illinois Appellate Court has explained, "[i]t is well settled that a contract, once made, must be performed according to its terms and that any modification of those terms must be made by mutual assent and for consideration." *Ross v. May Co.*, 377 Ill. App. 3d at 389; see also *Indiana-Michigan Corp. v. Sisk Fertilizer-Lime Service, Inc.*, No. 89 C 2735, 1992 WL 77692, at *3 (N.D. Ill. Apr. 7, 1992) ("[A] valid modification of a contract must meet all the criteria essential for a valid contract," and "[a]mong the essential elements to the formation of a contract is a manifestation of agreement or mutual assent by the parties to its terms . . . ."); *cf. Donoho v. O'Connell's, Inc.*, 18 Ill.2d 432, 435 (1960) ("[I]t is only the voluntary acceptance of benefits under a statute that bars a subsequent attack upon its validity," and "[a]cceptances that were induced by economic pressures much less severe than those which must have operated upon the plaintiff in this case have been regarded as the result of economic duress, and so as involuntary."); *People ex rel. Carpentier v. Treloar Trucking Co.*, 13 Ill.2d 596, 600 (1958) (defendant not estopped by its application for license plates for trucks in a certain

classification; defendant filed application out of duress generated by economic necessity). Part B of SB0001 fails for this additional reason, as would other legislation that would force a retired public employee to "elect" to surrender his or her vested pension rights in order to maintain his or her health coverage.

More fundamentally, Part B of SB0001 and similar legislation effectively are mechanisms for circumventing the Pension Protection Clause. As explained in *Kraus v. Board of Trustees of Police Pension Fund of Village of Niles*, 72 Ill. App. 3d 833, 849 (1979), legislation "which has an incidental effect on the pensions which employees would ultimately receive, is not prohibited" if it is "directed toward another aim." Conversely, because Part B is directed specifically toward penalizing pension annuitants, it is an impermissible end-run around the Pension Protection Clause. Similar end-runs around the Pension Protection Clause are equally impermissible.