

April 27, 2010

MEMORANDUM

ILLINOIS' AUTHORITY TO REDUCE THE PENSION BENEFITS THAT CURRENT EMPLOYEES WILL EARN FROM FUTURE SERVICE

In a prior legal analysis provided to the *Civic Committee of the Commercial Club*, we addressed the question whether the Illinois General Assembly may modify the formula used to calculate pension benefits earned by current State and local employees. We concluded that the Pension Clause of the Illinois Constitution (Ill. Const., art. XIII, § 5) prohibits State and local governments from reducing pension benefits that employees earned in prior years, but that there are compelling arguments that State and local governments may enact legislation that will *prospectively* reduce the pension benefits that current employees will earn as a result of *future* work performed after the prospective legislation takes effect.

In recent weeks, this analysis has been questioned. Former Illinois Appellate Court Justice Gino DiVito has issued a memorandum that disagrees with Sidley's legal analysis.¹ In his view, it is "crystal clear" that the Pension Clause of the Illinois Constitution gives each State and municipal employee contractual rights to have future pension benefits calculated under whatever formula was in effect on the day he or she began working and became a member of a State pension system. Also, former federal court Judge Abner Mikva has written a newspaper Op Ed piece that offers a more qualified view.² He acknowledges that there is language in Illinois Supreme Court opinions that supports our analysis and that it is possible that the Illinois Supreme Court would uphold legislation that prospectively reduces future pension benefits for

¹ Memorandum to Hon. Patrick Quinn from Gino L. DiVito, April 12, 2010.
<http://www.illinois.gov/publicincludes/statehome/gov/documents/DiVito%20Memorandum.pdf> ("DiVito Memo").

² A. Mikva, "Deserving of High Praise for Pension Reform Effort," Chicago Tribune, April 9, 2010.
<http://www.illinois.gov/publicincludes/statehome/gov/documents/Mikva%20Op%20Ed.pdf>.

current employees. But he believes that the issue would be contentious and that it is more likely that Illinois courts would invalidate such legislation. He bases this prediction, in part, on his belief that Illinois judges would be adversely affected by pension reform legislation and that this fact could influence their decision.

This legal issue has great importance. The State and local governments of Illinois face massive structural budget deficits that could imperil Illinois's ability to deliver essential governmental services in the future. Funds required to meet long-term pension obligations represent a very large share of these deficits, and the Civic Committee has estimated that Illinois has \$76 billion in unfunded pension liabilities.³ Illinois recently enacted legislation that would reduce pension benefits for employees who are hired after the effective date of that statute. Although this measure will produce some cost savings in the future, we understand that significant immediate reductions would be achieved only if these or similar reforms applied to determinations of future benefits earned by current employees. For example, legislation has been proposed that would reduce the rate at which current employees earn future benefits so that it is more closely aligned to what is typical in the private sector. We understand from the staff of the Civic Committee that such legislation would reduce the unfunded liability by an estimated \$20-25 billion. Thus, if constitutional, such legislation could play an important role in addressing a State financial crisis of massive and unprecedented proportions.

Because of the importance of this legal issue, we have prepared this memorandum to respond to the concerns expressed by former Judges DiVito and Mikva. It obviously is not possible to predict the decisions of any court with certainty, and we do not purport to predict the

³ See "Pension Financing Shortfall Is A Threat on the Horizon For State," *New York Times*, p. 33A, Midwest Edition, April 25, 2010 (stating that estimates of unfunded pension liabilities range from \$61 billion to over \$166 billion).

future actions of the Illinois Supreme Court. But it is our legal opinion that there are compelling arguments that Illinois has the constitutional authority prospectively to reduce the rate at which current State and local government employees will earn pension benefits in the future – with the sole exception of the benefits to be earned by judges and other State officials whose compensation cannot be reduced during their terms of office under other guarantees of the Illinois Constitution. It is therefore our view that there is a substantial likelihood that prospective pension reform legislation would be upheld under the Pension Clause.

Our basic analysis can be summarized briefly. Like salaries, rights to pension benefits are part of the compensation that State and local employees earn in exchange for their service. In circumstances in which an employer has a right to reduce an employee's salary prospectively (or to discharge the employee), the employer should inherently also have the right prospectively to reduce the pension benefits that the employee will earn in the future. In our view, it makes no sense to suggest that an employee who works for the State for a single day has acquired a right to have future pension benefits calculated for the next 20-40 years under whatever method was in effect on that single first day of service. In our view, it similarly makes no sense to suggest that an employer may discharge employees or prospectively reduce their salaries in response to a financial crisis – but cannot take the less onerous step of reducing the pension benefits earned in the future. We do not believe that the Illinois Constitution should be construed to dictate these outcomes.

To the contrary, we believe that there are two distinct grounds for upholding prospective pension benefit reform legislation. First, the Pension Clause of the Illinois Constitution should be read to protect only the pension benefits that employees earned in the past. That is how the Clause was construed in the first Illinois Supreme Court decision that interpreted this Clause.

This decision has not been overruled, and we believe this construction is required by the text of the provision and settled principles of constitutional interpretation.

Second, even if the Pension Clause protected future benefits, that would establish only that employees have a contractual right to have their future pension benefits calculated under the existing formula if the employee continues to work for State government. But like any other contract, this contract can be modified, and the Illinois Supreme Court has held that the General Assembly has an “undeniable interest and responsibility” to modify pension formulas prospectively in order to allow “adequate funding of the state pension system.” Following appropriate notice, the State can modify future pension benefits of current employees in lieu of terminating them or reducing their salaries.

In this latter regard, Justice DiVito agrees that the future pension benefits earned by current State employees can be reduced as a result of legislation that does so indirectly or as a result of modifications to the pension benefit formula that are supported by consideration. We believe that these undisputed principles also establish that the State has constitutional authority prospectively to reduce future pension benefits as an alternative to discharging or reducing the salaries of current state employees, for the State’s decision not to exercise these legal rights is consideration that supports the reduction in the pension benefits when appropriate notice is provided the employees. Justice DiVito does not dispute this point, and it is specifically endorsed by one of the decisions upon which he heavily relies in his analysis. Thus, there appears to be broad agreement on principles that would permit Illinois to respond to the financial crisis by enacting prospective pension reform legislation that is applicable to current State and local employees.

