

Clients & Friends Memo

Illinois Court Strikes Down Chicago Pension Reforms, Deepening City's Financial Crisis

July 29, 2015

On July 24, 2015, Judge Rita M. Novak of the Circuit Court of Cook County, Illinois struck down recently enacted legislation designed to shore up two of the City of Chicago's severely underfunded pension plans by, among other things, reducing benefits.¹ Judge Novak viewed as controlling a decision by the Illinois Supreme Court from May of this year which held that similar legislation reducing benefits for members of state-funded pension plans violated the "pension protection clause" of the Illinois constitution. (See Cadwalader's memo on the Supreme Court's decision [here](#)). Unlike the State of Illinois, however, which was left with few options after its own pension reform legislation was struck down in May, Chicago has the potential to access chapter 9 of the United States Bankruptcy Code as a means of achieving pension reform.

The Challenge to Chicago's Pension Reform Legislation

Illinois law establishes retirement plans for all public employees in the State, including those employed by the City of Chicago. As required by the Illinois Pension Code, the City of Chicago currently contributes to four pension funds, including (i) the Municipal Employees' Annuity & Benefit Fund of Chicago ("MEABF") and (ii) the Laborers' & Retirement Board Employees' Annuity & Benefit Fund ("LABF"). MEABF and LABF both administer defined benefit pension plans under which participating public employees receive specified annuities upon retirement. These annuities include a three-percent automatic annual increase, which is compounded annually. MEABF and LABF are funded by employee and employer contributions, as well as by investment returns on the funds' assets. According to an expert cited by Judge Novak, MEABF and LABF, along with the City's other two pension funds, are significantly underfunded.

In 2011, Chicago Mayor Rahm Emanuel began working with 31 unions representing City workers in an effort to agree on pension reform legislation designed to address the underfunding of MEABF and LABF. Elected representatives of 28 of the 31 unions ultimately voted in favor of a legislative proposal (Public Act 98-641, or the "Act") that was subsequently enacted by the Illinois General

¹ Jones v. Municipal Employees' Annuity and Benefit Fund of Chicago, 14 CH 20027 (Cir. Ct. Cook County, Ill., Chancery Div. July 24, 2015).

Assembly. The Governor of Illinois signed the Act into law on June 9, 2014. Among other reforms, the Act changed the amount of annual increases, removed the compounding component of the annual increases, eliminated annual increases entirely in specified years, and postponed the time when annuitants would receive the initial increase. In addition, the Act provided for increases in both the employee and employer contribution levels. The Act also introduced two specific mechanisms to enforce the City's obligation to fund the pension plans.

In December 2014, just before the provisions of the Act were to become effective, a number of individual participants in MEABF and LABF, along with certain labor unions and other associations representing MEABF and LABF members, brought suit in Cook County Court against MEABF and LABF, seeking a declaration that the Act violates the "pension protection clause" of the Illinois constitution. The pension protection clause provides, "Membership in any pension or retirement system of the State, any unit of local government or school district, or any agency or instrumentality thereof, shall be an enforceable contractual relationship, the benefits of which shall not be diminished or impaired." Illinois Const. art. XIII, sect. 5. The City of Chicago and the State of Illinois successfully sought to intervene in the Cook County litigation.

Illinois Supreme Court Precedent

In May 2015, while the litigation concerning the Act was pending in Cook County, the Illinois Supreme Court issued a major decision interpreting the pension protection clause. In In re Pension Reform Litigation (Heaton v. Quinn), 2015 IL 118585 (May 8, 2015), the Supreme Court held that a similar piece of reform legislation modifying benefits for members of State-funded (rather than City-funded) pension plans violated the pension protection clause by, among other things, reducing the value of automatic annual increases in annuity benefits. The Supreme Court held that the pension protection clause gives government employees in Illinois a legally enforceable right to receive the pension benefits they were promised at the commencement of their employment. The Supreme Court also rejected the State's argument that it could impair pension rights pursuant to its "reserved sovereign powers" or "police powers."

Judge Novak Strikes Down Chicago's Pension Reforms

The Illinois Supreme Court's May ruling proved to be decisive to the outcome of the Cook County litigation. Judge Novak held in her July 24 decision that In re Pension Reform Litigation was controlling authority and that the Act, like the legislation struck down by the Supreme Court in May, was void as a violation of the pension protection clause.

As an initial matter, Judge Novak noted that the Act reduced annual annuity increases for the plaintiffs, who had become members of MEABF or of LABF before the Act's effective date. In Judge Novak's view, these were precisely the types of reductions in promised pension benefits that the Supreme Court had held to be unconstitutional in In re Pension Reform Litigation.

Judge Novak next considered the City's defenses. She noted that prior to In re Pension Reform Litigation, the City had advanced a "retained sovereign powers" defense similar to the one ultimately rejected by the Supreme Court. Following the Supreme Court's May decision, however, the City had indicated that it no longer intended to pursue this defense. Instead, the City advanced two other arguments for the Act's constitutionality, namely (i) the "net benefit" argument and (ii) the "bargained-for exchange" argument, both of which Judge Novak ultimately rejected.

