

Public Pension Litigation Update: Summer 2015

Rising unfunded liabilities in public pension systems throughout the nation have prompted a wave of reform efforts over the past several years — and, in turn, legal challenges to these reforms. Below we discuss some important recent developments from the public pension arena. Specifically, we examine the decisions in the state of Illinois and city of Chicago striking down pension reform legislation; the New Jersey Supreme Court ruling allowing Governor Chris Christie to curtail promised contributions; the Oregon Supreme Court's protection of COLAs for benefits already earned; and the settlement in Rhode Island over challenges to that state's 2011 pension reform law.

Background

In recent years, states and localities throughout the country have enacted legislation aimed at reducing unfunded pension liabilities and associated fiscal pressures. In turn, since 2008, litigants have brought suits in 40-plus jurisdictions challenging these measures.

Unlike private-sector pension plans, which are regulated at the federal level under ERISA, public pension systems are not governed by a single body of law. Rather, public-sector pension reform efforts, and challenges thereto, proceed on a piecemeal basis under the state law applicable in a given jurisdiction. These challenges have succeeded in some jurisdictions and failed in others. (See our [February 3, 2015](#) and [April 23, 2014](#) *For Your Information* publications.)

Illinois “Pension Protection” Clause Stymies Reform Efforts

Under the Illinois state constitution's Pension Protection Clause, participation in the state's retirement system is “an enforceable contractual relationship, the benefits of which shall not be diminished or impaired.” Relying on this protection, Illinois courts recently struck down pension reform efforts both on the state level and in the city of Chicago.



Illinois Supreme Court Nixes 2013 Pension Reform

In late 2013, Illinois enacted pension reform that addressed the state's unfunded pension liability of approximately \$100 billion by raising the retirement age, decreasing cost-of-living adjustments (COLAs), and implementing a cap on salary for purposes of determining pensions. This law was expected to save the struggling state approximately \$160 billion. A coalition of labor unions waged a successful constitutional challenge to the law at the lower court level. (See our [February 3, 2015](#) and [April 23, 2014](#) *For Your Information* publications.)

In a May 8, 2015 [unanimous ruling](#), the Illinois Supreme Court agreed with the lower court's conclusion. Highlighting the Pension Protection Clause, the court struck down the 2013 law as "the latest assault in [the] ongoing political battle against public pension rights." While not intending to "minimize the gravity of the state's problems or the magnitude of the difficulty facing [Illinois] elected representatives," the court said it was obligated to "ensure that the law is followed" — particularly at times when "even clear principles and long-standing precedent are threatened."

In the wake of this decision, Illinois Governor Bruce Rauner (R) released a new pension reform proposal based on a "consideration" model designed to incentivize workers to move from the state's more generous "Tier I" retirement system to the less generous Tier II system by, for example, offering them continued salary increases while in service. The proposal would remove wage and other pay and vacation rules from the collective bargaining process, and would require workers to accept these new baselines if they wish to keep their Tier I benefits. The proposal would also allow units of local government to declare Chapter 9 bankruptcy. Rauner believes this model comports with the Pension Protection Clause because public employees can choose between different benefit options. However, he faces strong union opposition to this approach.

Meanwhile, in the City of Chicago ...

Like the state of Illinois, the city of Chicago faces a pension funding crisis — to the tune of an approximately \$20 billion deficit. In June 2014, then-Illinois Governor Pat Quinn (D) signed pension reform [legislation](#) modifying employee contributions and COLAs. The law was backed by 28 unions representing city employees.

In December 2014, a group of current and former city workers, along with four unions that had not supported the legislation, brought a lawsuit alleging that it violated the Pension Protection Clause. In defending its constitutionality, the city argued that there was no infringement on pension rights because, over time, the law would provide a net benefit — that is, imposing less drastic cuts than would be needed if the city became insolvent. The legislation provided a guarantee of fully funded pensions in the long term. And, unlike the state pension reform, many labor unions representing city workers had supported the city's law.

On July 24, 2015, a Chicago lower court [struck down](#) the reforms. This decision found the Illinois Supreme Court's May ruling as "particularly compelling," given that the decision was "so recent, deals with such closely parallel issues and provides crystal-clear directions on the proper interpretation of the law." On July 29, 2015, the Chicago court denied the city's request to keep the law in effect while an appeal is pending. So, absent a reversal by the Illinois Supreme Court, the city will have to devise another solution to its severe funding deficit. The Illinois Supreme Court will hear this appeal in November 2015.

Comment. In May 2015, Moody's lowered the city's credit rating to junk status and cited pension costs as "placing significant strain on the city's financial operations."

New Jersey Kicks Pension Funding Down the Road

In 2011, facing mounting unfunded pension liabilities, New Jersey Governor Chris Christie (R) signed bipartisan legislation increasing employee contribution rates to the state's strapped public employee health and pension plans. This law was expected to save taxpayers over \$120 billion in benefit costs over the next 30 years. In exchange, the state was required make its annual contribution to the pension system on a timely basis; New Jersey governors failed to make payments every year since 1997, which was one factor contributing to the funding problem.