ANALYSIS

Pension benefits are part of an employee's compensation for his or her services. Each day an employee works, he or she both earns a salary and earns rights to certain levels of pension benefits. In particular, whenever his or her employment is terminated, the employee will be entitled to receive a pension benefit (generally an actuarially calculated monthly annuity for life beginning at a specified retirement age) that is based on the employee's service to date and that is calculated under the formula provided under the plan. This is the pension benefit that has been "earned" as a result of an employee's previous service.

Under federal law, there is no limitation on the authority of employers to modify the formula for calculating pension benefits prospectively. *Lockheed Corp. v. Spink*, 417 U.S. 882, 890-91 (1996). An employer may prospectively modify a plan or even prospectively terminate it – so long as the modification does not diminish the benefits that the employees had earned as of the date of the modification. *Id.* Federal law therefore treats pension benefits no differently than an employee's salary. Neither can be modified retroactively, so employers cannot diminish either previously-earned salaries or previously-earned pension benefits. Conversely, just as the employer can reduce an employee's salary prospectively, the employer can prospectively reduce the pension benefits that will be earned as a result of future employment.

This memorandum addresses whether Illinois dictated a different rule when it adopted the Pension Clause of the Illinois Constitution in 1970. We believe it did not, for two separate reasons. First, the Pension Clause should be construed to protect only previously earned benefits. Second, in all events, prospective modifications in the formula are lawful if they are alternatives to reductions in salary, termination, or other conduct that the State is legally authorized to undertake – as they would be under the proposed legislation.

I. Prospective Reductions In The Rate At Which *Future* Benefits Are Earned Does Not Violate the Pension Clause.

Most of Justice DiVito's analysis is devoted to arguing that the terms of the Pension Clause, its history, and case law interpreting it establish that current State and local employees have a constitutional right to have their pension benefits calculated under whatever formula was in effect on the first day of their employment. We do not agree with his analysis. We think the better view is that the Clause prohibits only retroactive diminution of previously-earned benefits and that legislation prospectively reducing the rate under which future benefits will be earned does not implicate the Pension Clause.

A. The Text Of The Provision Does Not Give Employees Any Rights To Have Future Benefits Calculated Under A Particular Formula.

Article XIII, Section 5 provides that "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." We disagree with Justice DiVito's conclusion that it is "crystal clear" that this language gives each employee a right to have pension benefits earned from future employment determined under whatever formula was in effect on his or her first day of service. We do not believe that the plain language remotely supports this view.

This constitutional provision has two clauses. First, it states the "membership" in a State pension system is an "enforceable contractual relationship." That means that employees have a contractual right not to be excluded from membership in the system; it says nothing about the way in which benefits earned by future employment are to be determined.

Second, it states that the "benefits" of membership in the system "shall not be diminished or impaired." The only "benefits" of membership in a pension or retirement system are that employees, as a result of their service, earn rights to receive annuities at a certain level (upon

reaching retirement age). The Pension Clause does not prescribe any particular formula. Thus, so long as the benefits that were previously earned are not cancelled or reduced, a prospective change in the formula for calculating future benefits does not “diminish” or “impair” benefits or otherwise violate the plain meaning of the text of the provision.

In this regard, we do not believe that Justice DiVito’s contrary view makes sense. He contends that by working one day, an employee has earned the right to have future pension benefits calculated under the formula that was in effect on the employee’s first day. That is not correct. The only thing that an employee earns by working one day is one day’s salary and the pension benefit associated with one day’s work at that salary. That is the only “benefit” of membership in the pension system for one day, and that is the only benefit that may not be diminished or impaired. So we believe the plain terms of the provision foreclose Justice DiVito’s views and establish that the Pension Clause protects only those pension benefits that an employee has already earned.

We also believe that even if the language of the Pension Clause were ambiguous, settled principles of constitutional interpretation should foreclose Justice DiVito’s position. Absent the clear and unmistakable evidence of such a purpose, constitutional provisions should not be interpreted to limit or impair the ability of the Government to deliver essential services in the manner believed most efficient and appropriate. *See, e.g., McCullough v. Maryland*, 4 Wheat. 316 (1819). These considerations have acute importance now. Illinois is facing fiscal and financial crises of great magnitude. Its ability to deliver essential services may require reductions in its costs of operations, and prospective reductions in the rate at which current employees earn additional future pension benefits appears to be one of the most logical and effective means of achieving these fundamental governmental interests.

B. The Historical Purpose Of The Pension Clause Was To Establish That Pensions Are Contracts And Not Gratuities.

Justice DiVito also contends that statements made during the 1970 Constitutional Convention establish that the purpose of the Pension Clause was to guarantee that the rate at which pension benefits are earned would not be diminished at any time after an employee has accepted employment with the State. We agree with Justice DiVito that it is permissible to consider the debates during the Convention in construing the Pension Clause. But for the reasons stated, we believe the language of the Clause does not support Justice DiVito's reading and that the Clause could not be given his proposed construction unless the discussion during the debates established, with unmistakable clarity, that this was the understanding of the meaning of the Clause that was widely shared by all the delegates who voted for the Clause. In our view, the debates do not come close to supporting this conclusion.