"Net Benefit" Argument

In the "net benefit" argument, the City contended that, unlike the legislation struck down in In re Pension Reform Litigation, the Act provided a "net benefit" to MEABF and LABF members in the form of an enforceable obligation that the City fund their pensions. In the City's view, prior to the Act, the Illinois Pension Code had expressly absolved the City of any obligation to pay pension benefits and instead had made pensions the obligation of the pension funds alone. In support of this position, the City cited a provision of the Pension Code stating that "[a]ny pension payable . . . shall not be construed to be a legal obligation . . . of any county, city, town, municipal corporation or body politic and corporate located in the State, other than the pension fund concerned." See 40 Ill. Comp. Stat. § 5/22-403. Under the Act, however, the City would be obligated to fund MEABF and LABF in accordance with an actuarial formula that would prevent MEABF and LABF from becoming insolvent. The Act also added new enforcement mechanisms to ensure the City's compliance, such as the right to bring a mandamus action and the right to collect the City's unfunded pension obligations directly from State grants to the City. The City contended that, without the City's new funding obligation and the accompanying enforcement mechanisms, MEABF and LABF would inevitably become insolvent and unable to provide the promised benefits. Accordingly, in the City's view, the benefits of the Act outweighed any harm caused by the accompanying benefit reductions, meaning that, on a net basis, members' benefits were not "diminished or impaired."

Judge Novak rejected the basic premise of the "net benefit" argument, which was that the City did not have an obligation to pay pension benefits prior to the Act. She cited In re Pension Reform Litigation, where the Supreme Court interpreted the pension protection clause as creating "a contractual relationship between the employer and the employee." Because this contractual relationship derived directly from the Illinois constitution, it could not be altered by a mere statutory provision (such as the provision of the Pension Code cited by the City) purporting to limit the employer's obligation to pay benefits.

Judge Novak also noted a long-standing distinction in Illinois case law between pension *benefits*, which are constitutionally protected, and pension funding mechanisms, which are not. In light of this distinction, Judge Novak held that no "net" benefit to pension plan members could possibly result from trading a constitutionally protected right to receive benefits for an improved funding mechanism that was not itself constitutionally protected and that, as such, was subject to legislative modification at any time.

“Quite simply,” Judge Novak concluded, “the [Illinois] constitution removed diminishing benefits as a means of attaining pension stability.”

“Bargained-For Exchange” Argument

In the “bargained-for exchange” argument, the City contended that the provisions of the Act were enforceable as the product of a bargained-for exchange for consideration in which the City had assumed greater funding obligations in exchange for the unions’ agreement to increased employee contributions and reduced annual benefit increases.

In support of this argument, the City cited a footnote in In re Pension Reform Litigation in which the Illinois Supreme Court suggested that the State could require additional employee contributions or other consideration in “exchange” for increased benefits. Judge Novak rejected the City’s expansive reading of this footnote, however. In her view, the footnote merely referred to *legislation* that modifies pension benefits but offers some additional benefit in “exchange;” it did not refer to the enforceability of a “bargained-for exchange” arrived at outside the legislative process.

Judge Novak similarly rejected the contention that labor unions acting outside a collective bargaining process could bind all of their members or all of the members of the applicable pension plans. Although the City cited cases in which individual union members were held to be bound by agreements reached by their union representatives, Judge Novak distinguished these cases by pointing out that in those cases the unions had acted as the “true agents” of their members. By contrast, there was no evidence that, in agreeing to the Act, union officials had followed union rules and bylaws in such a way as to bind their members as true agents. Furthermore, to the extent the unions had held votes on whether to support the Act, these votes had not been unanimous and could not bind dissenting members. In any event, the specific unions appearing as plaintiffs in the Cook County litigation had not supported the Act.

More fundamentally, Judge Novak noted that the “bargained-for exchange” argument did not take account of the personal nature of the rights guaranteed by the pension protection clause. Citing numerous cases holding that this clause permits an individual to challenge reductions of his or her individual benefits, Judge Novak held that nothing in the process leading to the Act had resulted in a waiver of these individual rights. Accordingly, Judge Novak ruled that the Act was unconstitutional and void in its entirety.

Chapter 9 as a Tool for Pension Reform

Although the Illinois Supreme Court’s May decision on State pension reforms appears to have also decided the fate of Chicago’s pension reform efforts for the time being, Chicago may ultimately have more tools for dealing with its seemingly unsustainable pension obligations than does the State of Illinois. Specifically, while Illinois courts treat both State and City pension obligations as “contracts” under the Illinois constitution, there is a significant difference: As a “municipality,”

Chicago could potentially become eligible to file for protection under chapter 9 of the Bankruptcy Code, an option not available to a “State” like Illinois.

The most important precedent here would be the recent chapter 9 case of nearby Detroit, in which the Bankruptcy Court for the Eastern District of Michigan addressed the relationship between the federal Bankruptcy Code and the pension protection clause of the Michigan constitution. The Court there held that once a municipality enters chapter 9, “no state law can protect contractual pension rights from impairment in bankruptcy, just as no law could protect any other types of contract rights.”² This power to impair state law pension rights in bankruptcy, even where such rights are protected by a state constitution, gave Detroit the leverage to negotiate adjustments to its pension obligations that were ultimately confirmed in its chapter 9 plan.

Chicago currently lacks state law authorization to file a chapter 9 petition, which is a precondition for chapter 9 eligibility, but Illinois Governor Bruce Rauner has proposed draft legislation providing for such authorization. A chapter 9 filing is surely not the first choice of Mayor Emanuel and other Chicago officials, but in the long run such a filing may represent the City’s best, and perhaps its only, option for overcoming the pension protection clause and returning to financial health.

Conclusion

Unsurprisingly, Chicago has vowed to appeal Judge Novak’s decision. Given the Illinois Supreme Court’s broad reading of the pension protection clause in In re Pension Reform Litigation, however, the City’s chances of success in such an appeal appear questionable. Failing an unlikely appellate victory, the chapter 9 bankruptcy option is likely to receive increasingly serious consideration in the weeks and months ahead.

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² In re City of Detroit, Michigan, 504 B.R. 97, 161 (Bankr. E.D. Mich. 2013).

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