The state made its required pension payments for two years. However, in an effort to close the budget gap, Christie cut back on the payment in 2014 (contributing \$696 million instead of the required \$1.58 billion) and 2015 (contributing \$681 million instead of the required \$2.25 billion). A group of unions representing public employees sued, seeking to force Christie to complete the payments. They argued that the 2011 law gave them a contractual right to this funding.

Despite the Superior Court of New Jersey's [ruling](#) upholding Christie's decision not to make the full 2014 payment as within the state's emergency powers due to a severe unanticipated revenue shortfall, the same court [later agreed](#) with the unions that the failure to make the full 2015 contribution unlawfully impaired a contractual right. The court, however, could not dictate how the state would meet the obligation to its employees.

The Christie administration appealed the decision on the employees' contractual rights, and ultimately prevailed in a June 9, 2015 [New Jersey Supreme Court](#) decision. There, the court held the 2011 law did not create a legally enforceable contractual right to the full funding payments because, among other reasons, its provisions violated the state constitution's Debt Limitations Clause — which prohibits the state from incurring future debts or liabilities in excess of 1% of the annual appropriation for any given fiscal year. The importance of maintaining sound pension funds notwithstanding, the court found, the state Constitution "compels the declaration that there is no valid contractual right [under the 2011 law] that provides the basis for a contractual impairment analysis."

Comment. There is also a pending lawsuit challenging changes made to COLAs in the 2011 law. A New Jersey appeals court ruled in 2014 that COLAs are so integral to the state pension system that the legislature must have intended them to be a non-forfeitable, guaranteed right. However, the impairment of a constitutional right may be permissible if doing so is "reasonable and necessary to serve an important public purpose." The appeals court remanded the case to the lower court to make that determination.

In the weeks following this ruling, Christie vetoed a state budget passed by a Democrat-controlled legislature that would have included \$3.1 billion in state pension contributions, reducing that contribution to \$1.3 billion. On August 10, 2015, Christie vetoed a bill that would have set a quarterly schedule for pension payments, and another that would have forced a \$300 million payment to the pension system as part of the fiscal year that ended on June 30, 2015.

Mixed Bag for Oregon COLAs

In 2013, the Oregon legislature passed a bill reducing public-pension COLAs. Whereas the COLA had been based on the annual Portland consumer price index with increases capped at 2%, the new law capped the COLA at 1.25% on the first \$60,000 of benefits and .15 % on all benefits above that amount. These modifications were expected to reduce the unfunded liability of the Oregon public retirement system by \$5.3 billion.

Public employees challenged the constitutionality of the COLA changes, and the case went straight to the state's highest court because of a provision in the law allowing anyone affected to seek review by the Oregon Supreme Court within 60 days.

On [April 30, 2015](#), the Oregon Supreme Court held that the modified COLA rates could be used going forward — but not retroactively applied to benefits already earned. The COLA modification impaired retirees' contractual right to receive the annual COLA for benefits earned prior to the effective date of the legislation, according to the court, and the change was therefore unlawful as applied on a retroactive basis. However, the court found no contractual right to COLA levels for benefits earned after the legislation was enacted. Because of this ruling, members who were in service both before and after the effective dates of the legislation will receive “blended” COLA increases based on the different rates in effect during their years of employment.

Comment. The legislation also eliminated extra payments for out-of-state retirees designed to compensate them for the tax liability on their benefits. The court rejected challenges to this change.

As a result of the decision, the retirement system's unfunded liability is expected to rise by over \$5 billion, and employer rates are expected to rise by at least 5% of payroll starting in 2017 to pay for the increase. Nevertheless, the system is expected to be funded at around 89% — so Oregon's system remains one of the best funded public pension systems in the country.

Parties Settle Challenges to Rhode Island Pension Reform

In 2011, with a state retirement system that had an unfunded liability of \$6.8 billion and a funded ratio of 48.4%, Rhode Island passed pension reforms that included a higher retirement age, the suspension of COLAs, and the shifting of employees to a new defined contribution plan. Following a 2012 suit challenging the law as unconstitutional, the parties reached a settlement in February 2014 that left intact the basic structure of the legislation but softened its effect by, among other things, lowering the retirement age for certain employees and providing certain intermittent COLAs. (See our [April 23, 2014](#) *For Your Information*.)

The court [approved the settlement](#) on June 9, 2015 — leaving the constitutional questions unanswered.

Comment. Moody's Investors Services noted the settlement approval as a positive factor in the state's credit rating.

While the court dismissed all remaining challenges to the 2011 law itself, new lawsuits are expected in the coming months challenging the terms of the settlement.

In Closing

Many significant pension reforms are currently pending in state courts nationwide, and we continue to monitor legislative and judicial developments in this area. Unlike plans subject to federal law, there is much uncertainty for plans in the public sector as they try to rein in runaway costs.

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