Rather, in our view, the purpose of the Pension Clause was quite different and far more limited. It was to "put state and municipal government employers on notice that they may not abandon their pension obligations on the belief that such payments were gratuities." *McNamee v. State*, 173 Ill. 2d 433, 444 (1996); accord *People ex rel Sklodowski v. State*, 182 Ill. 2d 220, 233 (1998). This measure was deemed necessary because, prior to 1970, it was the settled rule in Illinois that employees who were required to contribute to pension funds did not have any contractual right to the benefits that they had earned. Courts held that earned pensions under such "mandatory" pension plans were "gratuities" that the State and local governments could nullify at will. See, e.g., *Bergin v. Board of Trustees of the Teachers' Retirement System*, 31 Ill. 2d 566 (1964). Because these employees had no contractual right to the pension, they also could not challenge legislative nullification of the pension under the state and federal constitutional provisions that prohibit legislative "impairment" of contracts. U.S. Const., Art. I, § 10. The

Pension Clause was adopted because the existing concerns about the unenforceability of vested pension benefits were “exacerbated” because the 1970 Constitution also created “broad home rule power for municipalities,” which “some delegates feared could lead municipalities into debt and result in their abandoning their pension obligations to police officers and fire fighters.” *McNamee*, 173 Ill. 2d at 440.

Justice DiVito suggests (1) that the delegates to the Convention had debated the question whether the Pension Clause would affect the ability of government to reduce benefits earned as a result of future performance and (2) that the debates established that the delegates believed the Clause prohibited purely prospective modifications of benefit formulas. Neither suggestion is correct.

The debates confirm that the Clause was adopted to prevent local home rule bodies from dishonoring pension benefits that had been earned. The delegates otherwise debated only two issues relating to the scope of the Pension Clause in the *Proceedings of the Constitutional Convention*. First, the major issue that was debated was whether the Clause would impose a funding obligation on the Illinois General Assembly and other legislative bodies. This issue arose because Illinois’s Pension Clause uses language that is similar to the pension clause provision in the New York Constitution. During the debates, the primary sponsor of the Clause (Delegate Green) noted that the New York Constitution had been construed to give employees a legal right to compel actuarially adequate funding by the New York Legislature, but indicated that the Illinois Clause would not impose this requirement on legislative bodies in Illinois. 4 *Record of Proceedings, Sixth Illinois Constitutional Convention* (hereinafter “*Proceedings*”) 2925.⁴ This led another delegate (Delegate Parkhurst) to object that, as he read the Clause, it

⁴ **“Mr. Green:** ...Our language is that language that is in the New York Constitution which was adopted in 1938, really under a similar circumstance. In 1938 you were about

would in fact impose a judicially enforceable obligation on state and municipal governments in Illinois to fund 100% of pension liabilities on the basis of actuarial projections. *Id.* 2926.⁵ Several other delegates agreed. Vice President Lyons, who was also a co-sponsor of the Clause, then expressed his view that the Clause imposed no funding obligation, but merely provided contractual protection for “pension rights” (without specifying what those rights were) (*id.*

at the end of the Depression, but there was a great consideration on the part of the New York General Assembly to really cut out some of the money that they were giving to the pension programs in New York; and it was for this reason that the New York Constitution adopted the language that we are suggesting. Since that time, the state of New York – the pension funds for public employees have been fully funded, and so I think we have good reason to believe that this type of language will be a mandate to the General Assembly to do something which they have not previously done in some twenty-two years.

Now we are not in any way suggesting that this \$2,500,000,000 that they are in arrears be brought up to date at any one time. The New York Constitution mandated that state to fully fund the program in two years. This would be a physical impossibility in Illinois.

I do believe that if we could contact the actuary of the programs, it may well be in the scheduling, we could come up with a scheduling to do it. *But in lieu of a scheduling provision, I believe we have at least put the General Assembly on notice that these memberships are enforceable contracts and that they shall not be diminished or impaired.*” (Emphasis added). 4 Record of Proceedings, Sixth Illinois Constitutional Convention 2925. See *McNamee*, 173 Ill. 2d at 442-44.

⁵ “Mr. Parkhurst: ...Now here’s – it seems to me – the fallacy of trying to constitutionalize this sort of a thing. First of all, the background in the legislature has been that many people who are entitled to a pension which is administered or given at the state level have come to Springfield and said, ‘Our pension is not fully funded. Our actuary tells us that you will have to have \$2,200,000,000 in state money to put into a special fund to pay off the potential claims that may now be filed to get this particular pension or that particular pension when the benefits become due and payable to the retirees.’

And the legislature has said, ‘For Heaven’s sake, we don’t have \$2,200,000,000. Why can’t you let us run it like the federal government runs the Social Security program, which is to pay the benefits out of the income as they become due.’

Now, the trouble with this amendment is, as I read it, that you would eliminate the argument constitutionally. You would mandate the General Assembly to put in 100 percent of the money to pay anybody’s pension on anybody’s actuarial projection right now, because it says, ‘the benefits of which shall not be diminished or impaired.’” 4 Proceedings 2926-27.

2928).⁶ He asked other sponsors to confirm that “the purpose of this amendment is only to provide security to people . . . in the event that sweeping home rule powers are given to local governments.” *Id.* 2929.⁷ The other primary sponsor of the Clause (Delegate Kinney) agreed that is what the Clause is “designed to do” and, in the course of explaining that funding is not required, she offered some descriptions of what she believed the Clause does require.⁸ *Id.* 2929. After Delegate Whalen and Vice President Lyons stated that they agreed with Delegates Kinney

⁶ “**Vice President Lyons:** ...I am a cosponsor of it myself – I *thought* that the purpose of this amendment was to give protection to those people who felt that they needed protection for their pension rights in the event that sweeping home rule powers were given to local governments. I recall receiving a flurry of letters and telephone calls early in the session when the local government articles began to be introduced from police and fire associations who were very fearful that a general grant of home rule powers to local governments might in some way impair their pension rights. I thought that all that this amendment was designed to do was to cure that. Now, if it does something else, or if the language needs to be cleaned up, that’s one thing. But the genesis of the amendment, I thought, was simply to protect people who up until now have felt protected. I am aware of no movement to upfund all the funds – nobody’s got that kind of money.

I would just appreciate an answer from somebody who feels that he knows.” (Emphasis in original). 4 Proceedings 2928.

⁷ “**Vice President Lyons:** ...The question is, am I wrong in my supposition that the purpose of this amendment is only to provide security to people who now feel that they are secure in the event that sweeping home rule powers are given to local governments? That’s what I thought this thing was designed to do.”

⁸ “**Mrs. Kinney:** Yes, you are right, Mr. Lyons. That is what it is designed to do. Benefits not being diminished really refers to this situation: If a police officer accepted employment under a provision where he was entitled to retire at two-thirds of his salary after twenty years of service, that could not subsequently be changed to say he was entitled to only one-third of his salary after thirty years of service, or perhaps entitled to nothing. That is the thrust of the word ‘diminished.’ It was not intended to require 100 percent funding or 50 percent or 30 percent funding or get into any of those problems aside from the very slim area where a court might judicially determine that imminent bankruptcy would really be impairment.

It is simply to give them a basic protection against abolishing their rights completely or changing the terms of their rights after they have embarked upon the employment – to lessen them.” 4 Proceedings 2929.

and Green that the Clause would not require the advance funding of pensions (*id.* 2929),⁹ the matter was put to a vote. President Witwer voted yes on the condition that Delegate Whalen's points will be "properly protected in the Style and Drafting Committee and that there will be an affirmation that this [Clause] does not direct or control funding."¹⁰ *Id.* 2932.

Second, the delegates also addressed the issue whether it would be an "impairment" or "diminution" of pension benefits if they did not provide automatic cost of living increases. This objection too was raised by Delegate Parkhurst,¹¹ and both Delegate Green and Delegate Kinney stated that the Pension Clause created no such right. Both stated that there would not be a violation of the Clause if the employee received the pension benefit in dollars that had been promised, even if the value of the dollars had been reduced because of the effects of inflation.¹²

⁹ "Mr. Whalen: Mr. President and fellow delegates, I agree with Delegate Kinney, that as I read section 16, it doesn't require the funding of any pensions, and therefore the whole question of funding is irrelevant to the issue of whether we should adopt the provision."

"Vice President Lyons: We now have heard from the proponents who have represented that that is the limit of the scope of this amendment. *It does not refer to upfunding, nor does it seek to establish some sort of an administrative elite to administer these various funds.*" 4 Proceedings 2929. (Emphasis added).

¹⁰ "President Witwer: I am voting yes in the hope that the points which Mr. Whalen has raised will be properly protected in the work of the Style and Drafting Committee and that there will be an affirmation that this does not direct or control funding. I vote yes." 4 Proceedings 2932.

¹¹ "Mr. Parkhurst: ...Now, what about diminished? Let's talk about that for a minute. Somebody alluded to cost of living a moment ago. Suppose this goes in the constitution. Suppose we have more inflation. Suppose we devalue the dollar in five years or ten years. Haven't we then diminished the pension funding and the pension rights of a pensioner, based upon today's dollars? Of course we have. So this is an admonition to the courts not to let them be diminished in terms of the general level of the economy or the value of the dollar, now or in the future. I submit that that is a kind of a left-handed way to increase their pension benefits and not let them ride with the value of the dollar in years to come." 4 Proceedings 2927.

¹² "Mr. Green: ...In answer to Delegate Parkhurst's question with regard to the diminishing aspect of it – the cost of living – any of you who know when you buy an insurance policy you're going to get back what that contract says. Now if the dollar isn't

To support his argument about the intended meaning of the Clause, Justice DiVito has quoted (out of context) portions of some of the statements that Delegate Kinney made to support her view that the Clause did not require either funding or cost of living increases. While her statements categorically provide that neither funding nor cost of living increases would be required, her explanations are otherwise vague and generally entirely consistent with the view that the Clause prevents retroactive changes to the previously-earned benefits of employees and does not give employees an absolute right to have future benefits calculated in a particular way. In this regard, Delegate Kinney (like Delegate Green) emphasized that pension benefits were contractual,¹³ and, as explained in detail below, it is elementary that contracts may be prospectively modified when employees receive appropriate notice and there is consideration supporting a prospective change in the benefit formula. Delegate Kinney never addressed the question whether legislation that protected previously-earned benefits could prospectively modify the rate at which benefits could be earned in lieu of discharges or salary reductions.

But to the extent Delegate Kinney's statements addressed matters other than funding and cost of living increases and suggested restrictions on prospective legislative changes, we believe

worth but twenty-seven cents when you get it back, there is absolutely no reason why you have any recourse against that insurance company.

What we are trying to merely say is that if you mandate the public employees in the state of Illinois to put in their 5 percent or 8 percent or whatever it may be monthly, and you say when you employ these people, "Now, if you do this, when you reach sixty-five, you will receive \$287 a month," that is, in fact, is what you will get."

Mrs. Kinney: ...All we are seeking to do is to guarantee that people will have the rights that were in force at the time they entered into the agreement to become an employee, and as Mr. Green has said, if the benefits are \$100 a month in 1971, they should be not less than \$100 a month in 1990." 4 Proceedings 2931-32.

¹³ See, e.g., 4 Proceedings 2925 ("Mr. Green: ...[T]his amendment ...mandated a contractual relationship between the employer and the employee.") & 2931 ("Mrs. Kinney: All we are seeking is to guarantee that persons will have the rights that were in force at the time they entered into the agreement to become an employee.").

that the statements should receive no weight. The specific issues that were debated were whether the Clause required funding and cost of living adjustments. Delegate Kinney was not called upon to offer a considered view on other issues, and it would be perfectly understandable if she had somewhat misstated or exaggerated the provisions of the Clause in the course of making the separate points that the Clause did not impose funding obligations or require cost of living adjustments.

Most fundamentally, even if Delegate Kinney had clearly stated that the Clause prohibited prospective changes to benefit formulas and that this represented her considered view, neither the other primary co-sponsor (Delegate Green) nor any other delegate endorsed those views. Indeed, because Delegate Kinney stated that “Mr. Green’s interest in this matter is a little different than mine” (*id.* 2926), it cannot be presumed that even he agreed with her statements. Further, while other delegates agreed with Delegate Kinney and Delegate Green that the Clause imposed no funding obligations, none addressed Delegate Kinney’s other views on the scope of the Clause, so they represent, at most, the “personal views” of one delegate to the convention. The personal views of one delegate cannot compel the adoption of an interpretation of the Pension Clause that is not supported by its plain meaning and that is contrary to settled principles of constitutional interpretation.

For these reasons, the same argument that Justice DiVito now makes was rejected by the Illinois Supreme Court in *Peters v. City of Springfield*, 57 Ill. 2d 142 (1974). There, the Court rejected the claim that this debate established that employees had a right to receive the level of benefits that was available under the law that was in effect at the time they began government service. It stated that “[t]he debate on the provision . . . indicates a general intent to protect the pension benefits of public employees, but, other than concern that vested rights not be defeated

by reason of the failure to provide necessary funding, *reflects uncertainty as to the scope of the restriction* which the section imposed on legislative bodies.” 57 Ill. 2d at 151 (emphasis added). *Peters* thus held that the purpose of the provision is only to prevent retroactive diminution of previously “earned benefits.” *Id.*¹⁴

C. The Illinois Supreme Court Has Read The Clause Narrowly.

Justice DiVito next contends that the case law interpreting the Pension Clause is also “clear.” He contends that it establishes that the General Assembly may not enact legislation that prospectively modifies the rate at which current employees will accrue future pension benefits as a result of future work. Justice DiVito supports this argument by contending that the Illinois Supreme Court’s decision in *Peters* has been and should be read narrowly, and that subsequent decisions have established that prospective modifications to pension accrual rates are *per se* unconstitutional if they are applied to current employees. We disagree with Justice DiVito’s analysis in all respects.

Preliminarily, we underscore that most of the subsequent decisions that the Illinois Supreme Court has issued under the Pension Clause are irrelevant to the question that would be raised if the General Assembly enacted comprehensive prospective changes in pension benefit formulas as part of its efforts to deal with the financial crisis. Most of these decisions deal with the question whether the Pension Clause requires the General Assembly to provide actuarially adequate funding of future pension liabilities. In these decisions, the Illinois Supreme Court declined to follow the decisions that New York courts have rendered in construing the similarly-

¹⁴ We are aware that subsequent Illinois Supreme Court decisions have relied on Delegate Kinney’s statements in other contexts. See *Felt v. Bd. Of Trustees of Judge’s Retirement System*, 107 Ill. 2d 158, 162 (1985). But as detailed below, the Illinois Supreme Court has not overruled *Peters*, and the subsequent decisions are readily distinguished. We believe the Illinois Supreme Court should and would comprehensively review the issues if it were asked to determine the constitutionality of prospective pension reform legislation that was enacted to address a financial crisis.

worded provision of the New York Constitution, and the Illinois Supreme Court has held that the Pension Clause imposes no specific funding obligations on the legislative bodies in Illinois.¹⁵

There have been only three decisions that address the restrictions that the Pension Clause imposes on legislation that reduces future pension benefits of current employees: *Peters v. City of Springfield*, 57 Ill. 2d 142 (1974); *Felt v. Board of Trustees of the Judge's Retirement System*, 107 Ill. 2d 158 (1985); and *Buddell v. Board of Trustees, State University Retirement System of Illinois*, 118 Ill. 2d 99 (1987). The most recent of these decisions is over 20 years old, and none of these decisions has endorsed Justice DiVito's view that the Illinois General Assembly is prohibited from enacting the kind of comprehensive prospective pension reform legislation that has been proposed.

Peters. The Court's first construction of the Pension Clause was in *Peters*, which was a bare four years after the Clause was adopted. *Peters* involved a challenge to a reduction in the mandatory retirement age for firemen from 65 to 63 which prevented many firemen from increasing their earned pension benefits by working until age 65. The Illinois Supreme Court upheld the statute and rejected the claim that the Pension Clause gave a fireman the right to work up to the "minimum retirement age provided by law at the time he enters the [retirement] system." As noted above, it concluded that the delegates' debate on the Pension Clause establishes only "a general intent to protect the pension benefits of public employees" and that the "purpose and intent of the constitutional provisions" is limited to "insur[ing] that pension rights of public employees which had been earned should not be 'diminished or impaired.'" *Id.* at 151-52 (emphasis added). Because it held that the Clause protects only previously earned benefits, *Peters* concluded that prospective changes in the law that reduce the benefits that could

¹⁵ See, e.g., *People ex rel. Illinois Fed'n of Teachers v. Lindberg*, 60 Ill. 2d 266 (1975); *McNamee v. State*, 173 Ill. 2d 433 (1996); *People ex rel. Sklodowski v. State*, 182 Ill. 2d 220 (1998).

be earned in the future do not raise any issue under the Pension Clause. *Peters* has never been disavowed by the Illinois Supreme Court.

Peters led to amendments to the pension laws. In 1978, the General Assembly enacted Section 14-103.12, which prospectively reduces pension benefits by excluding some of the compensation received during an employee's final year of service from the calculation of his or her pension benefits. On the authority of *Peters*, the Illinois Attorney General issued an opinion that concluded that this legislation is constitutional notwithstanding the facts that it "may result in lower pensions for some employees than they would have received otherwise" and that the statute applies to employees who were members of the pension system before the statute was passed. Atty. Gen. Op. No. S-1407, 1979 Ill. Atty. Gen. 9 (Jan. 10, 1979)), at 1 & 9-10. The Attorney General reasoned that, under *Peters*, the Pension Clause protects only those pension rights "which had been [previously] earned" and this statutory provision did not affect pension benefits earned prior to the enactment of the statute. *Id.* at 8. Against the background of *Peters* and this Attorney General opinion, no party challenged the constitutionality of this statute.

Justice DiVito states that *Peters's* determination that the Pension Clause protects only those pension benefits that already "had been earned" is *dicta*. That is incorrect. This is the Court's holding in *Peters*. It is the only ground for the decision that is set forth in the opinion, and it was the Court's interpretation of the Pension Clause. Justice DiVito may believe that *Peters* is incorrect or that it is distinguishable on its facts, but he should not deny that this was the holding of *Peters*. For the reasons explained above, we believe that *Peters's* interpretation of the Clause is compelled by its text, by its purpose, and by principles of constitutional interpretation. The Supreme Court has never overruled *Peters*, although one subsequent decision (*Buddell*) does contain dictum that suggests a narrow reading of *Peters*.

Further, even apart from *Peters*, neither of the Illinois Supreme Court's two subsequent decisions remotely establishes that a comprehensive prospective modification of pension laws would be *per se* invalid as applied to all current State employees. To the contrary, we believe that such a statute should be upheld under the rationales of both decisions.

Felt. In the 1985 decision in *Felt*, the Court invalidated a statute that made a change in the formula for calculating judicial pension benefits that affected only those very few judges who retired within a year after there had been an increase in judicial salaries. Whereas the law had previously provided that pensions were based on the salary that was in effect on the last day of a judge's service, the amended law based the pension on the average salary during the judge's last year of service – resulting in decreased pensions for any judge who retired or died less than 12 months following a salary increase. As explained below, this statute could have been invalidated under the constitutional provision that prohibits reductions in judicial compensation during their terms of service, but the Court in *Felt* held that the statute violated both the Pension Clause and the Clause prohibiting an impairment of contracts.

Contrary to Justice DiVito's suggestion, *Felt* did not hold that prospective changes in pension benefit formulas are *per se* invalid. Rather, it applied a balancing test in which it compared the "severity of the impairment" with the purpose served by legislation to determine whether the legislation was an unconstitutional impairment of a contract rather than a "reasonable exercise of the police power." *Felt*, 107 Ill. 2d at 165-67 (citations omitted). In this regard, the Court specifically held that the "legislature has an undeniable interest and responsibility in ensuring the adequate funding of State pension systems." *Id.* at 166. But the Court held that there was no substantial evidence that early retirement by judges "are a cause of the retirement system's underfunding" or that the legislation would lead to any significant

reduction in the State's present or future liabilities. *Id.* at 167. Accordingly, the Court held that the statutory amendment "is not defensible as a reasonable exercise of the State's police powers" and that it "impaired" the pension contract. *Id.*

For the reasons set forth below in Part III of this memorandum, we believe that the statute in *Felt* should have implicated only the constitutional provision that limits changes in judicial compensation and not the Pension Clause. But we note that under the Court's analysis in *Felt*, there are compelling arguments that comprehensive prospective pension reform legislation could constitutionally apply to all current employees – with the exception of judges and other officials whose compensation cannot be diminished during their terms under other provisions of the Illinois Constitution.

Felt applied a balancing test, and it recognized the General Assembly's responsibility to enact measures to ensure adequate funding of pension obligations. In contrast to the legislation at issue in *Felt*, the proposed prospective pension reform legislation would substantially advance this governmental interest. The evidence is that the proposed legislation would reduce the State's \$76 billion in unfunded future pension obligations by an estimated \$20-25 billion, so there is a compelling governmental and public interest served by the legislation. Conversely, any adverse effect on current employees would be slight, for the legislation would not retroactively affect any employee's previously earned benefits at all, but would merely reduce benefits to be earned as a result of future employment. This slight adverse impact should also be weighed in light of the possibility that, without reform, the pension funds could run out of money, such that even previously-earned benefits would not be paid. In addition, if this measure were not permitted, current employees could have their salaries reduced prospectively or their jobs

terminated. On these facts, there are compelling arguments that the measure is a reasonable exercise of the police power and is valid under the rationale of *Felt*.

Buddell. Justice DiVito also relies upon the Illinois Supreme Court's 1987 decision in *Buddell*, but the holding in that case is entirely consistent with the interpretation of the Pension Clause that was adopted in *Peters* and that we believe to be correct. It involved a statute that retroactively deprived a current employee of a pension benefit that he had earned *before* the statute took in effect. In particular, Buddell had served in the military, and when he later became an employee of the State in 1969, the Pension Code provided he could purchase additional service credit for time spent in the military service. The Court held that the Pension Clause meant that a 1974 statute that prohibited purchases of credit based on military service could not be constitutionally applied to Buddell. It reasoned that his right to purchase additional service credit "became contractual in nature" when the 1970 Constitution was adopted and that his right could not thereafter be "altered, modified, or released except in accordance with usual contract principles." *Buddell*, 118 Ill. 2d 99, 104-05.

This decision is consistent with the principles that we believe should control. The right to purchase additional service credit for his military service is a benefit that Buddell "earned" before the 1974 statute was passed, for Buddell could have exercised this right on his very first day of service. As the Court stated, the "consideration" that gave Buddell this right was the mere fact of "his employment and continued employment by the public body, and, in addition, his prior military service." *Id.* at 106. Thus, under the Court's characterization of the benefit, the statute at issue in *Buddell* retroactively deprived an employee of a previously-earned benefit and was invalid as applied to that employee under *Peters* and our interpretation of the Pension Clause. By contrast, for the reasons explained above, we do not believe that it can be plausibly

contended that, by working one day, current non-judicial employees have earned a right to have future benefits accrue under whatever formula was in effect on their first day of service.

Lower Court Decisions And Dicta. Justice DiVito also relies extensively on the Illinois Appellate Court's decision in *Kraus v. Board of Trustees Of the Police Pension Fund Of The Village Of Niles*, 72 Ill. App. 3d 833 (1st Dist. 1979). *Kraus* involved a police officer who became disabled in 1967, and the issue in the case was whether a subsequent statute could be applied to justify payment of lower pension benefits than he was entitled to under the formula in effect during his period of active service. *Kraus* held it could not. Its holding is unexceptional. But Justice DiVito contends that its rationale repudiates our analysis. We disagree.

Kraus is not a Supreme Court case, and neither purports to, nor could, overrule *Peters*. Justice DiVito notes, correctly, that the Supreme Court has approved aspects of *Kraus*. However, these points are not germane here. In *Buddell*, the Supreme Court stated that this holding in *Kraus* is "in accord with our holding" in *Buddell* and generally endorsed the proposition that an employee is not entitled to "additional [future] benefits without additional consideration." *Buddell*, 118 Ill. 2d at 188. In addition, in *Felt*, the Supreme Court cited *Kraus* in partial support of the Court's decision not to follow decisions of courts of Alaska, Hawaii, Michigan, and other states whose constitutional provisions are differently worded than Illinois's. *Felt*, 107 Ill. 2d at 167-68. We disagree with Justice DiVito's suggestion that these narrow approving citations constitute the Illinois Supreme Court's endorsement of all the reasoning of *Kraus*. We further note, for the reasons stated in Part II below, that under the principles set forth in *Kraus*, comprehensive prospective modifications to the rate at which pension benefits accrue in the future would be valid.

That said, we acknowledge that there is language in *Buddell* and *Felt* that might be interpreted to read *Peters* narrowly or to give credence to the view that employees have some sort of contractually protected interest in continuation of the benefits formula in effect when they commenced employment. Those statements were made in cases that involved statutes that quite plainly frustrated expectations of employees without advancing any substantial governmental interest. These narrow issues were also decided over two decades ago. If the General Assembly addresses the State's financial crisis by enacting legislation that prospectively reduces the rate at which current employees earn pension benefits in the future, we believe that the Illinois Supreme Court would not and should not extrapolate from isolated statements made in old decisions that involved fundamentally different facts and legal issues. Rather, we believe that the Illinois Supreme Court should and would comprehensively examine the legal issue independently and determine the proper scope of the Pension Clause. For the reasons stated, we believe that the better view is that the Clause should be held to protect only previously-earned benefits and not to prevent prospective reductions in future pension benefits adopted to foster essential government interests.

II. Even Under Justice DiVito's Analysis, Prospective Pension Reform Legislation Would Not Violate The Pension Clause.

The foregoing discussion addresses only the question whether the protections of the Pension Clause are limited to the benefits that an employee has earned in his or her employment to date. We believe that this is the better view and that Justice DiVito's contrary conclusion on this point is mistaken.

But we emphasize that, notwithstanding this area of disagreement, we and Justice DiVito agree on certain points. We will now demonstrate that, under the principles on which we agree, the comprehensive prospective pension reform legislation that has been proposed would be valid.

The Pension Clause establishes that the pension benefits of public employees are contractual rights and not mere gratuities. We argue, and Justice DiVito concedes, that contract rights can be modified or surrendered as long as “consideration” is provided that supports the change in the contract.

We believe that there plainly would be consideration that supports a prospective modification of the pension benefits that current employees would earn in the future. Contractual modifications are supported by consideration if there is a “new benefit to the employee, a new detriment to the employer, or . . . a mutual agreement.” *Robinson v. Ada S. McKinley Community Services, Inc.*, 19 F.3d 359 (7th Cir. 1994). *See also, Doyle v. Holy Cross Hosp.*, 186 Ill. 2d 104, 112 (1999) (“Consideration consists of some detriment to the offeree, some benefit to the offeree, or some bargained-for exchange between them.”). Here, consideration exists because the reduction in future benefits would be an alternative to actions that governments have the constitutional authority to undertake for all current employees (other than judges and other officers whose compensation and tenure is constitutionally protected): that is, prospective reduction in salaries or termination of employment. The employer’s failure to take those actions prospectively is a “new detriment to the employer” and is thus consideration that supports the prospective reduction in pension benefits. Similarly, the employer’s decision not to take the other prospective actions is “a new benefit to the employee.” So assuming appropriate notice, there is consideration supporting the change, and there cannot be any objection to prospective modification of pension benefits to be earned in the future.

These points were made in our prior memoranda. In his analysis, Justice DiVito disagrees that there would be consideration that supports a prospective modification in the pension formula. He relies on cases that, in his view, hold that continued employment is not

consideration for modifying an existing employment contract: *Doyle v. Holy Cross Hosp., supra*, and *Ross v. May Co.*, 377 Ill. App. 3d 387, 392 (1st Dist. 2007). But contrary to Justice DiVito's suggestion, we do not contend that continued employment, without more, is consideration that supports a prospective modification in benefit formulas and, in our view, the cases cited by Justice DiVito are inapposite.

In *Doyle*, the employee handbook had provided various protections related to termination at the time the employees were hired. Sometime thereafter, the employer unilaterally changed those portions of the handbook to state that they did not create a contract. Years later, the employer terminated the employees and relied on the new handbook provisions, arguing that the new provisions had become part of the employment contract because the employees could have quit if they had disagreed with the changes, but instead continued in their positions and thereby implicitly agreed to the modification. 186 Ill. 2d at 111. The employer's argument, however, ignored the fact that the opportunity to choose was never offered to the employees. The employer did not present the new handbook to the employees and did not make clear that it was offering continued employment in exchange for their agreement to its terms. Rather, the change was simply made, and the employees continued in their positions, with no connection being drawn between the two. *Id.* at 114-16.

Ross is much the same. The employee there was hired in 1968, when a handbook that provided termination protection was in place. Twenty years later, in the late 1980s, the employer changed the handbook, and nearly 20 years after that, the employee was discharged in a manner consistent with the new handbook but contrary to the 1968 version. The employer argued that the employee's continued employment, as well as additional benefits provided in 1990, constituted consideration for the modification of the contract. 377 Ill. App. 3d at 390. The court

rejected this position because a contractual change made by one party “without the knowledge and consent” of the other party is not a “bargained-for exchange.” *Id.* at 391. A bargained-for exchange requires that “one party’s promise induces the other party’s promise or performance.” *Id.* Because there was no connection between the changes to the handbook and the continued employment or added benefits, there was no bargained-for exchange and no consideration. *Id.* at 391-92.

Justice DiVito appears to recognize that *Ross* and *Doyle* are narrow rulings that do not support his opinion. For Justice DiVito goes on to state that employees who are subject to civil service or collective bargaining agreements may have a preexisting right to continued employment and that “the continued employment of *such* individuals would not constitute valid consideration for a unilateral diminishment of those individuals’ pension benefits, since the State is already obligated to continue their employment absent cause for termination.” (DiVito Memo at 8 (emphasis added).) Justice DiVito thus acknowledges the key point – *i.e.*, that the Pension Clause itself does not in any way limit the State’s ability to change, or even terminate, the employment relationship and that, absent binding obligations created by some other source, the State is free prospectively to modify the terms of employment regardless of the incidental impact of such a modification upon pension benefits. Justice DiVito’s point thus could mean that pension reform legislation cannot be applied to current employees during the terms of the collective bargaining agreement. But it is an implicit acknowledgement that the prospective legislation would otherwise be valid.

Justice DiVito could hardly have taken a different position, given that, as noted above, he places heavy reliance on *Kraus v. Board of Trustees*. *Kraus* holds that the only action the State may not take under the Pension Clause is “action which directly diminishes the benefits to be

received by those” who are members of the State pension system. 72 Ill. App. 3d at 849. And “directly,” *Kraus* makes clear, is meant quite literally. Thus, a reduction in the mandatory retirement age would be perfectly permissible, for the pension law itself does not specify a retirement age and the reduction of it does not *directly* reduce pension benefits. *Id.*, citing *Peters*, 57 Ill. 2d at 152. If a change in something as fundamental and closely related to pension benefits as the mandatory retirement age does not “directly” affect pension benefits for purposes of the Pension Clause, there can be no doubt that other employment-related actions with an impact on pensions likewise do not, and the *Kraus* Court made that clear by endorsing reductions in salary and hours as examples of such permissible actions. 72 Ill. App. 3d at 849-50. Even outright termination of employment does not run afoul of the Pension Clause, for as *Kraus* explains “the loss of pension benefits accompanying dismissal from public employment does not unconstitutionally impair or diminish benefits.” *Id.* at 850. *Kraus* goes on to explain that “there is nothing to prohibit an employee from agreeing, for consideration, to accept a reduction in benefits,” and identifies salary increases as an example of such consideration, noting that the State could make such increases conditional upon the employee’s agreement to a change in pension benefits. *Id.* at 849.

In this regard, *Doyle* and *Ross* support an approach in which the State gives employees notice that, due to the unfortunate financial situation, the State is reducing the rate at which future pension benefits will be earned instead of terminating employees or reducing salaries. *Ross* makes clear that an employer’s “forbearance” from an action it is otherwise entitled to take is valid consideration for modification of a contract. 377 Ill. App. 3d at 391. By the same reasoning, there is consideration when the State reduces pension benefits instead of reducing salary or other benefits which the State is not contractually or constitutionally obligated to

maintain at a particular level. Similarly, as *Kraus* states, the State may agree to provide future increases in salary or benefits, following notice that these steps are consideration for prospective reductions in the rate at which future pension benefits are earned. 72 Ill. App. 3d at 849-50. Although this formality may not be required, the statute could specifically provide that employees agree to the prospective reductions in the rate at which they earn future pension benefits by continuing work following the notice that this constitutes assent to the prospective modifications of the pension agreement.

So while we and Justice DiVito disagree over the points discussed in Part I, these fundamental principles are not in dispute:

- Pension benefits, for constitutional purposes, are contractual rights, and like any contractual rights, they may be surrendered or modified in exchange for consideration.
- The Pension Clause does not itself impose any limit on the State's ability to modify non-pension aspects of the employment relationship, including aspects of the relationship that affect pension benefits, and including even terminating the relationship.
- To the extent that an employee does not have a right to continued employment stemming from some other source, such as civil service or collective bargaining, continued employment is valid consideration for a contract modification in a bargained-for exchange in which the employee receives full notice.
- Even as to employees who may have an independent right to continued employment, the State (subject to other constitutional or contractual limitations) can reduce their salaries, hours, and other employment benefits, and the State's agreement to forbear from taking such action would be valid consideration for a prospective modification of pension benefit formulas.
- Likewise, the State is free to condition future enhancements to the employment arrangement, such as salary or benefit increases, upon an employee's agreement to prospective modification of his pension rights.

In short, while we and Justice DiVito disagree on other points, we agree on contract principles that would permit significant prospective pension reform in Illinois.

III. Prospective Pension Reform Legislation Cannot Constitutionally Be Applied To Judges And Other Officials Whose Compensation And Tenure Is Protected By Other Provisions Of The Constitution.

For the foregoing reasons, we believe that there are compelling arguments that the Pension Clause would not invalidate comprehensive prospective pension reform legislation that reduces benefits that current employees will earn as a result of future employment. But that does not mean that such reforms could constitutionally be applied to all State employees. To the contrary, our analysis proceeds from the fact that the annually earned pension benefits are part of an employee's compensation. To the extent that other provisions of the Illinois Constitution prohibit reductions in compensation during an employee's terms of office, the prospective legislation could not be constitutionally applied to those employees.

Article VI, section 14, of the Illinois Constitution (Ill. Const. 1970, art. VI, §14) provides, in pertinent part, that "Judges shall receive salaries provided by law which shall not be diminished to take effect during their terms of office." This Clause has been broadly construed by the Illinois Supreme Court to apply to formulas that provide for automatic cost of living increases and other forms of compensation. *Jorgensen v. Blagojevich*, 211 Ill. 2d. 286 (2004).

Because pension benefits are compensation, there are substantial arguments that any prospective reductions in rates of pension benefit accruals cannot constitutionally be applied to judges and other State officials whose salaries and tenures are constitutionally protected during their term in office.

CONCLUSION

For all the reasons stated herein and in our prior memorandum, it is our opinion that there are compelling arguments that legislation that reduces the pension benefits that will be earned in the future by current State and local employees does not violate the Pension Clause and

will be constitutional as applied to State employees whose compensation is not protected from diminution by the Illinois Constitution during their terms in office.

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